



**European Bank**  
for Reconstruction and Development

*A framework for a development  
strategy in a market economy:  
objectives, scope, institutions and instruments*

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## **INTRODUCTION:**

### **DEFINING A DEVELOPMENT STRATEGY IN A MARKET ECONOMY**

*Defining responsibilities and assigning roles in a partnership between the state and the market economy and other elements of society to promote basic development objectives and specifying how the state discharges its responsibilities within the partnership.*

A well-functioning economy requires a mix of government and markets. The balance, structure and functioning of that mix is at the heart of a development strategy. The mix is not simply an assigning of certain areas to one or the other domain. The more appropriate analogy is that of a partnership, in which each partner is assigned certain areas of responsibility. The political process makes the assignments, and the task of this book<sup>1</sup> is to provide an analytic basis to help examine how those assignments should be made.

The first ingredients of a development strategy are its basic objectives, together with an analysis of the long-term assignments in light of those objectives. The nature of those assignments clearly changes with changes in the world economic environment and the circumstances of the country, as well as with changes in, and emphasis among, the objectives that government sees as falling within its purview. These are the issues to which we turn in the first section. The second section then focuses on institutions and instruments. The details of these institutions and the precise nature of the instruments employed by government are as crucial a part of the development strategy – determining how the partnerships actually function – as the assignments themselves.<sup>2</sup>

## **OBJECTIVES AND SCOPE**

### **OBJECTIVES**

This book presents a broad set of objectives that should underlie development strategies. While all of these may be summarised within the rubric of “raising living standards”, they go far beyond the standard objective of increasing GDP per capita. They include promoting education and health, maintaining and improving the environment, and enhancing and protecting opportunities for all citizens to participate in and benefit from the economy and society. Some of these objectives are also important instruments – means for obtaining other objectives. Nonetheless, we should not forget that they have value in their own right: improved education may lead to higher incomes, but it also enriches directly the lives of individuals; improved medical care may lead to enhanced productivity, but it also improves directly the quality of life.

A focus on living standards involves a focus on individuals and therefore on distributions, as well as aggregates. Again, reducing inequality and poverty may be viewed as objectives or as instruments: societies with less inequality may perform better, because

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<sup>1</sup> This paper was written as a chapter for Malinvaud *et al* (eds), Development Strategy and Management of the Market Economy (2 volumes), Oxford: Clarendon Press, forthcoming 1997.

<sup>2</sup> The approach here does not have rigid, compartmentalised assignments to one sector or the other. Neither does it have unique assignments of objectives to particular instruments and institutions. It is concerned with how government and markets can and should function. It thus differs fundamentally from Tinbergen's influential objectives-instruments approach. (Implicitly, Tinbergen envisioned the economy as described by a set of  $N$  equations, determining the values of the variables designated as "objectives", with a set of  $N$  "instruments" or control variables, Tinbergen held that the objectives could be moved to desired levels. In special cases objectives could be "assigned" to instruments.)

they avoid some of the political tensions associated with huge disparities in income and wealth and because egalitarian policies result in more of a society's human resources being used closer to their full potential. Still, within this broad mandate, different economies, societies or political movements may emphasise different aspects of an egalitarian agenda. Some may attach priority to ensuring equality of educational opportunities and access to health care, regardless of the short-run impact that this might have on measured inequality, while others might focus more directly on measured outcomes, for example, through a safety net so that no-one's access to basic needs, such as food and shelter, falls below a certain threshold.<sup>3</sup>

We have defined the objectives of a development strategy fairly broadly in terms of standards of living and examined the major elements determining those standards. However, development strategies will have more specific objectives (what may be viewed as intermediate goals) depending on where the country finds itself. Thus, for example, while women's literacy may, or should, constitute a high operational priority in some circumstances, this objective is less pressing where the population is already broadly literate.

We must, however, ask deeper questions concerning the origins of objectives for a community. If everyone agreed on the objectives – and on the weights to be assigned to each – of a development strategy, matters would be simple. However, there is never such unanimity. Objectives and the strategy that supports them will emerge from a political process. If there is a broadly shared commitment to the objectives and strategy, then the strategy is likely to function much more effectively than without it. However, that broad commitment may not be present. If it is not, then the government faces difficult dilemmas. It could try to confine itself to introducing only those policies on which there is a neat unanimity. This will represent only a narrow range of options. Or, a government could try to build a consensus. Some methods of consensus building may be deeply unattractive, such as starting external wars or promoting heavy propaganda. Other examples are much more positive and involve a process of discussion among different groups. In some circumstances a broad consensus can come from shared values, traditions and cultures. It can also come from solidarity. There is no magic formula for producing consensus and cohesion and attempts to enforce such an approach would be deeply worrying and unacceptable from some political perspectives.<sup>4</sup>

We cannot resolve these issues here – we simply draw attention to their importance for the building and implementation of a strategy. We can say, however, that realism as to what can be achieved and a track record of honesty and achievement – particularly

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<sup>3</sup> The focus on outcomes versus opportunities reflects in part perspectives on the terms of the partnership between the state and its citizens. Some argue that in this partnership it is the responsibility of the state to ensure that all have opportunities, and it is the responsibility of individuals to take advantage of those opportunities. If some individuals fail to take advantage of the opportunities afforded them – and the consequence is inequality – it is the individuals who carry the responsibility. Others propose a wider role for the state within the partnership, recognising its roles in either shaping preferences or overcoming "handicaps" that impede certain groups availing themselves of these opportunities.

<sup>4</sup> Some countries have been successful in developing some degree of consensus through the public education system. However, the political process sometimes works to break down consensus by emphasising differences/product differentiation.

achievement that is in accord with expectations, or government promises – are likely to make the development of a strategy easier.

The institutions that support strategies, and the strategies themselves, must take account of uncertainty and lack of information, and the limitations on what organisations can expect to achieve. Thus any attempt at finely tuned optimisation runs the risk of going badly wrong – which is not, of course, a counsel to do worse rather than better if the option is there. It is simply to recognise that information and capacities are limited and that it is thus important to build strategies and institutions that will function well in a range of circumstances. In this sense we should be looking for robustness as an important feature of strategies and institutions.

The issues of robustness and the formation of objectives are linked to a changing perception of the role of planning and strategies. Early planning models embodied optimisation under (pressured) direct control and full information. They then moved to principal-agent models, which took account of incentive compatibility issues. At this later stage it was still assumed, if only implicitly, that the planner had full information, but limited ability to control households and firms. Models of planning remained those of constrained optimisation problems, but with the important extra constraint that planners could use only the limited instruments under their control (such as indirect and direct taxes) to induce firms and households to act in a preferred manner. These models are useful for understanding important features of planning problems, but they capture only one aspect of a fuller story.

A broader perspective puts much more emphasis on the lack of knowledge, both about the structure of the economy and the relevant parameters. While it is still possible to formulate an optimal Bayesian plan, taking formally into account limitations on information and changes in information over time, the difficulty of solving such problems in any practically usable way has led to a switch in emphasis – to robust development strategies and institutions that perform well under a wide set of relevant environments.

The formal modelling described above depicted the planner working outside of the political framework. The planner solved the optimisation problem. If the model is taken literally, and everyone agrees that we should do what is optimal, there is seemingly no reason that the optimal strategy not be adopted. The broader perspective recognises that planning and, more generally, all aspects of economic decision-making are highly political: there are winners and losers, or at least some who win more than others. Although there are no formal political constraints – governments repeatedly undertake policies that only a short time earlier were judged to be politically unfeasible – political pressures do affect the ease with which different strategies can be undertaken or the likelihood that particular processes will be adopted. In some cases the political process may even reject a proposal that appears, from a static perspective, to be a Pareto improvement, because that decision will affect future options or decisions in ways that will adversely affect a particular group. For example, in the United States recent proposals to auction off rights for further development of hydroelectric sites have been criticised by those currently receiving below-market electricity, not because they would be hurt directly, but because they worry that it would make more transparent the hidden subsidy they currently receive (electricity priced below the opportunity cost, though at or

above the production cost) and in the long run increase the likelihood that their subsidy would be eliminated.<sup>5</sup>

#### **THE BASIC ELEMENTS OF A PARTNERSHIP**

The basic elements of a partnership are the allocation of responsibilities and frameworks for finance and decision-making. In both areas there are a variety of sharing arrangements. It has long been recognised that finance and production are not the same issue – the government may provide finance, leaving production to private entities (as in the case of health care for the aged in the United States), or it may engage in production, relying on conventional pricing mechanisms to raise revenue (as in the case of public utilities). Arrangements for sharing in finance can be fairly transparent (although the ultimate incidence/destination of expenditures is not always straightforward). In education, for instance, most governments assume a large financial responsibility for elementary education, but put some of the financial burden for higher education on students and their families (though they often provide loans, sometimes at subsidised rates).<sup>6</sup> However sharing decision-making is often more complex. In many sectors there are complex regulations governing the decisions of private actors.

There is an emerging consensus, based on both theory and experience, on certain elements of how sharing can be most effectively conducted. Markets have primacy in the production and allocation of goods and services. However, markets on their own often fail to produce socially desirable outcomes. Government has the central responsibility to provide an institutional infrastructure in which markets can function: defence and law and order; macroeconomic stability; an environment to preserve public health; access to education and health care that allows, protects or enhances effective participation in the market economy and provides a safety net. There is shared responsibility – the terms of which differ across countries – to provide education and health, establish the physical infrastructure and technology.

#### **AREAS IN WHICH GOVERNMENT IS THE MAJOR PARTNER**

Placing the private sector at the centre of production means that there is a presumption against government production and in favour of privatisation. However, there are several important caveats: there must, for example, be ways of ensuring that markets are competitive. And when government does privatise, it must ensure that it receives fair value – receiving less is not only an invitation for corruption, but also imposes a heavier burden on distortionary taxation in the future.

*Institutional infrastructure.* Governments must provide the institutional infrastructure in which markets function. This institutional infrastructure goes beyond the legal

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<sup>5</sup> Formally, one can think of this in terms of a dynamic game, in which those involved have differing objectives and limited information and understanding of the pay-offs. The government can be thought of as attempting to change the parameters (or perceptions of the players) of the game and/or as a player in the game itself.

<sup>6</sup> There are principles which underlie this division; at some age individuals can be made responsible for their own decisions. At this point the individual becomes the "partner" and the state provides the opportunities, which may or may not be taken. In this context distributive consequences should be evaluated in this forward-looking way, rather than backward-looking (that is, in terms of the family from which the individual comes). On the other hand, parents make decisions concerning their children, and the state may feel it has some responsibility to ensure that those decisions are made in ways that advantage the children, particularly in cases where parents may behave in ways that are irreparably damaging.

framework (contract, tort, bankruptcy and competition law). It includes the regulatory structure affecting key industries such as telecommunications and the financial services sector. Ensuring the safety and soundness of the financial system is necessary, not only because this sector has a vital role to play in allocating capital efficiently<sup>7</sup> (without confidence in the stability of the financial structure, savers will not entrust their savings to it, and it thus cannot perform its role of intermediation) but also because instability in this sector can be a source of macroeconomic instability.

Ensuring macroeconomic stability must itself be recognised as one of the central responsibilities of government (see Chapter 10 of this volume).<sup>8</sup> This basic and fundamental function must be discharged by the government. Given its extensive discussion elsewhere in the book, we do not dwell on it here.

Neither do we discuss defence and law and order. Again, this is not in anyway intended to underestimate their importance. Stability and effectiveness in these areas is crucial. Indeed, many of the disasters of economic development are associated with a breakdown of order, particularly internal and external wars.

We examine health and education issues under shared responsibilities and develop the discussion further in the second section. At this point we simply emphasise that it is a government responsibility to provide public health and to ensure access and regulate private activity.

The provision of a safety net is an area in which government activity may be viewed both as directly pursuing objectives – here these include a sense of equity and community – and as instrumental for other objectives. Without an adequate safety net there is often resistance to changes that are essential for economic progress and development. What constitutes an adequate safety net and how it can or should be provided, will clearly vary with the circumstances in each country. Poorer countries – with limited abilities to raise taxes – may have to rely heavily on families and local communities to provide the safety net. However, even in more developed countries increasing attention is being paid to the adverse incentive effects of poorly designed safety nets and to the, often very heavy, costs of their provision. In these countries there is increased emphasis on individual responsibility. This arises not only from considerations of efficiency or cost – for many commentators it is itself a moral imperative (or, more loosely, an objective of government policy). Policies are then evaluated not only in terms of their direct impact on outcomes (in particular, on individual incomes), but also in terms of their impact on opportunities<sup>9</sup> and the extent to which individuals take charge of their own lives. There is nevertheless some agreement on the proposition that a civilised society should provide some protection from extreme deprivation.

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<sup>7</sup> The “East Asia Miracle” arose partly because these countries were able to generate so much savings, but also because they were able to invest this huge flow of savings efficiently. Elsewhere, marginal capital-output ratios soared when savings rates increased.

<sup>8</sup> Macroeconomic stability, sound fiscal management and a robust and well-regulated financial sector played an important role in delivering the level and efficient allocation of savings that underpinned the “East Asia Miracle.”

<sup>9</sup> This can be reflected (albeit imperfectly) in the transition probabilities in mobility matrices (i.e. in the chances that a lower-income individual becomes a middle-income individual, or a middle-income individual becomes an upper-income individual), where the probabilities for an individual are affected by her/his own decisions.

*Environmental issues.* We emphasised earlier that the objective of a development strategy must be to increase standards of living. An important ingredient in living standards is the quality of the environment. Development strategies that accept the sacrifice of a clean environment today for larger growth rates in GDP are generally being misled by, or deliberately overlook, the limitations on our measures of standards of living. Such policies are likely to be worse than “penny wise and pound foolish”. Society can lose today *and* lose tomorrow, especially as the costs of clean-up are often a multiple of the costs of avoiding pollution (air, water, toxic wastes) in the first place.<sup>10</sup> Government must enforce regulations, taxes and other mechanisms that impel private actors to take account of environmental consequences and government must carry out those investments that cannot be promoted by market incentives, but that are productive in a broader environmental perspective.

Depletion of natural resources represents a different type of problem. Growth can be sustainable, as long as there is a more-than-compensating increase in the stock of other capital. However, growth strategies must explicitly recognise this necessity and provide for increases in capital stock that are larger than they otherwise would have been to offset resource depletion.<sup>11</sup>

#### **AREAS OF SHARED RESPONSIBILITY**

Standard analyses of economic growth present three sources of that growth: the accumulation of physical capital, increased human capital and improvements in the efficiency with which resources are utilised (growth in total factor productivity). Although there has been some debate in recent years about the relative importance of the various components,<sup>12</sup> a comprehensive growth strategy must address all of the components. The terms of the partnerships in each area differ, and we discuss them, not in the order of their relative importance in an overall growth strategy, but in order of the significance of the government role within the partnership.

*Education.* Although education has long been an area in which the private and public sectors have shared responsibility whatever the institutional arrangement, governments in those countries that have had successful development strategies have ensured that there is universal primary education – including the education of women – and that there is widespread access to further education. Education, as we have noted, is not only an end in itself, enriching individuals’ lives, but it ensures opportunity and enhances

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<sup>10</sup> In developing countries the greatest immediate environmental threat is through inadequate water supply and treatment. There are at least three major environmental issues associated with air pollution: that associated with particulate emissions from automobiles and factories in towns, that derived from domestic cooking and that from acid rain (largely from coal burning utilities). There are, of course, many other environmental issues that are threatening to livelihoods in developing countries including deforestation and pollution from natural resource development and other industrial activity. While the environmental damage associated with each is large, inroads into each of these can be made at relatively low cost.

<sup>11</sup> Similarly, non-renewable resources should be considered a further part of the capital portfolio (in addition to conventional capital and renewable resources) and their reduction should be accounted for. Put more generally, the intra- and inter-temporal trade-offs should be set in the context of the whole range of capital stocks, including environmental.

<sup>12</sup> The importance of the residual, or total factor productivity growth may have declined, at least within the United States in the past two decades, while, it seems, human capital may have become more important. It is not easy to tell, of course, the extent to which these statements are artefacts of modelling or measurement.

productivity. It is necessary if developing countries are to absorb and adopt advanced technologies and methods of organisation that will enable them to close the gap between their standards of living and those of the more developed countries.

*Technology.* Active policies promoting the transfer and development of technology have been an ingredient in most successful development strategies. The nature of these industrial policies remains one of the more controversial aspects of development strategy. Although the United States, Japan, Taiwan, province of China and many European countries had selective and effective policies promoting technology,<sup>13</sup> economists remain sceptical about their industrial policies.<sup>14 15</sup> It must be recognised that central to industrial policy should be the provision of competition and openness – which is crucial to the process of technological change.

However, while there is a debate about the appropriate extent and nature of active policies promoting technology, there is little disagreement that government must put in place the institutional infrastructure that is required for the rapid and effective transfer and development of technology. This includes a strong, broad-based education system, with a high (and well-structured) science and engineering content. Education must provide the skills to learn new ideas and the flexibility to adapt to them. There will also be requirements for the setting of standards and quality control, and for a system of intellectual property protection.

*Saving and investment.* Most of the successful countries of East Asia had active policies promoting saving and investment and avoided policies that discouraged saving and investment. We have referred to several of these previously – they clearly fall within the responsibility of government in this economic partnership: maintaining macroeconomic stability, with low deficits (or possibly surpluses), and providing the solid prudential regulation necessary for a safe, sound financial system. However, governments have done more: they helped create markets, for instance debt and equity markets, by ensuring that there were regulatory mechanisms that would give investors confidence in these markets and by helping to create a demand for the instruments provided by these markets. The development banks provided long-term financing and arguably, through a variety of risk sharing and signalling mechanisms, helped catalyse private investment in certain vital areas.<sup>16</sup> By the same token, the postal savings banks, prudential regulation of other banks and provident funds all helped stimulate saving, both by increasing access to

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<sup>13</sup> For instance, in the United States the government paid for the first telegraph line and developed the internet. It played a major role in the enormous increases in productivity in agriculture. It engaged in basic research that led to important surges in the biotechnology industry. In many countries the civilian aeronautics industry (including the jet engine) has been heavily influenced by military research. Government-sponsored research (or research in regulated industries) was responsible for the transistor, the laser, the computer and many of the other innovations that have transformed modern society.

<sup>14</sup> Much of this is based on the view that government is less effective in picking winners than the private sector. This stance misses the point. The issue is not picking winners, but identifying spillovers.

<sup>15</sup> In some cases industrialised policies were focused on shifting resources away from low-economic-return activities (such as speculative real estate investments) rather than towards specific high-return projects.

<sup>16</sup> The mechanisms by which they did this are discussed at greater length in Chapter X and are similar to those by which the MDBs can hope to have a stimulative effect on investments in developing countries.

financial intermediaries and by enhancing depositors' confidence in their safety.<sup>17</sup> There is much to learn from these experiences.

### CHANGING ROLES

There are many areas in which the scope for government activity is now seen to be smaller than in earlier discussions of development strategy.

*Information services.* While government must still make plans for its own activities (indeed, an essential ingredient of a development strategy is the formulation of these plans for the public sector), the role of government planning (or more broadly, information services relating to the future evolution of the economy) for private sector activities will vary from country to country. In some countries private information services providing, for instance, short and medium-term forecasts, are sufficiently developed that there may be little value to be added by additional public provision. However, in other economies government can provide important information services that extend well beyond the collection and dissemination of statistics. Whether they go far enough to be labelled a "plan" for the economy may be a matter of semantics, but they may provide guideposts for the economy, an issue to which we shall turn shortly. Indeed, whether or not private services exist, the private sector should be interested in, and informed of, the government's perspectives.

*Provision of physical infrastructure.* Another area in which the scope for government has changed dramatically is the provision of physical infrastructure (see, for example, the *World Development Report*, 1994). Fifty years ago it was simply assumed by many that the government should provide infrastructure. However, this view overlooked the lessons of historical experience: in the United States, as well as in many other countries, roads and canals were privately provided throughout the nineteenth century. A key argument for government ownership in that context was that some government involvement was required to establish a right-of-way. It was also recognised that the potential for abuse of private monopolies was great and that regulation provided an inadequate safeguard. Although these arguments had considerable validity, there is now an increased recognition and understanding of the disadvantages inherent in government monopoly – both in terms of efficiency and rent diversion. At the same time it has become apparent that in many parts of the infrastructure – including electricity generation<sup>18</sup> and virtually all parts of the telecommunications sector except the "local loop"<sup>19</sup> – competition is, in fact, viable. The limited budgets of most developing countries, the requirement to finance investment and the tendency of government enterprises to produce losses imply that there is an obvious advantage – beyond the enhanced efficiency – to providing infrastructure privately. International competition among providers, in turn, may have changed the terms of trade: developing countries may be able to obtain foreign capital and technology at favourable terms, with a risk of exploitation limited by competition and by international experience in regulation.

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<sup>17</sup> The low returns often offered on these accounts suggests that safety and convenience may be a far more important consideration than high real returns in generating savings.

<sup>18</sup> Beyond electricity generation, it is not clear how much of power should be public. For example, the transmission lines are likely to remain a natural monopoly (whether government-owned or privately owned and government-regulated).

<sup>19</sup> Even there, new technologies (cellular, interactive cable) may soon make competition viable.

*Assignment of responsibilities.* Strategies of development and the assignment of responsibilities may have to alter with changes in technology (as the example of telecommunications illustrates), changes in the world economy (globalisation and reduced transportation costs have facilitated export-oriented strategies and the transfer of technologies between industrial and developing countries, and rising real interest rates have put added pressure on government finances) and changes in the state of development of the economy. Markets are less developed in poorer economies but so, too, are public institutions. Thus while the need or scope for government intervention may be greater, the capacity of the government to intervene in ways that enhance growth and welfare may be more limited. Development entails the advancement of public and private institutions, and on a priori grounds, it is not obvious at any particular stage whether relatively more or less reliance should be placed on the public sector. For instance, poor governments' relative difficulties in taxing could suggest a smaller role in the provision of infrastructure than in some developed economies – or at least point to pricing services in a way that would not only cover costs, but also provide net contributions to government revenue.

The areas of government activity for that we have described go well beyond the “night-watchman state” of defence and law and order plus the institutional infrastructure for markets. However, it must be recognised that ambitions for the state's role must be limited by financial and institutional constraints. Notice, further, that the suggested activities do not involve direct government responsibility for the overall level and allocation of investment. In contrast, in older theories of development planning, for instance, emphasis was placed on rapid capital accumulation and investment in basic industries, with the government given a strong role.<sup>20</sup> Further, pessimism about opportunities for export contributed to an emphasis on import-substitution strategies (implicitly, it was assumed that given these limitations, the marginal returns to developing import substitutes exceeded that to developing exports). The success of the countries of East Asia and the phenomena summarised under “globalisation” in earlier chapters have not only ended export pessimism, but have shown that the promotion of exports can be an effective strategy for the transfer of technology and the enhancing of competitiveness of domestic industries.

It should be recognised that the central components of the development strategy described here follow directly from the problems a development strategy is designed to overcome. Developing countries are characterised by low standards of living, in particular, low income per capita. Income per capita is low in part because workers lack training, capital and technology. However, it is also often the case that the given skills, technology and capital are used inefficiently, making the output per worker low. Competition and openness in markets provide the greatest forces for increasing efficiency and promoting technological change. However, there is much that government can and should do. Government can promote saving and can develop financial institutions that

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<sup>20</sup> The older approach was linked to perceptions of a more closed economy. In a closed economy materials balance equations are satisfied through local production. With a lack of confidence in the markets' forward looking abilities, it was natural to turn to government to provide the requisite check. In an open economy any gap between supply and demand for tradable goods can be resolved by expanding or contracting exports and imports. The older approach was also based on a perception of the development process that gave excessive emphasis to the accumulation of capital goods relative to the standard of living. The models of inter-temporal optimisation often pointed to a sequencing in development similar to that pursued by the Soviet economies.

increase the efficiency with which scarce capital is allocated. Government can promote education, which not only directly raises the standard of living, but which is also necessary for the transfer of technology and which improves the productivity of the labour force. Government can promote the development and transfer of technology directly. Finally, infrastructure is an essential complement to private investment and contributes directly to the standard of living of individuals. While the government need not provide the infrastructure itself, it must ensure that it is provided in a sound manner.

There is some, though not universal, consensus concerning the elements of the development strategy sketched above. However, elements of controversy remain about what further role government should play in formulating and executing a development strategy, and what that strategy should look like. In most of the countries of East Asia government did far more: it helped establish market institutions (like development banks), helped create markets (such as bond and equity markets) and made decisions about which industries to promote (sometimes at a fairly detailed level – steel, plastics, chemicals; sometimes at a broad level – exports) and which sectors to discourage (speculative real estate). It acted as a catalyst, outlining future directions, as well as marshalling resources.<sup>21</sup>

In this more comprehensive view national strategies have some similarities to corporate strategies: they identify problems and opportunities and possible approaches to addressing those problems and opportunities. They are partly for information gathering and dissemination and partly national consensus building. Thus as Singapore's per capita output and income increased, the government recognised that if its growth was to continue, it would have to move into high-value-added sectors. While many smart business people had probably already recognised this, public discussion disseminated this idea more widely and, given the complementarity between public investment (in infrastructure, education, technology) and private investment, the discussion provided the basis for coordination.

Still it must be recognised that nations are not corporations. Their objectives are not unique, not necessarily shared and much less well-defined. Individual agents can, and should, have much greater freedom to pursue their own lines of activity and interests in their lives than employees of a corporation.

## **NORTH-SOUTH RELATIONS AND DEVELOPMENT STRATEGY**

Earlier discussions of development focused particularly on two aspects of North-South relations: capital and technology. Developing countries were viewed as lacking both capital and know-how, and therefore needed transfer of capital and technical assistance. The East Asian experience has shown that the developing countries can make major strides in generating capital and establishing the conditions (industry, development of human capital, competition and openness) for the transfer of technology. While the main responsibility lies with the developing countries themselves, wealthier countries can make real contributions in these directions. However, perhaps more importantly, they can help generate the conditions in which development strategies can succeed.

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<sup>21</sup> Indeed, there is evidence, for example, that the Japanese development banks provided only a small fraction of total funds. The development banks did more than just provide direction; they provided monitoring services for loans. Their activities may have enhanced the likelihood of repayment.

Industrial economies have, with a fairly unified voice, recited the mantra of markets and competition for more than a decade. As they too have faced budgetary stringencies, they have promoted "trade not aid." They have encouraged developing countries to open their markets to investment. For the most part they have made good on their promises: they have often granted developing countries preferential access and have not always asked for fully reciprocal treatment.

However, in some instances there has been an element of duplicity. For example, as some of the transition economies have attempted to enter the world market, they have found the door shut, by quotas on textiles or through threats of anti-dumping actions and countervailing duties. While insisting that the developing countries and economies in transition must face competition from developed countries, the latter have resorted to protection when confronted with market surges and changing comparative advantage that disadvantaged some of their own industries.

While insisting on the protection of intellectual property rights, industrial countries have been less enthusiastic in insisting that owners of intellectual property refrain from discriminating against poor countries. In some cases pharmaceutical companies have charged poor countries far more for the same drugs than the prices charged to others.

Other issues, the most difficult problems from an international perspective, are associated with international environmental public goods,<sup>22</sup> such as the production of greenhouse gasses associated with global warming. Many developing countries are among those most likely to be affected adversely by these environmental public goods, yet each country has an incentive to try to induce others to cut back on their pollution without doing so themselves. There is growing international understanding that without cooperation from at least the major developing countries, which are likely to rely more heavily on coal as a source of energy than richer countries, greenhouse gas concentrations are likely to increase to potentially dangerous levels by the middle of the next century. There is a growing international consensus (reflected in the Rio Convention) that the increases in greenhouse gases represent a global problem. The cost of reducing the greenhouse gas emissions can be lowered if it is done efficiently. The way that this issue is addressed – including the transfer of environmentally sound technologies to developing countries – will play an important role in the design of development strategies in coming years, particularly in vital areas of energy policy.

## **MULTILATERAL DEVELOPMENT BANKS AND DEVELOPMENT ASSISTANCE**

The development strategy of a developing country must depend on its opportunities for trade and the availability of other forms of support from other sources. As an outside player, in repeated and long-term relationships with developing countries, a multilateral development bank can build trust and understanding and make a contribution far beyond the value of the resources provided.<sup>23</sup> There is, from the host-country perspective, a greater willingness to accept, and greater recognition of the potential contribution of, an MDB relative to a private investor or a single-country partner, since it is a party whose

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<sup>22</sup> Some more local environmental issues were discussed above.

<sup>23</sup> And thus there will be a greater incentive for the borrower to fulfil conditionalities and commitments than with an ordinary investment bank. MDBs are in a better position to enforce sovereign guarantees than are most private lenders.

interest in a transaction extends beyond narrow self-interest. Moreover, because MDBs are involved in multiple lending projects, they have an incentive to be worried about macroeconomic performance and they have the ability to enforce, as part of their lending programmes, “conditionality”, ensuring that a sound policy environment is maintained. Of course, that conditionality derives primarily from their analysis of good policy and their objective to promote development. Thus a major argument for MDB involvement is their direct role in improving policies and the conditions for investment and growth.

MDBs' long-term involvement in development issues has a further advantage: they have developed a collective memory, which can be used to evaluate and design projects and programmes. At their best they have become repositories of information about what does and does not work. This knowledge is particularly important, because many programmes and projects, such as the privatisation of the telecommunications sector or the construction of a major dam, are likely to be undertaken only once by a particular country.

The role of MDBs, however, goes far beyond that of promoting good policies or public investments. In a world of rising international private capital flows, they have a central part to play as participant investors who can unlock, expand and improve the quality and impact of these flows. The fact that multilateral development banks are active partners may comfort other partners, including private investors, who recognise that MDB involvement enhances the strength and reliability of relationships with the host government. In turn, the host government will have more confidence in the private investor if an MDB is involved, because private investors also have valued long-term relationships with MDBs. They also value their own reputation. As a result of this greater comfort a variety of private projects may materialise that otherwise would fail to get off the ground.

The recent market-oriented philosophies of MDBs point to a very important area of activity. Their task is not only to promote the policies, institutions and infrastructure for a market economy. By directly participating in the process of private investment they can open up new areas of activity for private investment itself. This is a further example of partnership between a public institution and the market, that does not involve the displacement of the market by the public institution.

## **INSTITUTIONS AND INSTRUMENTS**

A coherent development strategy will also require a description of the institutions and instruments that will carry out or steer the tasks assigned to government or shared with the private sector. The details of the functioning of the institutions and of the way in which the instruments are constructed are so central to the chances of success of any strategy that it is sensible to see their design as part of the strategy itself.

### **WHY INSTITUTIONS MATTER**

Our emphasis on institutions requires that we offer an interpretation of the term. Dictionary definitions would normally include “an established custom, law or relationship in an economy or society” and “an organisation with a specific purpose” among the possible meanings. A focus on institutions, then, is a focus on relationships, organisations and ways of doing things.

Traditional microeconomic theory paid minimal attention to institutions. It centred on technology, endowments and individual agents (and their preferences). The hypothesis

was that the outcome was determined by these underlying factors; one did not need to look at the superficial arrangements through which transactions were mediated. Institutions such as sharecropping represented conveniences, but they could not have a significant effect on outcomes – if they did, the tension with the underlying economic forces would overwhelm the institutional arrangements, and the latter would ultimately have to change.

Institutional analysis, by contrast, begins with the hypothesis that institutions do matter, at least in the short and medium term. To be sure, when there are large discrepancies between underlying economic forces and institutional arrangements, there will be pressure for institutions to change. Such changes may, however, occur very slowly, and in some cases not at all. Thus, institutions that originally may have been well suited for dealing with a set of economic problems may become obstacles. Institutions shape change and are shaped by change.

Institutions can be important for economising on transaction costs. Take the institution of sharecropping, with a particular set of terms (including sharing provisions). Modern economic theory would have predicted or imagined that there would be a complicated state-contingent contract; and even if the only observable variable was output, only under stringent conditions would the contract entail a linear relationship between payments to the landlord (share) and output. However, the cost of negotiating a contract that deviated from a simple standard contract, like a 50-50 share, could be large. If the landlord proposed the contract, the renter would worry that the landlord might have differential information and was trying to turn the contract to his favour. Conversely, if the worker proposed a new contract, the landlord might think that in doing so the worker was signalling something potentially adverse about himself, inducing the landlord to turn down the offer of a contract altogether. Indeed, it is often the case that, when there is ambiguity in contract law (as there always is), a non-standard contract is interpreted against the writer of the contract. These considerations provide a further rationale for the use of standard contracts – and the slow evolution of contract forms.

Sharecropping is an example of a (fairly) simple institution. In other contexts there is a much wider range of activities in which participants can be engaged and for which institutions specify appropriate behaviour. Whereas in a few cases relationships can be relegated to formal economic terms – for example, a performance-based contract with a limited number of performance measures – in most cases it is difficult to capture all relevant aspects of desired behaviour in one or two variables. Workers, for instance, have to train new hires, and it is difficult to monitor the extent of such training, let alone to find quantifiable measures of its quality. Institutions thus serve to regulate this kind of behaviour.<sup>24</sup>

Broadly speaking, then, institutions provide incentives and regulate behaviour to promote actions that enhance the organisational objectives in complex situations where a simple monetary reward structure will not provide appropriate incentives. One of the central problems in institutional design for such a partnership is to put appropriate

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<sup>24</sup> It is sometimes suggested that institutions arise when markets fail. Thus the absence of insurance markets gives rise to informal insurance institutions (such as the family). Some families may regulate behaviour, e.g. providing assistance only for those who it has judged have made adequate efforts to help themselves. Note that there is no formal contract nor an explicit statement of what an "adequate level of effort" is.

incentives into place and, in particular, incentives that ensure cooperative behaviour, which can enhance economic efficiency.

It is also important to deter collusive behaviour, which may be defined as cooperative behaviour among, say, the firms in an industry at the expense of the general interest. Traditional economic theory suggested that self-interested behaviour ensured economic efficiency. Partnerships were simply not required or desirable. (Adam Smith himself was explicit on this point.) However, the limitations of that perspective are now widely recognised. In some cases the desirability of partnerships is obvious: the relationship between workers and firms is typically not mediated simply through an impersonal price system.

Economic institutions also enable the resolution and avoidance of conflict. Thus, for example, parties with possibly conflicting short-run interests may arrange for forums that allow for an exchange of views (for example, unions, government and employees' organisations). They may construct institutions for arbitration between, or for supervision of, different parties in an industry or contract.

#### SUCCESSFUL AND UNSUCCESSFUL INSTITUTIONS

It is easy to identify institutional arrangements that work well: each partner does what it is supposed to do, there is good coordination, little conflict and the economy grows smoothly and rapidly. We can also recognise ill-functioning institutional arrangements: change is inhibited by bureaucratic requirements or there is "bandit capitalism" with pervasive corruption and deceit.

It is, however, somewhat more difficult to identify the essential ingredients of good institutional arrangements. As we have argued, they lower transaction costs, they provide appropriate incentives and avoid or resolve conflict. They thus enable engagement in socially constructive activities and do not provide incentives to take actions which enrich one partner at the expense of the others. They typically place considerable reliance on trust,<sup>25</sup> rather than explicit contract enforcement, but they do have some method of enforcement (for without that, long-term relationships cannot function effectively).

*Incentive compatibility and dynamic consistency.* The set of institutions and instruments that are adopted must follow incentive-compatibility and dynamic consistency. Thus economic agents should have an incentive to conform with or honour allocations or commitments. What they plan to do today for some future contingency must be consistent with what they would want to do in the event that that future contingency arises. For example, one of the crippling defects of the command system in the former Soviet Union was that there was little incentive to work so that the notional allocation of tasks and effort in the Plan was not incentive-compatible when it came to actually doing the work. Similarly, non-tradable rationing of goods in general is not incentive-compatible, since, following any rationed allocation, there will be an incentive to trade in rationed goods. It was a system that inevitably generated, on a grand scale, behaviour that went against the rules. This, in turn, generates cynicism, which further corrodes standards of behaviour and acceptance of rules and government.

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<sup>25</sup> They typically are designed to promote long-term relationships for, without such long-term relationships, it is harder to establish trust. For instance, firms that have a steeply rising wage profile provide strong incentives for workers to stay with the firm.

*Institutional rigidities.* However, just as institutions, in the process of simplifying decision-making, do not adapt perfectly to their particular circumstances (e.g. to the economic circumstances of each pair of individuals engaging in a sharecropping contract), by the same token they may not change quickly in response to changes in economic circumstances. They thus face the risk of, at best, not addressing adequately the current needs of the economy and, at worst, becoming obstacles to change. There are a variety of reasons why institutions adjust slowly, some of which we have already hinted at. Institutions economise on transaction costs. Also, the design and establishment of new institutions is a public good, entailing high transaction costs. Thus investing in designing a new institution is a high-risk, expensive activity with adverse individual incentives.<sup>26</sup> Moreover, the world is a sufficiently complex place that typically two parties may not be in a position to fully appraise themselves of the consequences of a proposed change. Again, risk aversion may create a bias for maintaining the status quo or for slow change.

The interdependence of institutions often makes it necessary to change several institutional arrangements at the same time. This gives rise to the possibility of a coordination failure: given the institutions within a society, even when it does not pay to change a particular institution, it may pay to change several of them simultaneously. Governments can facilitate institutional change – they can address the coordination failure and the free-rider problems. However, turning institutional redesign over to the government raises a host of other difficult questions. For almost any institutional redesign has strong equity consequences, and the political process may block changes that have large adverse consequences for any particular group.<sup>27</sup>

*Institutions and economic transitions.* Problems associated with inadequate or ill-functioning institutional arrangements are likely to become most severe in periods of rapid transformation, when institutions have not yet had the opportunity to adapt to changed circumstances. Indeed, successful transformation may involve at its heart the constraints of new institutions. While in traditional societies social pressure may serve as an effective mechanism for the enforcement of contracts, as a society develops, greater mobility may make social pressure less effective. Yet the long-term relationships that serve to enforce (implicit) contracts may not have developed. Ideally, institutions should both facilitate change and adapt to change, but that is asking a great deal.

While the above examples are far from exhaustive, they do bring out the importance of institutions and rules of behaviour needed if market systems are to yield effective results. Broadly speaking, one can summarise the issues involved by saying that a market economy requires certain kinds of institutional infrastructure if it is to function well. It is important to understand and analyse institutional design.<sup>28</sup> The building and protection of

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<sup>26</sup> Especially given the presumptions of courts, or of the sceptical, in interpreting the contract against the interests of the proposer of reform.

<sup>27</sup> These equity concerns play a role in the persistence of seemingly inefficient social arrangements. For instance, while unregulated use of commons can lead to overgrazing, the enclosures (which ensure efficiency) made those without access to the land worse off. Proposals that on the face of it seem as if they represent Pareto improvements may be resisted because it is perceived (or feared) that they will change the future dynamics of the political process in ways that could adversely affect particular groups.

<sup>28</sup> It is, however, important to recognise that history is not only important for determining the evolution of institutions, but also for the equilibrium that emerges within an institutional structure. History and culture

the institutional infrastructure is a major challenge to which we return briefly at the end of this section.

#### **BASIC INSTITUTIONAL ARRANGEMENTS FOR A PUBLIC-PRIVATE PARTNERSHIP**

We begin our more detailed discussion of institutions and instruments by looking at the general institutional arrangements required for a well-functioning public-private partnership. We group these general institutional arrangements under three broad headings: democracy and openness, governance, and contracts/trust/long-term relationships.

Democracy and openness should be seen as both objectives and institutions/instruments. It is clear that democracy and openness are not necessary conditions for economic growth in the short or medium run. Indeed, there are many historical examples of successful growth and transformation in non-democratic societies, though, typically, not for very long periods. In post-war experience there are clear examples of growth without democracy in Africa, Asia, Europe and Latin America. On the other hand, democratic institutions are a vital end in themselves and should thus form part of the strategy. Further, they have many important advantages for the functioning of a market economy. First, they allow for political acceptance of economic and in contract law other structures, and for acceptance of change in these structures. Second, they can provide for some stability in other institutional arrangements, which may facilitate change. Third, they can improve the quality of governance by providing checks and balances on the executive. Fourth, they can rapidly bring attention to serious problems. For example, Sen (and see chapter 10 of this volume) has argued that democratic institutions have been very important in the prevention of serious famine in India since independence in 1947. The political process is such that speedy reaction to the probability of severe famine is demanded.<sup>29</sup>

High standards and competence in public administration provide an efficient and stable environment in which to make economic decisions. Many studies of comparative economic growth have concluded that the quality of governance is a crucial determinant of economic performance. Such results are not surprising, since intelligent and reliable governance, as we have discussed, is important for the functioning of markets and, particularly, for investment decisions. Further, in understanding the determinants of good governance, it should be recognised that in democracies there is at least some alignment of interests between the governed and the governing, since the governing must from time to time persuade those who are governed that they are acting in their best interests. Thus, while no form of government has a monopoly on either good or incompetent governance, democracy has a fundamental check: bad governments can be thrown out. And thus the nadirs that non-democratic governments can attain are seldom reached in democracies.

Governance is not only a matter for governments but also for enterprises. Indeed, high standards of corporate governance are central to the performance of firms. In the case of

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affect perceptions of what other participants will do. When there are multiple equilibria, they affect the equilibrium that emerges.

<sup>29</sup> We should further recognise that, in the new information age, the level of control required by authoritarian governments to stop the flow of information is such that it would almost inevitably stifle economic development.

corporate governance the issue of objectives would seem to play a less important role: are not managers simply supposed to maximise the value of shares on behalf of shareholders? Yet information asymmetries, the limited incentives of shareholders to vote (and to acquire the information required to vote intelligently) combined with the limited ability to displace existing management, all give incumbent management enormous discretion. And there is considerable evidence that they frequently use that discretion, not only to entrench their power, but to enrich themselves at the expense of shareholders.

Investors from outside a firm can play a crucial role in establishing good corporate governance. Investors are not prepared to provide resources to a firm, be it through loans or equity, unless they have a clear idea of how those resources will be used. High standards of business conduct will not, however, arise from strong corporate governance alone. In business affairs there must be standards of transparency, information and behaviour that are enforced by both the state and effective corporate governance. Without such standards a system of external finance (loans, equity or other instruments) will not function effectively. That is why strong legal and accounting systems, with effective protection from fraud, are so essential to the development of modern capital markets. Thus institutions – laws, regulations and customs, including accounting systems, fraud laws, securities and exchange commissions – both constitute the financial market and determine how well it functions, that is, whether investors have confidence to trust their money to certain institutions within the financial market and whether the market brings about an efficient allocation of resources.

We have emphasised incentives and long-term contracts in institutional relationships. These will form part of, and be underpinned by, definitions of property rights. In many cases these rights will be supported by the law, but one should not take an excessively legalistic approach. The key issue is one of confidence – that commitments and obligations will be met.<sup>30</sup> Confidence arises from social relationships, as well as from legal underpinning. For example, in a number of East Asian (and other) societies formal legal structures for contracts and their enforcement are weak, but enforcement is, nevertheless, made strong through social and other sanctions.

#### **SPECIFIC EXAMPLES: PUBLIC RESPONSIBILITY**

We turn now to some specific examples of the importance of the ways in which institutions operate. Following the pattern of the preceding section we focus first on areas of government responsibility and then on those of shared government-private responsibility. As has been argued in a number of chapters in this volume, macroeconomic issues are clearly matters for government responsibility. We give two examples to emphasise the importance of institutional arrangements and associated instruments: tax policy and administration, and the workings of a central bank.

Tax policy is a classic example in which instruments (tax bases and rates) should be designed both to reflect the objectives of government and to be incentive-compatible. In a market economy resources must be raised by government from taxpayers. In contrast, in a command economy the government, at least in theory, has first call on resources<sup>31</sup>

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<sup>30</sup> Government actions can enhance confidence, e.g. actions that increase the franchise value of a bank and thus increase the likelihood that the bank will act in a trustworthy manner in order to preserve its franchise.

<sup>31</sup> In practice, those at the farm, factory and distribution levels in eastern Europe and the former Soviet Union, under the old regime, had great power to divert resources.

and residuals are then provided to consumers. The collapse of tax revenues in many transition economies has highlighted these issues in a dramatic fashion.

It is not enough to simply design tax policy in a way that accounts for individual responses (incentive-compatibility). Taxes must be collected and this requires commitment and administrative capacity. It also requires acceptance of taxation by taxpayers. These requirements are much more easily satisfied if tax systems are transparent and simple and the resources raised by taxation are used effectively. The institutional arrangements for collection and enforcement will be crucial to the effective functioning of an economy. Without effective collection arrangements there will be a cynicism which devalues the legitimacy of the state and destroys good governance. A tax system that is not enforced effectively leaves great and arbitrary power in the hands of officials. It can lead to macroeconomic instability and the inability of the state to discharge its basic functions. Thus an effectively designed and administered tax system is at the heart of a well-functioning economy. Indeed, one could go so far as to say that one key measure of the extent of good governance is the ability of a government to collect the taxes it has set.

Economic development can enhance the ability of the tax authorities to collect taxes. More sophisticated technology allows the government to monitor transactions that it otherwise could not monitor; but these advances in technology may also allow the private sector to find new ways to avoid taxes. Developments in financial markets provide an illustration: it is impossible for the government to monitor every loan between two parties in a village, but the government can monitor transactions that occur in sophisticated financial markets. On the other hand, sophisticated financial markets have the ability to reorganise transactions to avoid taxation. If, for instance, a government taxes loans made within its country, the location of the transaction can easily move.

A second example of the importance of strong institutions in a market economy is the functioning of a central bank. This must have sufficient strength as an institution to be able to say no to a government that seeks to expand credit in an irresponsible way. It must also have the ability to enforce standards in financial institutions. Without such enforcement the confidence of transactors, which is vital for the functioning of a market economy, will be absent. Again, the design of its institutional structure - the powers, responsibilities, accountabilities and incentives - will be crucial if the market economy is to work well.

The degree of independence of the central bank is an issue of the balance of power in a democratic society. The variables controlled by the central bank are of great importance and thus require democratic accountability. At the same time the central bank can act as a check on government irresponsibility. The most successful economies have developed institutional arrangements that afford the central bank considerable autonomy, but in which there is a check provided by public oversight, an oversight that ensures the broader national interest is taken into account in the final decisions.<sup>32</sup>

These two examples underline the general principle that good governance involves actions and policies that show credibility, competence and probity. These should be

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<sup>32</sup> It should be noted that of the banking community (as holders of long-term debt) may place a greater emphasis on the control of inflation relative to reducing unemployment than would the populace as a whole.

supported by the right kind of checks and balances, training, rewards and punishments. The systems that provide this support will be crucial. They are also greatly influenced by culture and history. For this reason good governance may be difficult to reconstruct, or create, but it *can* be created and good system design and vigilance by the population through democratic procedures, including a free press, will be basic ingredients in the process.

#### **SPECIFIC EXAMPLES: SHARED RESPONSIBILITY**

We turn now to examples of the importance of the institutions and instruments surrounding shared public-private responsibilities. We focus briefly on four examples that are vital to both the functioning of the economy and the standard of living of its participants: infrastructure, health, education and industrial policy.

*Infrastructure.* As we argued in the first section, *infrastructure* is no longer seen as the exclusive reserve of government. The change in perception is partly due to experiences in which government monopolies have performed badly, pressures on public finances together with the fact that public infrastructure has often made huge losses, a general view that the role of government should be limited and changes in technology which have made many areas of activity no longer natural monopolies. If the private sector is involved in the provision of infrastructure services, its activities are usually regulated. Regulation can apply to prices, rates of return, requirements and allowances for capital expenditure, access of suppliers and consumers to parts of the market, quality, environmental obligations, and so on.

The institutional arrangements for the regulator, and the way they work, will have strong influences on the performance of the industry. Many economists have argued that the most important feature of regulation is to ensure competition in an industry, where this is feasible. And, increasingly, changing technology and unbundling (for example, separating electric power generation from the grid and from distribution to consumers) makes real competition possible in parts of those sectors, where the sector as a whole might previously have been a natural monopoly. In other areas, such as water supply, allowing competition and free access will be technologically more difficult. In these cases it will be important to promote competition *for the market* (i.e. a monopoly concession for some time period) in place of competition *within the market* and then to regulate closely prices and services after concessions have been granted. In a sense the regulator has to step in where competition is not able to control suppliers and stimulate them to perform well.

When the right to provide a service is to be auctioned off, delicate issues of control arise: maximising the auction price might entail committing to not impose new restraints, but then social welfare will not be maximised. The outcome is analogous to what would have happened if the government had run the enterprise as a monopolist. Hence, there must be some price and service regulation.

It might appear desirable to auction off a “temporary” monopoly and only if the firm performs well (in the social interest) will the right be renewed. This, too, has its problems: the initial winner would either underinvest in long-term assets and/or overinvest in firm-specific assets that give it an advantage in the next round of bidding (regardless of how they contribute to social welfare).

Substantial areas of infrastructure will remain in the public domain, as decided by technology, history and politics. It is likely, for example, that roads and railways will remain largely in the public sector in most countries for some time. Telecommunications,

on the other hand, is becoming increasingly a private sector activity. However, there are important examples involving both public and private activity in virtually all areas of infrastructure and the best prognosis is for a continuing mixture between the two, with private activity increasing, and where the mix depends on, and changes with, technology.

As with other aspects of policy and strategy, the credibility, competence and probity of the regulator of an infrastructure sector are crucial to performance. Investors will not make long-term commitments to markets if the rules of the game are not clear and reasonable profits are not available. Consumers will not, or should not, accept private monopolies that can exploit rents and abuse privilege, or for which political and democratic supervision is inadequate. However, all too often the choice facing a country is between a private monopoly, checked with government regulators of limited competence, and a public monopoly, which has most of the vices of a private monopoly plus unfettered access to the treasury to finance any losses.

Where privatisation of infrastructure works well, improved incentives enhance economic efficiency. And while the infrastructure will always be part of the political process, whether public or private, its movement to the private sector may reduce the temptation to use productive activity as a form of rent seeking (which can take on a variety of forms, for example, locating or not closing activities in politically critical districts, regardless of economic merits). These challenges in providing for infrastructure are tasks for government – the institutions created, how they function and the instruments they use are fundamental to the quality and cost of services that influence both the standard of living of consumers and the effectiveness of production. Details matter.

*Health.* A second area of shared responsibility is health. Most countries have active public and private health sectors. The issues for public policy concerning health are, in many respects, deeper than those for, say, telephony. First, health is in itself a vital element in an individual's standard of living. It is a key determinant of an individual's ability to enjoy other aspects of life and to participate in the society and economy. It is, therefore, universally recognised as a central issue for public policy in all countries. Further, there can be strong external diseconomies to bad health. Individuals are regarded as having rights to both protection (good public health) and health care. Correspondingly, governments have a responsibility to ensure certain basics. The nature of these rights is, however, much less clear and agreement on what they are, or should be, is far from universal. Second, the determinants of good health have much more to do with public health and lifestyle (which are, in part, determined by income, but also by education, culture and other social forces) than with medical care. Third, information is central to any form of health care provision. Individuals have information about themselves that others may not have, but are typically ignorant of medical science and practice.

We cannot do justice to the importance and complexity of these issues in a few short paragraphs. We will focus on health care, though without denying the relative importance of public health, including clean water supplies, disposal of sewage, immunisation, air pollution and so on, in determining health status. Also, influencing lifestyles and eating, smoking, drinking and other habits may be much more cost-effective ways of improving health status than the provision of health care. Nevertheless, health care takes a very large fraction of government budgets and national income in most countries. The institutions surrounding its delivery play a very important role in

determining quality and coverage of supply and, thus, the lives and anxieties of the population.

Health care generates three related and difficult challenges: how to organise its provision, how to finance its provision and whether to ration access and, if so, how. The response to these questions affects both the efficiency of the health care sector and the degree of inequality in the provision of health care services. For instance, the design of the system is likely to affect the extent to which a two-tier health care system develops. Some take the view that equality in the provision of health care services is desirable in its own right (specific egalitarianism).<sup>33</sup>

The asymmetries of information between consumers and providers (who, after all, are supposed to know what consumers need) combined with the limited ability of consumers to make informed choices because they are not repeat buyers of the treatment or information, has led to various organisational arrangements for screening and initial provision. In many countries, including the UK, a general practitioner makes a preliminary assessment and usually prescribes treatment. The patient is then passed on, if judged necessary, to a specialist. Transaction costs may be much lower in this organisational form than in fee-for-service systems (especially when fee-for-service is combined with reimbursement through insurance companies which have to be concerned with fraud and abuse). At the same time, capitation systems may provide incentives for doctors to underprovide services,<sup>34</sup> while fee-for-service systems may provide incentives for excessive provision (especially when a significant fraction of the costs are borne by third parties).

In the US we see, increasingly, reliance on what are called Health Maintenance Organisations (HMOs). In this system capitation fees are provided to competing health organisations, whose overall performance can be judged on statistical bases. Rather than managing their own care, individuals, in effect, hire doctors to manage their care. A competitive market can then arise among these managing doctors. Such an organisational form (like the fee-for-service) can occur within either the public or the private sector. Capitation schemes tend to provide fairly equal treatment to those within the same plan, but different plans may provide markedly different levels and quality of services – with corresponding differences in prices.<sup>35</sup>

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<sup>33</sup> While this view is widely shared, the fact that health itself is not that closely linked to health care suggests that the more fundamental concern should be equality of health status, or opportunity to achieve adequate health status, rather than health care itself.

<sup>34</sup> Though this incentive will be mitigated with information that allows practices to develop reputations concerning the quality of service provided.

<sup>35</sup> Thus HMOs do not resolve the issue of inequality of access, except if there is a standard plan (at a standard cost), and no one is allowed to provide services beyond the standard plan. (Even then there may be some inequality, since plans may attempt to select a more healthy population, allowing them either to lower costs or provide additional services. An HMO located on the fifth floor of a building without an elevator will discourage clients with heart conditions, just as an HMO that has a plethora of sports doctors will encourage clients in good health.) Just as some hold it to be a fundamental principle that everyone should have equal access to health care, others hold it as a fundamental principle that an individual should be allowed to buy as much of any good as he wants. (As long as there is some elasticity of supply of health care services, additional purchases of health care services by a rich individual do not necessarily come at the expense of less health care services for the poor.)

The arrangements for screening and initial provision (primary care) will also vary with the stage of development. For example, paramedics with only modest qualifications may provide a service that is of considerable value if spread broadly throughout the population, notwithstanding the fact that they (possibly) make more mistakes than would a better, but more expensively trained and paid, counterpart. There is some question as to whether the balance between primary and specialist care in some developing countries accurately reflects an assessment of social costs and benefits.

There are two major problems facing private market financing of health: because there is large variability in expenditure, finance will inevitably be through insurance firms, and insurance can raise the problem of adverse selection.<sup>36</sup> Insurance companies react to this problem in part by seeking information on the health status and risks of individuals so that each group pays for its actuarial risk, in part by limiting protection and in part by requiring deductibles. There is no general agreement about the desirability of such reactions, but there are two consequences. First, there is inefficient utilisation of resources (e.g. insufficient protection), and, second, the premiums facing some groups may be so high that they simply do not buy insurance, thus becoming charges on society as a whole in the event of illness.<sup>37</sup> Many governments have responded by requiring a form of at least minimum compulsory insurance or providing a public sector safety net.<sup>38</sup>

The underlying philosophical rationale for a society's commitment to provide health care to all seems appealing: everyone has a right to live, and this should not be conditioned on income (health as a basic right), and a healthy populace will be a more productive one (an instrumental approach). There is broad acceptance of the principle that social justice requires some help to be provided to those who have poor health.<sup>39</sup> However, the demand for medically provided services that are effective in relation to some specified criteria, such as life extending, may be beyond the capacity of the economy. There will have to be rationing and, in a sense, all societies face an "error trade-off" inherent in information problems: denying services to those who need it versus providing services to those who do not. In most cases the form of rationing will be determined within the medical services in an informal way. It is not easy to provide more formal methods that can command broad ethical support.

*Education.* Education provides a further example in which considerations of rights and costs/quality of service will lead to a combination of public and private provision and in

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<sup>36</sup> Insurance also raises the problem of moral hazard. Since individuals do not bear the full cost of their care, they overconsume, in part by taking less care of themselves.

<sup>37</sup> Formally speaking, there is a free rider problem here - the government cannot commit itself to provide health services for those in need, regardless of whether they have resources. The problem is analogous to that of poverty among the elderly: the government cannot commit itself not to help the elderly who fail to save sufficient amounts during their working years to provide themselves with a decent standard of living in retirement.

<sup>38</sup> In many developing countries a major issue is the imposition of fees for public sector health care services. Given the severe financial constraints facing most developing countries it is natural that they look for fees wherever they can. Charging fees can increase the efficiency of resource utilisation. However at the same time that it reduces over-consumption by some, it may result in under-consumption (relative to an ideal health care standard) by others.

<sup>39</sup> In practice, however, the question is often posed, do health problems arise because of actions undertaken by individuals? In some quarters there is concern that public provision of health care attenuates incentives for healthy living.

which the institutional arrangements will have a profound influence on outcomes. Again, we cannot go into great detail here and many issues have been covered in earlier chapters. Education allows effective participation in society and can be regarded as a right. It has strong positive externalities. It is also regarded in many countries as a duty of parents or guardians to insist on children's education and of the state to make it available up to a certain age. It can also be argued, as for health, that individuals have a right to buy private education if they wish.<sup>40</sup>

There are difficult issues, however, of deciding how far rights to education go and how education should be supplied. As with health the assertion of rights does not imply unlimited rights and does not imply state provision. In adulthood (e.g. over the age of 18) it can be argued that individuals and families have a responsibility to provide for themselves, but again the relevant markets will have deep imperfections and institutional arrangements will be important. Borrowing to finance education is not straightforward. Human capital is not easily collateralised. Banks find it very costly to keep track of former students who are indebted to them. This need for tracking provides a further example of where the public sector can be administratively more efficient than the private sector.<sup>41</sup> The state is better positioned to follow individuals over time at low cost than the private sector. This can occur in a number of ways (for example, through the tax or social security system). Again, the institutional arrangements of public-private partnerships depend intimately on the structure of the industry or activity.<sup>42</sup>

*Industrial policy.* Industrial policy should not be about picking winners. It is not clear that governments are able to do this better than markets. And it should not be about judgements that some production or consumer activities are inherently better than others. The neglect of services and the promotion of heavy goods in the former communist countries was a clear example of ideology and prejudice imposing limitations on choice that were deeply damaging to the quality of life. There are, on the other hand, important issues for industrial policy concerning capital markets and risks and concerning technological spillovers.

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<sup>40</sup> As in the case of health supply is elastic, so that extra consumption by some does not come at the expense of less consumption by others (at least in the long run). The issues concerning inequality in education and health care are not identical. Inequality in access to education can lead to social division and divisiveness and the perpetuation of poverty and elites classes.

<sup>41</sup> In the United States the direct lending program has provided forms of loans (such as those that make annual repayments contingent on the individual's income) that the private sector has not, and it appears as if their overall lending costs are lower than those of the private sector. Again, a variety of institutional arrangements can be devised. One that leaves the lending activity in the private sector entails auctioning off the right to make the loans. This ensures that the premiums paid to private firms are not excessive.

<sup>42</sup> We have touched upon only one aspect of the public-private partnership in education. In several countries there is a debate about the role of the private versus the public sector in production. The debate typically involves issues that extend beyond efficiency. Advocates of private production argue that competition will enhance efficiency. Critics argue that education differs from conventional commodities in numerous ways, which make the standard competitive model inappropriate (e.g. consumers are ill-informed about what they are buying, decisions are made not by consumers, but by their parents; in any locale, there are typically only a limited number of schools, so that competition is at best limited). Private systems may result in more social stratification, with adverse long-run implications for the economy. In developing economies the criticisms of public education often seem to have considerable force, yet the imperfections of competition in the education market raise more fundamental problems about the competitive market alternative.

Capital markets do not always provide for finance and risk allocation for investment projects that are risky and that have long time horizons. Governments may be able to help private markets develop by providing appropriate protection or insurance, or facilitating the creation of bond or equity markets. Other alternatives are development banks. (For further discussion see chapter 10 in this volume.)

There are many technological knowledge-based activities for which advance involves investment, but where not all the benefits from the knowledge produced come only to the investors (others share in the benefits). These are areas of spillovers or positive externalities. The government can help in part by providing for intellectual property rights. On the other hand such institutions have their costs not only in administration, but more fundamentally in that they restrict access to knowledge, the dissemination of which has low (or zero) cost after it has been produced. In these circumstances there are arguments for government subsidisation of, or direct involvement in, research and development activities. These are essentially arguments why, to use a popular phrasing, production of computer chips does indeed merit more government support than the production of potato chips.

*Changing strategies.* For the most part in this chapter we have been describing the content of government strategies for economic development in a market economy. We have not, however, focused on the process of transition or adjustment from one type of strategy to another. To some extent this issue of transition can be embodied in the kind of strategy that we have been describing. Appropriate private-public combinations, as outlined above, are indeed oriented to investment, growth and improving the standard of living in a dynamic economy. On the other hand, as the importance of market-oriented strategies becomes more widely understood, some countries face the problem of switching away from a strategy that gave the market less emphasis. Indeed, many countries are faced with the industrial and institutional legacy of a system that attached great importance to government control of the details of economic activity, whether through public ownership or strong restrictions on private activity (including biases against trade). The task of changing from one system to another is formidable.<sup>43</sup>

In this process of change competition, hard budget constraints and economic macrostability will be crucial in promoting and setting the right context and incentives. These can be achieved fairly quickly. Institution building will, however, take longer and will require close attention. The length and depth of the tasks involved mean that this process cannot be delayed – nor will it happen quickly or automatically. Building legal structures and institutions, financial institutions and restructuring industries takes time. Furthermore, the state will have to play an active role in its own redesign.

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<sup>43</sup> One of the challenges of any change is that it affects different groups differently. Those who oppose change will always point to those who are adversely affected. Even though the gains to the winners are far greater than the losses to the losers, the losers will put up effective resistance. They may even resist when they are compensated for their losses. Compensation will typically only be for short-term losses and they worry that the compensation will eventually wither away, leaving them worse off. Societies that allow small, well organised groups who lose from particular changes to have sway inevitably wind up with institutional ossification. It is too glib to say that "a rising tide lifts all boats". We know that that is not necessarily true. Policies have to take into account those who are adversely affected. Still, an exclusive focus on equity as interpreted by the losers (which in many cases simply means preserving rents for those who currently enjoy them, e.g. from controlling a government monopoly) will in the long run result in everyone being worse off.

The investments in structural adjustment or transition will look less attractive if real interest rates are high. Hence the current era of high real interest rates makes these problems more onerous. This underlines the importance of raising world savings and limiting uncertainties so that real interest rates can be reduced.

When we recognise, however, the difficulty of changing institutions, once put into place, we also understand the importance of getting things right as we go through the adjustment process. We cannot blithely say, "this institutional arrangement will do for now, we will fine-tune it later". Property rights and special interests are quickly established, and even temporary arrangements have a way of maintaining themselves. Thus it may be far easier to break up a government monopoly before privatisation than to privatise a monopoly and, after anti-trust laws are passed, attempt to implement them to stop restrictive practices.

## CONCLUSIONS

Over the last two to three decades there have been major changes in views about the development process, the role of government in general and the role of planning in particular. There is confidence that development is possible. While markets are at the centre of most successful development, government has played a vital role. It is recognised that the role of government should be, and has been, far more circumscribed than envisaged in the command and control approaches in the early planning literature. We have a better understanding of the limitations – both on resources and on control – facing governments and of the myriad indirect ways in which government actions can affect economic activity.

In thinking about development strategies, it may be useful to visualise the similarities and differences between national strategies and corporate strategies. In both cases one can think of three pieces to the strategy: the setting and clarification of objectives; the formulation of organisational design; and the identification of the substantive agenda. A sensible strategy must, of course, be one that can be implemented. We have argued for seeing the objectives of development strategies in terms of raising living standards (not just increasing GDP), taking into account impacts on the environment, education, health, opportunity (in a broad sense) and political rights. At the same time, we recognise that the objectives of a nation and of a corporation are very different. The democratic process can elect governments to govern, but this does not imply consensus on, or clarity of, objectives. Some governments may see part of their job as building consensus and a sense of shared values, but one should not expect these values to have a coherence that might be seen in the corporation.

The old planning models were essentially models of optimisation under full information, certainty and control. The models became more sophisticated when indirect control was introduced through prices, taxes and rewards as principal-agent models embodying incentive compatibility. However, a still different kind of model sees government and private individuals as players in a dynamic game in which rules are to be set and argued over, and government is composed of individuals and groups with their own agenda. In our view the analysis of the role of the state should be enriched by both the principal-agent and the game-theoretic approaches. Institutional design is not merely a matter of optimisation, but of building on existing foundations and finding institutions that work fairly well under a variety of circumstances. Development strategies then have to be

based on a broad interpretation of objectives, where they come from and the institutions through which, and with which, they have to work.

A central element in institutional or organisational design is to view the various participants/institutions within the economy as forming a partnership. Development strategies focus on the assignment of roles within that partnership, and on establishing the institutional infrastructure that affects each of the participants in the economy (through impacts on incentives, information flows and transaction costs). This institutional infrastructure embraces not only the basic legal structure (which defines property rights, including those pertaining to intellectual property, contract, bankruptcy and liability law), but also ensures competitive markets and the safety and soundness of the financial system. The government must establish a partnership framework that ensures the provision of physical infrastructure (and protects consumers against abuses of monopoly power associated with control of the infrastructure), education and health.

The organisational approach suggested here as part of a development strategy differs markedly from that associated with Gosplan, the central planning agency of the former Soviet Union and from that of a standard firm planning its activities. It is crucial to recognise that "central headquarters" can (fortunately) exercise only limited control over participants in the economy, especially within democratic societies – and that it has only limited information about the actions of participants. The institutions established as part of the development strategy do affect behaviour, but they do not control directly the actions of participants in the economy. The government plays a role not only in helping create institutions and the institutional infrastructure that allows them to operate (e.g. prudential regulation of banking, securities and exchange commissions for bond and stock markets), but also in establishing pay-offs in ways that are conducive to cooperative actions that are in the national interest.<sup>44</sup> Given uncertainty and limited information, it is important to underline the role of robustness in the sense of finding arrangements that will work fairly well across a range of circumstances.

The final aspect of a development strategy is its substance: the decisions about which sectors to encourage or discourage; whether and how to spend more on primary or secondary education, basic research or improvements in technology. Here again, there are similarities and differences between the formulation of corporate and national strategies. Corporate strategies typically begin by identifying the resources and special features of the enterprise, focusing on areas in which those resources can yield a (dynamic) comparative advantage, and looking for niches - areas in which corporate rents will not be eroded quickly as a result of competitive entry. National strategies, too, can begin by identifying underlying special resources. They, too, look at the dynamics: both areas in which competence can be developed and in which comparative strengths can be maintained over extended periods of time.

However, national strategies focus on the particular role of government relative to what markets will do on their own. They thus focus particularly on market failures, areas in which there are large spillovers or limitations posed by capital market imperfections. And they focus especially on the role of the government in providing the conditions for markets to flourish – not only on the institutional infrastructure, but the macroeconomic

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<sup>44</sup> One of the insights of some of the recent literature in this area is to establish that such government interventions may even be incentive compatible from the perspective of government, that is, it pays for government to follow through on its promises, even when it is not compelled to do so.

stability, which is so essential for long-run economic performance. Competition and openness are crucial to technological advance, which is itself crucial for economic growth. Thus a national strategy differs fundamentally from a corporate strategy in that the central concern of government is, or should be, to allow other parties to benefit from its actions, whereas that of the corporation is to focus on its self-interest. Of course, in looking at the problem in this way we do not assume a benign, all-knowing government. A development strategy should take account of what can be expected of government in terms of behaviour, competence and knowledge.

This leads us directly to implementation – a strategy that does not take account of issues of implementation cannot be a good one. Ability to implement will depend on the dynamic consistency of the strategy itself. If there are clear incentives to renege on commitments they will not be believed. Procedures, institutions and instruments should be sufficiently simple to match the degree of competence of the participants, be they public or private. They should not assign levels of trust to public servants that are unrealistic. At this stage we can only underline the importance of implementation issues and cannot go into them in any further detail, except to note the following. The implementation of a development strategy (at least as conceived here) reflects organisational decisions *within* the public sector. Part of the development strategy must be a strategy to reorganise the public sector in ways which make it more likely that it will be able to execute the development plan. As noted, this requires that the plan exhibit incentive compatibility (it is in the *interests* of those charged with implementing the plan to do so) and dynamic consistency (as time unfolds, it is in the interests of those charged with implementing the plan to carry through on what they had promised or originally planned to do). We know a lot about policies that enhance the likelihood of success in implementation. These include: repeatedly checking, and rewarding, performance, competence and probity; paying “efficiency wages”, i.e. not pushing wages down to levels where energy and commitment are lost; ex post as well as ex ante evaluations of costs and benefits of projects; and a variety of policies designed to reduce the likelihood of corruption of public officials.

We recognise that consensus on the appropriate role of the state and on government strategy for economic development is unlikely to appear. Fairly universal agreement is probably likely only on the need for: defence/law and order; the basics of institutional infrastructure for markets and contracts; and macrostability. However, the arguments presented here go well beyond the ‘night-watchman state’. The market itself cannot deliver broad-based improvements in the standard of living without an active state which establishes the right conditions, responds to change, and which together with the market, provides for the delivery of health, education, infrastructure and social protection, which the market cannot provide by itself. The way in which the role of the state is defined, and in which its services are delivered, is probably the most important determinant of the standard of living of the community over the long term.

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