Overview

Consider two South African children born on the same day in 2000. Nthabiseng is black, born to a poor family in a rural area in the Eastern Cape province, about 700 kilometers from Cape Town. Her mother had no formal schooling. Pieter is white, born to a wealthy family in Cape Town. His mother completed a college education at the nearby prestigious Stellenbosch University.

On the day of their birth, Nthabiseng and Pieter could hardly be held responsible for their family circumstances: their race, their parents' income and education, their urban or rural location, or indeed their sex. Yet statistics suggest that those predetermined background variables will make a major difference for the lives they lead. Nthabiseng has a 7.2 percent chance of dying in the first year of her life, more than twice Pieter's 3 percent. Pieter can look forward to 68 years of life, Nthabiseng to 50. Pieter can expect to complete 12 years of formal schooling, Nthabiseng less than 1 year.[1] Nthabiseng is likely to be considerably poorer than Pieter throughout her life.[2] Growing up, she is less likely to have access to clean water and sanitation, or to good schools. So the opportunities these two children face to reach their full human potential are vastly different from the outset, through no fault of their own.

Such disparities in opportunity translate into different abilities to contribute to South Africa's development. Nthabiseng's health at birth may have been poorer, owing to the poorer nutrition of her mother during her pregnancy. By virtue of their gender socialization, their geographic location, and their access to schools, Pieter is much more likely to acquire an education that will enable him to put his innate talents to full use. Even if at age 25, and despite the odds, Nthabiseng manages to come up with a great business idea (such as an innovation to increase agricultural production), she would find it much harder to persuade a bank to lend her money at a reasonable interest rate. Pieter, having a similarly bright idea (say, on how to design an improved version of promising software), would likely find it easier to obtain credit, with both a college diploma and quite possibly some collateral. With the transition to democracy in South Africa, Nthabiseng is able to vote and thus indirectly shape the policy of her government, something denied to blacks under apartheid. But the legacy of apartheid's unequal opportunities and political power will remain for some time to come. It is a long road from such a (fundamental) political change to changes in economic and social conditions.

As striking as the differences in life chances are between Pieter and Nthabiseng in South Africa, they are dwarfed by the disparities between average South Africans and citizens of more developed countries. Consider the cards dealt to Sven—born on that same day to an average Swedish household. His chances of dying in the first year of life are very small (0.3 percent) and he can expect to live to the age of 80, 12 years longer than Pieter, and 30 years more than Nthabiseng. He is likely to complete 11.4 years of schooling—5 years more than the average South African. These differences in the quantity of schooling are compounded by differences in quality: in the eighth grade, Sven can expect to obtain a score of 500 on an internationally comparable math test, while the average South African student will get a score of only 264—more than two standard deviations below the Organisation for Economic Co-operation and Development (OECD) median.

Nthabiseng most likely will never reach that grade and so will not take the test.[3]

These differences in life chances across nationality, race, gender, and social groups will strike many readers as fundamentally unfair. They are also likely to lead to wasted human potential and thus to missed development opportunities. That is why World Development Report 2006 analyzes the relationship between equity and development.

By equity we mean that individuals should have equal opportunities to pursue a life of their choosing and be spared from extreme deprivation in outcomes. The main message is that equity is complementary, in some fundamental respects, to the pursuit of long-term prosperity. Institutions and policies that promote a level playing field—where all members of society have similar chances to become socially active, politically influential, and economically productive—contribute to sustainable growth and development. Greater equity is thus doubly good for poverty reduction: through potential beneficial effects on aggregate long-run development and through greater opportunities for poorer groups within any society.

The complementarities between equity and prosperity arise for two broad sets of reasons. First, there are many market failures in developing countries, notably in the markets for credit, insurance, land, and human capital. As a result, resources may not flow where returns are highest. For example, some highly capable children, like Nthabiseng, may fail to complete primary schooling, while others, who are less able, may finish university. Farmers may work harder on plots they own than on those they sharecrop. Some efficient developing-country producers of agricultural commodities and textiles are shut out of some OECD markets, and poor unskilled workers have highly restricted opportunities to migrate to work in richer countries.

When markets are missing or imperfect, the distributions of wealth and power affect the allocation of investment opportunities. Correcting the market failures is the ideal response; where this is not feasible, or far too costly, some forms of redistribution—of access to services, assets, or political influence—can increase economic efficiency.

The second set of reasons why equity and long-term prosperity can be complementary arises from the fact that high levels of economic and political inequality tend to lead to economic institutions and social arrangements that systematically favor the interests of those with more influence. Such inequitable institutions can generate economic costs. When personal and property rights are enforced only selectively, when budgetary allocations benefit mainly the politically influential, and when the distribution of public services favors the wealthy, both middle and poorer groups end up with unexploited talent. Society, as a whole, is then likely to be more inefficient and to miss out on opportunities for innovation and investment. At the global level, when developing countries have little or no voice in global governance, the rules can be inappropriate and costly for poorer countries.

These adverse effects of unequal opportunities and political power on development are all the more damaging because economic, political, and social inequalities tend to reproduce themselves over time and across generations. We call such phenomena "inequality traps." Disadvantaged children from families at the bottom of the wealth distribution do not have the same opportunities as children from wealthier families to receive quality education. So these disadvantaged children can expect to earn less as adults. Because the poor have less voice in the political process, they—like their parents—will be less able to influence spending decisions to improve public schools for their children. And the cycle of underachievement continues.

The distribution of wealth is closely correlated with social distinctions that stratify people, communities, and nations into groups that dominate and those that are dominated. These patterns of domination persist because economic and social differences are reinforced by the overt and covert use of power. Elites protect their interests in subtle ways, by exclusionary practices in marriage and kinship systems, for instance, and in ways that are less subtle, such as aggressive political manipulation or the explicit use of violence.

Such overlapping political, social, cultural, and economic inequalities stifle mobility. They are hard to break because they are so

closely tied to the ordinary business of life. They are perpetuated by the elite, and often internalized by the marginalized or oppressed groups, making it difficult for the poor to find their way out of poverty. Inequality traps can thus be rather stable, tending to persist over generations.

The report documents the persistence of these inequality traps by highlighting the interaction between different forms of inequality. It presents evidence that the inequality of opportunity that arises is wasteful and inimical to sustainable development and poverty reduction. It also derives policy implications that center on the broad concept of leveling the playing field—both politically and economically and in the domestic and the global arenas. If the opportunities faced by children like Nthabiseng are so much more limited than those faced by children like Pieter or Sven, and if this hurts development progress in the aggregate, then public action has a legitimate role in seeking to broaden the opportunities of those who face the most limited choices.

Three considerations are important at the outset. First, while more even playing fields are likely to lead to lower observed inequalities in educational attainment, health status, and incomes, the policy aim is not equality in outcomes. Indeed, even with genuine equality of opportunities, one would always expect to observe some differences in outcomes owing to differences in preferences, talents, effort, and luck.[4] This is consistent with the important role of income differences in providing incentives to invest in education and physical capital, to work, and to take risks. Of course outcomes matter, but we are concerned with them mainly for their influence on absolute deprivation and their role in shaping opportunities.

Second, a concern with equality of opportunity implies that public action should focus on the distributions of assets, economic opportunities, and political voice, rather than directly on inequality in incomes. Policies can contribute to the move from an "inequality trap" to a virtuous circle of equity and growth by leveling the playing field—through greater investment in the human resources of the poorest; greater and more equal access to public services and information; guarantees on property rights for all; and greater fairness in markets. But policies to level the economic playing field face big challenges. There is unequal capacity to influence the policy agenda: the interests of the disenfranchised may never be voiced or represented. And when policies challenge privileges, powerful groups may seek to block reforms. Thus, equitable policies are more likely to be successful when leveling the economic playing field is accompanied by similar efforts to level the domestic political playing field and introduce greater fairness in global governance.

Third, there may be various short-run, policy-level tradeoffs between equity and efficiency. These are well recognized and extensively documented. The point is that the (often implicit) cost-benefit calculus that policymakers use to assess the merits of various policies too often ignores the long-term, hard-to-measure but real benefits of greater equity. Greater equity implies more efficient economic functioning, reduced conflict, greater trust, and better institutions, with dynamic benefits for investment and growth. To the extent that such benefits are ignored, policymakers may end up choosing too little equity.

By the same token, however, those interested in greater equity must not ignore the short-term tradeoffs. If individual incentives are blunted by income redistribution schemes that tax investment and production too steeply, the result will be less innovation, less investment, and less growth. The history of the twentieth century is littered with examples of ill-designed policies pursued in the name of equity that seriously harmed—rather than spurred—growth processes by ignoring individual incentives. A balance must be sought, taking into account both the immediate costs to individual incentives and the long-term benefits of cohesive societies, with inclusive institutions and broad opportunities.

While careful assessment of policy design in local contexts is always important, equity considerations need to be brought squarely into the center of both diagnosis and policy. This is not intended as a new framework. It means integrating and extending existing frameworks: equity is central both to the

investment environment and to the agenda of empowerment, working through the impact on institutions and specific policy designs. Some may value equity for its own sake, others primarily for its instrumental role in reducing absolute poverty, the World Bank's mission.

This report recognizes the intrinsic value of equity but aims primarily to document how a focus on equity matters for long-run development. It has three parts.

- Part I considers the evidence on inequality of opportunity, within and across countries. Some attempts to quantify inequality of opportunity are reviewed but, more generally, we rely on evidence of highly unequal outcomes across groups defined by predetermined circumstances—such as gender, race, family background, or country of birth—as markers for unequal opportunities.
- Part II asks why equity matters. It discusses the two channels of impact (the effects of unequal opportunities when markets are imperfect, and the consequences of inequity for the quality of institutions a society develops) as well as intrinsic motives.
- Part III asks how public action can level the political and economic playing fields. In the domestic arena, it makes the case for investing in people, expanding access to justice, land, and infrastructure, and promoting fairness in markets. In the international arena, it considers leveling the playing field in the functioning of global markets and the rules that govern them—and the complementary provision of aid to help poor countries and poor people build greater endowments.

The remainder of this overview provides a summary of the principal findings.

Inequity within and across nations

From an equity perspective, the distribution of opportunities matters more than the distribution of outcomes. But opportunities, which are potentials rather than actuals, are harder to observe and measure than outcomes.

Within-country inequities have many dimensions

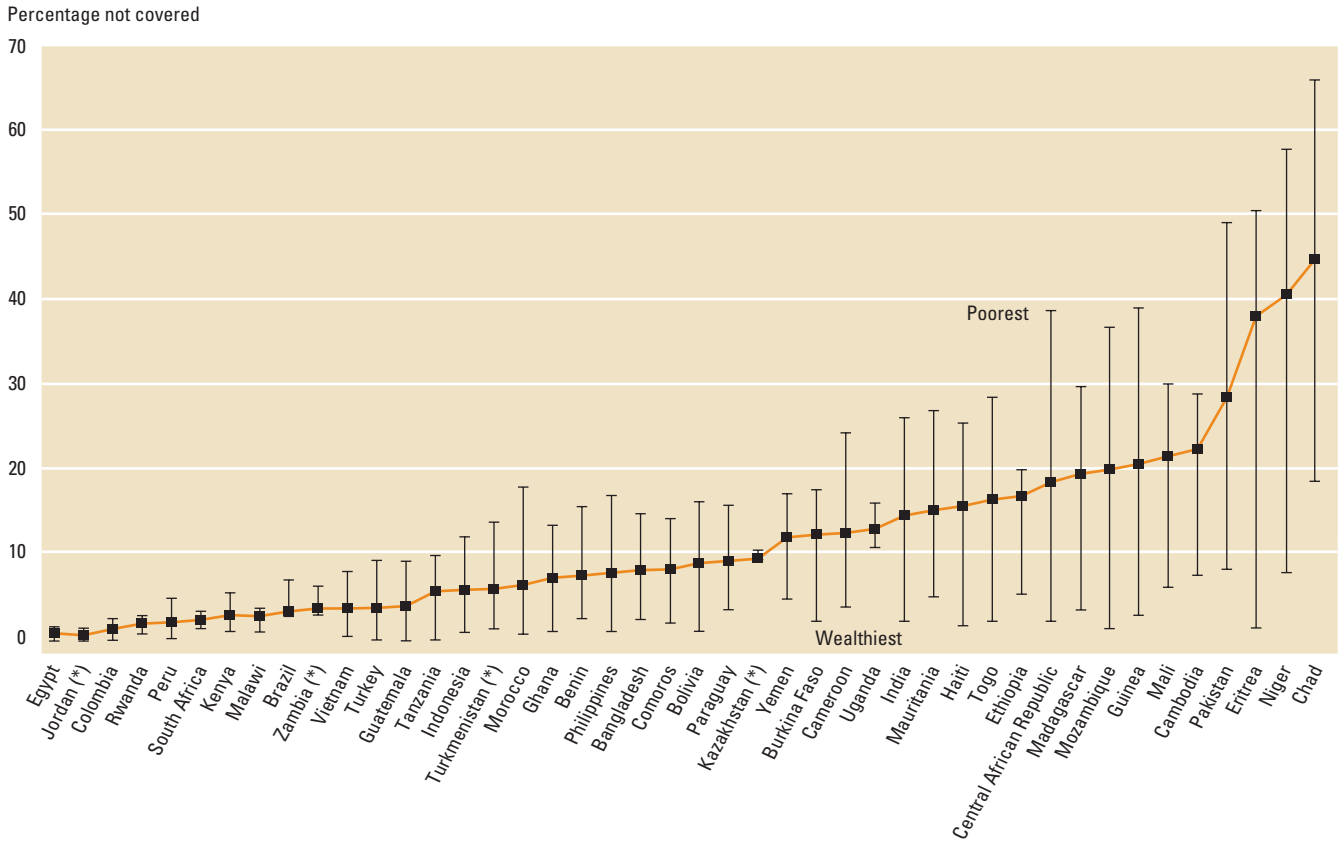
Direct quantification of inequality of opportunity is difficult, but one analysis of Brazil provides an illustration (chapter 2). Earnings inequality in 1996 was divided into one share attributable to four predetermined circumstances that lie beyond the control of individuals—race, region of birth, parental education, and paternal occupation at birth—and a residual share. These four circumstances account for around one-quarter of overall differences in earnings between workers. Arguably, other determinants of opportunity are equally predetermined at birth but not included in this set—for example, gender, family wealth, or the quality of primary schools. Because such variables are not included in the inequality "decomposition," the results here can be seen as lower-bound estimates of inequality of opportunity in Brazil.

Unfortunately, predetermined (and thus morally irrelevant) circumstances determine much more than just future earnings. Education and health are of intrinsic value and affect the capacity of individuals to engage in economic, social, and political life. Yet children face substantially different opportunities to learn and to lead healthy lives in almost all populations, depending on asset ownership, geographic location, or parental education, among others. Consider how access to a basic package of immunization services differs for the rich and the poor across countries (figure 1).

There is substantial inequality in access between, for example, Egypt, where almost everyone is covered (on the left), and Chad, where more than 40 percent of children are excluded (on the right). Yet the disparities can be as large within some countries as they are across all nations in the sample. In Eritrea, for instance, the richest fifth enjoys almost complete coverage, but almost half of all children in the poorest fifth are excluded.

Significant gender differences also persist in many parts of the world. In parts of East and South Asia, notably in certain areas in rural China and northwest India, the opportunity to life itself can depend on one single predetermined characteristic: sex. These regions have significantly more boy

Figure 1 Wealth matters for the immunization of children



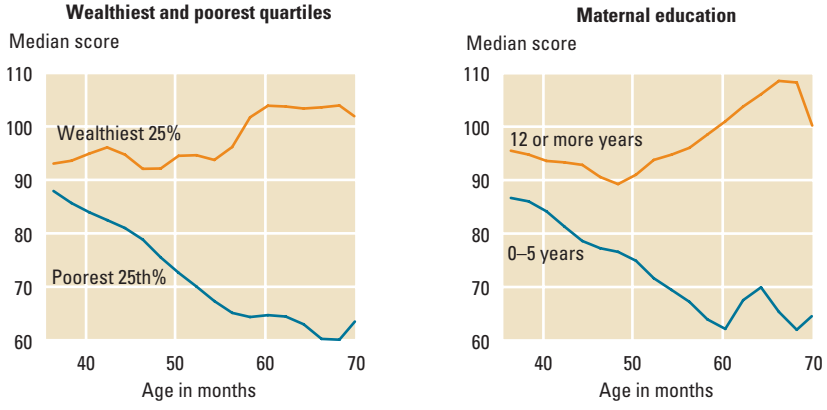
Source: Authors' own calculations from Demographic Health Survey (DHS) data
Note: * indicates that the poorest quintile have higher access to childhood immunization services than the wealthiest quintile.
The continuous orange line represents the overall percentage of children without access to a basic immunization package in each country, while the endpoints indicate the percentages for the top and the bottom quintile of the asset ownership distribution.

infants than girls, in part because of sex-selective abortion and differential care after birth. And in many (though not all) parts of the world, more boys than girls attend school. The hundreds of millions of disabled children across the developing world also face very different opportunities than their able-bodied peers.

These inequities are usually associated with differences in an individual's "agency"—the socioeconomically, culturally, and politically determined ability to shape the world around oneself. Such differences create biases in the institutions and rules in favor of more powerful and privileged groups. This is seen in realities as diverse as the low chances for mobility of scheduled castes in a village in rural India and the frequent episodes of discrimination against the Quichua people in Ecuador. Persistent differences in power and status between groups can become internalized into behaviors, aspirations, and preferences that also perpetuate inequalities.

Inequalities of opportunity are also transmitted across generations. The children of poorer and lower-status parents face inferior chances in education, health, incomes, and status. This starts early. In Ecuador, three-year-old children from all socioeconomic groups have similar test scores for vocabulary recognition and are close to a standard international reference population. But by the time they are five, all have faltered relative to the international reference group, except for those in the richest groups and with the highest levels of parental education (figure 2). Such pronounced differences in vocabulary recognition between children whose parents had 0 to 5 years of schooling and those whose parents had 12 or more years are likely to

Figure 2 Opportunities are determined early
Cognitive development for children ages three to five in Ecuador differs markedly across family backgrounds



Source: Paxson and Schady (2005).
Note: Median values of the test of vocabulary recognition (TVIP) score (a measure of vocabulary recognition in Spanish, standardized against an international norm) are plotted against the child's age in months. The medians by exact month of age were smoothed by estimating fan regressions of the median score on age (in months), using a bandwidth of 3.

carry over to their performance once they enter primary school, and will likely persist thereafter. Intergenerational immobility is also observed in rich countries: new evidence from the United States (where the myth of equal opportunity is strong) finds high levels of persistence of socioeconomic status across generations: recent estimates suggest that it would take five generations for a family that earned half the national average income to reach the average.[5] Immobility is particularly pronounced for low-income African Americans.

Global inequities are massive

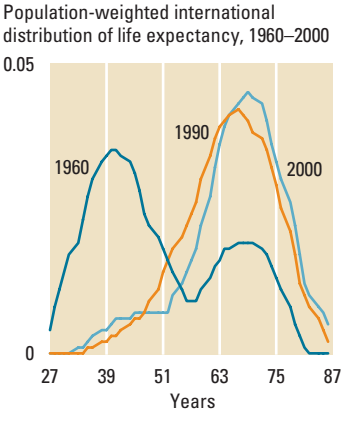
If unequal opportunities are large within many countries, they are truly staggering on a global scale. Chapter 3 shows that cross-country differences begin with the opportunity for life itself: while 7 of every 1,000 American babies die in the first year of their lives, 126 of every 1,000 Malian babies do. Babies who survive, not only in Mali but in much of Africa and in the poorer countries of Asia and Latin America, are at much greater nutritional risk than their counterparts in rich countries. And if they go to school—more than 400 million adults in developing countries never did—their schools are substantially worse than those attended by children in Europe, Japan, or the United States. Given lower school quality, undernutrition, and the earnings a child can generate by working instead of studying, many children leave school early. The average person born between 1975 and 1979 in Sub-Saharan Africa has only 5.4 years of schooling. In South Asia, the figure rises to 6.3 years; in OECD countries, it is 13.4 years.

With such differences in education and health, compounded by large disparities in access to infrastructure and other public services, it is not surprising that opportunities for the consumption of private goods differ vastly between rich and poor countries. Mean annual consumption expenditures range from Purchasing Power Parity (PPP) $279 in Nigeria to PPP $17,232 in Luxembourg. This means that the average citizen in Luxembourg enjoys monetary resources 62 times higher than the average Nigerian. While the average Nigerian may find it difficult to afford adequately nutritious meals every day, the average citizen of Luxembourg need not worry too much about buying the latest generation cell phone on the market. Because of the much greater restrictions on the movement of people between countries than within countries, these inequalities in outcomes among countries are likely to be much more closely associated with inequalities in opportunities than within countries.

Global inequality trends have varied. Between 1960 and 1980 there was a pronounced decline in the inequality in life expectancy across countries, driven by major increases in the poorest countries in the world (figure 3). This welcome development was due to the global spread of health technology and to major public health efforts in some of the world's highest mortality areas. Since 1990, however, HIV/AIDS (predominantly in many African countries) and a rise in mortality rates in transition economies (largely in Eastern Europe and Central Asia) have set back some of the earlier gains. Because of the AIDS crisis, life expectancy at birth has fallen dramatically in some of the world's poorest countries, sharply increasing the differences between them and richer societies.

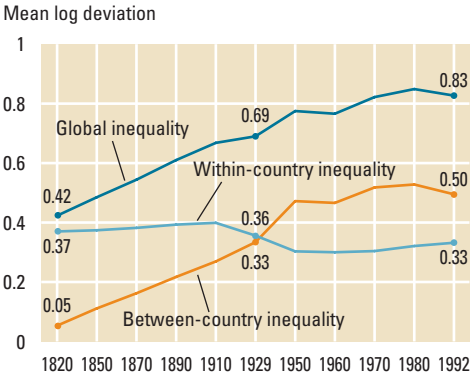
Inequality in access to schooling has also been falling around the world, within most

Figure 3 Life expectancy improved and became more equal—until the onset of the AIDS crisis



Source: Schady (2005).

Figure 4 A long-run diverging trend in income inequality begins to reverse because of growth in China and India



Source: Authors' manipulation of data from Bourguignon and Morrisson (2002).

countries as well as across them, as average schooling levels rise in the vast majority of countries. This too is a welcome development, although concerns over the quality of schooling provide reasons for guarding against complacency.

While our primary concern is with inequality of opportunities, the large differences in income or consumption across countries surely affect the life chances faced by children born today in those different nations. Trends in life expectancy at birth and years of schooling were converging, at least until 1990, but a different picture emerges for income and consumption. While the recent trends depend greatly on the specific concept chosen (discussed in great detail in chapter 3), global income inequality has steadily increased over the long run until the onset of rapid economic growth in China and India in the 1980s (figure 4).

It is possible to decompose total inequality across individuals in the world into differences among countries and differences within countries. Between-country differences were relatively small early in the nineteenth century, but they came to account for a larger part of total inequality toward the end of the twentieth century. If China and India are excluded, global inequalities have continued to rise, owing to the continuing divergence between most other low-income countries and rich countries.

Why does equity matter for development?

Why do these persistent inequalities—both within and across countries—matter? The first reason is that the interconnections and resilience of these inequalities imply that some groups have consistently inferior opportunities—economic, social, and political—than their fellow citizens. Most people feel that such egregious disparities violate a sense of fairness, particularly when the individuals affected can do little about them (chapter 4). This is consistent with the teachings of much political philosophy and with the international system of human rights. The core moral and ethical teachings of the world's leading religions include a concern for equity, although many have also been sources of inequities and historically have been linked to unequal power structures. There is also experimental evidence suggesting that many—but not all—people behave in ways consistent with a concern for fairness, in addition to caring about how they fare individually.

Important as these intrinsic reasons are for caring about inequality of opportunities and unfair processes, the primary focus of this report is on the instrumental relationship between equity and development, with particular emphasis on two channels: the effects of unequal opportunities when markets are imperfect, and the consequences of inequity for the quality of institutions a society develops.[6]

With imperfect markets, inequalities in power and wealth translate into unequal opportunities, leading to wasted productive potential and to an inefficient allocation of resources. Markets often work imperfectly in many countries, whether because of intrinsic failures—such as those associated with asymmetric information—or because of policy-imposed distortions. Microeconomic case studies suggest that an inefficient allocation of resources across productive alternatives is often associated with differences in wealth or status (chapter 5).

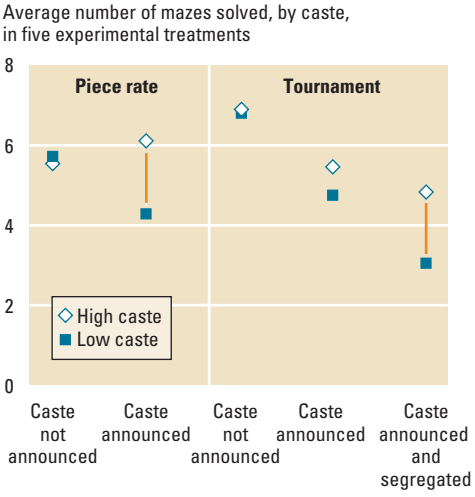
If capital markets worked perfectly, there would be no relation between investment

and the distribution of wealth: anyone with a profitable investment opportunity would be able to either borrow money to finance it, or to sell equity in a firm set up to undertake it. But capital markets in just about every country (developed and developing) are very far from perfect: credit is rationed across prospective clients, and interest rates differ considerably across borrowers, and between lenders and borrowers, in ways that cannot be linked to default risk or other economic factors affecting expected returns to lenders. For example, interest rates decline with loan size in Kerala and Tamil Nadu in India, and across trading groups in Kenya and Zimbabwe, in ways not explained by risk differences.[7] In Mexico, returns to capital are much higher for the smallest informal sector firms than for larger ones.

Land markets also have imperfections associated with a lack of clear titling, histories of concentrated land ownership, and imperfect rental markets. In Ghana, lower security of tenure among women leads to an inefficiently low frequency of land fallowing and, hence, to progressive declines in land productivity.

The market for human capital is also imperfect, because parents make decisions on behalf of their children and because the expected returns to investment are influenced by location, contacts, and discrimination—on grounds of gender, caste, religion, or race. Discrimination and stereotyping—mechanisms for the reproduction of inequality between groups—have been found to lower the self-esteem, effort, and performance of individuals in the groups discriminated against. This reduces their potential for individual growth and their ability to contribute to the economy.

Figure 5 Children's performance differs when their caste is made salient



Source: Hoff and Pandey (2004).
Note: The figure depicts the number of mazes correctly completed by low-caste and high-caste children from a set of Indian villages in a number of different experiments. The difference between the first two and the last three columns refers to payouts: whether children are paid per correct maze completed (piece rate) or only if they complete the most mazes (tournament).

Striking evidence of the impact of stereotyping on performance comes from a recent experiment in India. Children from different castes were asked to complete simple exercises, such as solving a maze, with real monetary incentives contingent on performance. The key result of the experiment is that low-caste children perform on par with high-caste children when their caste is not publicly announced by the experimenter but significantly worse when it is made public (figure 5). If a similar inhibition of talent occurs in the real world, this implies a loss of potential output owing to social stereotyping.

Economic and political inequalities are associated with impaired institutional development. The second channel through which inequity affects long-run processes of development is the shaping of economic and political institutions (chapter 6). Institutions determine the incentives and constraints people face and provide the context in which markets function. Different sets of institutions are the outcome of complex historical processes that reflect the interests and structure of political influence of different individuals and groups in a society. From this perspective, market imperfections may arise not by accident but because they distribute income or power in particular ways. In this view, there will be social conflict over the institutions of society and incentives for people who control power to shape institutions in ways that benefit them.

The central argument here is that unequal power leads to the formation of institutions that perpetuate inequalities in power, status, and wealth—and that typi-

cally are also bad for the investment, innovation, and risk-taking that underpin long-term growth. Good economic institutions are equitable in a fundamental way: to prosper, a society must create incentives for the vast majority of the population to invest and innovate. But such an equitable set of economic institutions can emerge only when the distribution of power is not highly unequal and in situations in which there are constraints on the exercise of power by officeholders. Basic patterns in cross-country data and historical narratives support the view that countries moving onto institutional paths that promoted sustained prosperity did so because the balance of political influence and power became more equitable.

One example comes from a comparison of the early institutions and of the long-term development paths of European colonies in North and South America. The abundance of unskilled labor prevalent in the South American colonies—where either native Americans or imported African slaves were available in large numbers—combined with the technology of mining and large plantation agriculture to provide the economic base for hierarchical and extractive societies, in which land ownership and political power were highly concentrated. In North America, by contrast, similar attempts to introduce hierarchical structures were foiled by the scarcity of labor—except where agro-climatic conditions made slavery economically feasible, such as in the southern region of the United States. Competition for free labor in the northern areas of North America led to the development of less unequal land ownership patterns, a faster expansion of the franchise, and rapid increases in literacy and basic education. The resulting economic and political institutions persisted over time, with positive consequences for long-run economic development.

Leveling the economic and political playing fields

So a portion of the economic and political inequalities we observe around the world is attributable to unequal opportunities. This inequality is objectionable on both intrinsic and instrumental grounds. It contributes to economic inefficiency, political conflict, and institutional frailty. What are the implications for policy, and do they give rise to an agenda that is different from the poverty reduction agenda already embraced by the World Bank, other multilateral institutions, and many governments?

We argue that an equity lens enhances the poverty reduction agenda. The poor generally have less voice, less income, and less access to services than most other people. When societies become more equitable in ways that lead to greater opportunities for all, the poor stand to benefit from a "double dividend." First, expanded opportunities benefit the poor directly, through greater participation in the development process. Second, the development process itself may become more successful and resilient as greater equity leads to better institutions, more effective conflict management, and a better use of all potential resources in society, including those of the poor. Resulting increases in economic growth rates in poor countries will, in turn, contribute to a reduction in global inequities.

One manifestation of the greater participation of the poor in economic growth is the fact that the growth elasticity of poverty reduction falls with greater income inequality. In other words, the impact of (the same amount of) growth on poverty reduction is significantly greater when initial income inequality is lower. On average, for countries with low levels of income inequality, a 1 percentage point growth in mean incomes leads to about a 4 percentage-point reduction in the incidence of $1 per day poverty. That power falls to close to zero in countries with high income inequality.[8] Policies that lead to greater equity thus lead to lower poverty—directly through expanding the opportunities of the poor and indirectly through higher levels of sustained development.

An equity lens adds three new—or at least often neglected—perspectives to development policymaking:

- ***First, the best policies for poverty reduction could involve redistributions***

of influence, advantage, or subsidies away from dominant groups. Highly unequally distributed wealth associated with unduly concentrated political power can prevent institutions from enforcing broad-based personal and property rights, and lead to skewed provisioning of services and functioning of markets. This is unlikely to change unless voice and influence, and public resources, shift away from the dominant group toward those with fewer opportunities.[9]

- ***Second, while such equity-enhancing redistributions (of power, or access to government spending and markets) can often be efficiency-increasing, possible tradeoffs need to be assessed in the design of policy.*** At some point, higher tax rates to finance spending on more schools for the poorest will create so much disincentive to effort or investment (depending on how the taxes are raised), that one should stop raising them. When making a policy choice along such tradeoffs, the full value of the benefits from equity enhancement should be considered. If greater spending on schools for lower-caste children means that, over the long term, stereotyping will decline in society, with attendant increases in performance that are additional to the specific gains from greater schooling today, these gains should not be ignored.
- ***Third, the dichotomy between policies for growth and policies specifically aimed at equity is false.*** The distribution of opportunities and the growth process are jointly determined. Policies that affect one will affect the other. This does not mean that each policy needs to take equity into account individually: for example, the best way to deal with inequitable effects of a particular trade reform is not always through fine-tuning trade policy itself (which might make it more susceptible to capture) but through complementary policies for safety nets, labor mobility, and education. The overall package and the fairness of the underlying process are what matter.

The analysis of development experience clearly shows the centrality of overall political conditions—supporting the emphasis on governance and empowerment in recent years. However, it is neither the mandate nor the comparative advantage of the World Bank to engage in advice on issues of political design. In turning to policy implications, we focus instead on the core areas of development policy, while recognizing that policy design needs to take account of the broader social and political context, and that accountability mechanisms influence development effectiveness.

Because economic policies are determined within a sociopolitical reality, *how* policies are designed, introduced, or reformed matters as much as which specific policies are proposed. Policy reforms that result in losses for a particular group will be resisted by that group. If the group is powerful, it will usually subvert the reform. The sustainability of reforms, therefore, may depend on making information about its distributional consequences publicly available and, perhaps, forming coalitions of middle and poorer groups that stand to gain from them to "empower," directly or indirectly, relatively disadvantaged members of society.

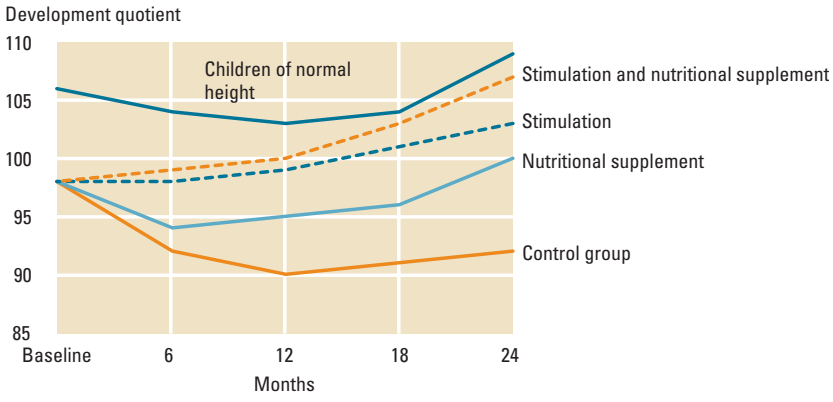
How policies are implemented has a technical aspect as well. Just as we emphasize that the full long-term benefits of redistributions need to be taken into account when making policy choices, so must all their costs. A focus on equity does not change the facts that asset expropriations—even in instances of historical grievances—may have adverse consequences for subsequent investment, that high marginal tax rates create disincentives to work, or that inflationary financing of budget deficits tends to lead to regressive implicit taxation, economic disorganization, and reduced investment and growth. In short, a focus on equity must not be an excuse for poor economic policy.

The report discusses the role of public action in leveling the economic and political playing field under four main headings. Three of the headings concern domestic policies: investing in human capacities; expanding access to justice, land, and infra-

structure; and promoting fairness in markets. The fourth turns to policies for greater global equity, in terms of access to markets, resource flows, and governance.

Throughout the discussion, the report weighs a desire to be specific and practical against the fact that the best specific policy mix is a function of country context. The educational challenges facing Sudan are different from those facing Egypt. The optimal sequencing of reform in the public sectors of Latvia and Bolivia are unlikely to be the same. The capacity for implementing health finance reform in China and Lesotho are also different. So the detailed, specific policy advice always needs to be developed at the country—or even subnational—level. Everything that is said below therefore retains some level of generality and should be interpreted accordingly, and cautiously.

Figure 6 Catching up through early interventions



Source: Grantham-McGregor and others (1991).
Note: The development quotient is an index of progress on four behavioral and cognitive indicators of childhood development. Number of months refers to the time after entry into the program—generally at an age of nine months.

Human capacities

Early childhood development. In many developing countries, the actions of the state in providing services magnify—rather than attenuate—inequalities at birth. A guiding principle is to shape public action so that the acquisition of human capacities is not driven by circumstances of their birth, although it can reflect people's preferences, tastes, and talents.

Because differences in cognitive development start to widen from a very early age (see figure 2), early childhood development initiatives can be central to more equal opportunities. Evidence supports the view that investing in early childhood has large impacts on children's health and readiness to learn and can bring important economic returns later in life—often greater than investments in formal education and training.

An experiment in Jamaica focused on undersized children (ages 9 to 24 months) and found that they suffered from lower levels of cognitive development than those of normal height. Nutritional supplements and a program of regular exposure to mental stimulation, helped offset this disadvantage. After 24 months, kids who received both better nutrition and more stimulation had virtually caught up developmentally with children who started life at a normal height (figure 6). This illustrates how decisive and well-designed public action can substantially reduce the opportunity gaps between those least privileged and the societal norm. Investing in the neediest people early in their childhoods can help level the playing field.

Schooling. The process continues throughout the school system. Actions to equalize opportunities in formal education need to ensure that all children acquire at least a basic level of skills necessary to participate in society and in today's global economy. Even in such middle-income countries as Colombia, Morocco, and the Philippines, most children completing basic education lack an adequate level of achievement, as measured by internationally comparable test scores (chapters 2 and 7).

Access to schooling matters—especially in very poor countries—but, in many countries, it is only a small part of the problem. Greater access needs to be complemented by supply-side policies (to raise quality) and demand-side policies (to correct for the possibility that parents may underinvest in the education of their children for various reasons). There are no magic bullets for this, but increasing teachers' incentives, enhancing the basic quality of the school's physical infrastructure, and researching and implementing teaching methods to increase the learning performance of students who do

not do well when left to their own devices are some of the suggestions on the supply side.

On the demand side, there is now a considerable body of evidence showing that scholarships conditional on attendance have significant impacts. Such transfers work in countries from Bangladesh to Brazil, with the impacts often greater for girls. There are also promising approaches to bring in excluded groups—as in the Vidin model of reaching Roma in Bulgaria—and to bring up those left behind through remedial education—as in the Balsakhi program using young women as para-teachers in 20 cities in India. As argued in World Development Report 2004, developing the accountability of schools and teachers to students, parents, and the broader community can help ensure effective service provider behavior.

Health. Two areas stand out in reducing inequity and tackling economic distortions in the provision of health services. First, there are many cases when the benefits spill over beyond the direct beneficiary in a range of areas of service provision: for immunization, for water and sanitation, and for information on hygiene and child care. Public assurance of provisioning makes sense in these areas. Demand-side subsidies to provide incentives for maternal and child health increase use, offsetting possible information problems as in Mexico's *Oportunidades* program.

Second, insurance markets for catastrophic health problems are beset with failures. (Here "catastrophic" is in relation to the capacity of the household to deal with the direct costs and the loss in earnings.) The traditional supply-side model of relying on public hospitals works badly, especially for poor and excluded groups. What can work better is public provisioning or regulation that provides some insurance for all. Examples include risk pooling in Colombia, health cards in Indonesia and Vietnam, and Thailand's "30-baht" universal coverage scheme. As with education, these interventions need to be combined with incentives for providers to be responsive to all groups.

Risk management. Social protection systems shape opportunities by providing people with a safety net. In addition to ill health, macroeconomic crises, industrial restructuring, weather, and natural disasters can constrain investment and innovation. The poor, with the lowest capacity to manage shocks, generally are the least well covered by risk-management structures, although in most countries many among the non-poor risk falling into poverty. Broader social protection systems can help prevent today's inequalities—sometimes generated by bad luck—from becoming entrenched and leading to tomorrow's inequities. Just as safety nets can spur households to engage in riskier activities that can yield higher returns, they can also help complement reforms that produce losers.

Safety nets typically target three groups: the working poor, people viewed as unable to work or for whom work is undesirable, and special vulnerable groups. If safety nets are designed in a manner appropriate to the local realities on the ground in each country, individual targeted interventions in these three categories can be combined to provide an effectively universal public insurance system. In such a system, each household that suffers a negative shock, and falls below some predetermined threshold of living standards, would qualify for some form of state support.

Taxes for equity. Successful interventions to level the playing field require adequate resources. The main aim of good tax policy is to mobilize sufficient funding, while distorting incentives and compromising growth as little as possible. Because taxes impose efficiency costs by altering individual choices between labor and leisure and consumption and savings, most developing countries are likely to be best served by avoiding high marginal taxes on income and relying on a broad base, especially for taxes on consumption. Public spending should play the primary role in actively furthering equity. Nevertheless, there is some scope for making the overall tax system moderately progressive without large efficiency costs. Societies that desire such an outcome can consider simple exemptions for basic foodstuffs, and an expanded role for property taxation, for example.

While the capacity of the tax administration and the structure of the economy influ-

ence the ability to raise revenues, the quality of institutions and the nature of the social compact are also critical. When citizens can rely on services actually being provided, they likely are more willing to be taxed. Conversely, a corrupt or kleptocratic state engenders little citizen trust in authority and little incentive to cooperate. As a general rule, a more legitimate and representative state may be a prerequisite to an adequate tax system, even as the notion of adequacy varies from country to country.

Justice, land, and infrastructure

The development of human capacities will not broaden opportunities if some people face unfair returns on those capacities and unequal protection of their rights, and have unequal access to complementary factors of production.

Building equitable justice systems. Justice systems can do much to level the playing field in the political, economic, and sociocultural domains, but they can also reinforce existing inequalities. The report pays attention to both codified law and the ways in which the law is applied and enforced in practice. Legal institutions can uphold the political rights of citizens and curb the capture of the state by the elite. They can equalize economic opportunities by protecting property rights for all and ensuring nondiscrimination in the market. They underpin and reflect the rules of the game in society and thus are central to fair process—and to the broad-based property rights and unbiased dispute resolution mechanisms so important for investment.

The law can also accelerate shifts in norms, and justice systems can serve as a progressive force for change in the social domain by challenging inequitable practices. For example, the U.S. Civil Rights Act of 1964 and Medicare in 1965 enforced the desegregation of hospitals and led to large reductions in infant mortality for African Americans. Affirmative action programs have also been shown to reduce group-based differences in earnings and education. But they can become politically entrenched and limited to helping the better-off among disadvantaged groups.

Equity in laws and fairness in their implementation involve striking a balance between strengthening the independence of justice systems and increasing accountability—especially to counter the risk that the powerful and wealthy might corrupt, influence, or ignore the law. Measures to make the legal system more accessible—mobile courts, legal aid, and working with customary institutions—all help reduce the barriers that excluded groups face. Customary institutions raise complex issues and may incorporate inequities (for example, with respect to gender), but they are too important to be ignored. South Africa is an example of a country that is pursuing a policy that balances recognition of customary practices with the rights and responsibilities in state law.

Toward greater equity in access to land. Broader access to land does not necessarily have to come through ownership (chapter 8). Instead, improving the functioning of land markets and providing greater security of tenure for poorer groups may be a more fruitful area for policy—as in rural Thailand and in urban Peru. Redistributive land reform can make sense in some circumstances in which land inequalities are extreme and the institutional context allows for designs that effectively redistribute land to smaller farms and support this with complementary services, without large transitional costs. But this can be difficult, and tradeoffs may be large when property rights have a high degree of legitimacy.

Expropriating land (with compensation) is probably the most disruptive redistribution instrument. Divesting state lands and recuperating illegal settlements, possibly in exchange for titling a portion of the settlement, may be two cost-effective alternatives. Market or community-based approaches that allow community members to obtain subsidized credit for land rentals or purchases according to the willing-buyer-willing-seller principle, as in Brazil and South Africa, appear promising. A land tax can be a useful complement, generating revenues to purchase land to redistribute or encouraging redistribution by disproportionately taxing large or underused plots.

Providing infrastructure equitably. Access to infrastructure—roads, electricity, water, sanitation, telecoms—is typically highly unequal across groups. For many people in developing countries, lack of access to affordable infrastructure services means living in isolation from markets and services and having intermittent or no supply of power or water for productive activities and daily existence. This often results in a significant curtailment of economic opportunities.

While the public sector will in many cases remain the main source of funds for infrastructure investments aimed at broadening opportunities for those who have the fewest, the efficiency of the private sector can also be harnessed. Although utility privatizations have often been attacked for having unequal effects, the evidence indicates a more complex reality. Privatizations in Latin America typically led to expansions in access to services, particularly in electricity and telecommunications. In some cases, however, postprivatization increases in prices more than outweighed gains from quality and coverage, leading to widespread popular discontent.

Privatizations are therefore a classic case of a policy that may or may not make sense, depending on the local context. If the public system is highly corrupt or inefficient, and one expects postprivatization regulatory capacity to be adequate, it can be a useful tool. In other cases, poorly designed privatizations may be captured, transferring public assets, at excessively low prices, into private hands.

Experience suggests that whether infrastructure services are provided by private operators or public utilities seems less important for equity than the structure of incentives facing providers and how accountable these providers are to the general public. We argue that policymakers can improve the equitable provision of infrastructure services by focusing on expanding affordable access for poor people and poor areas—which often means working with informal providers and targeting subsidies—and strengthening the governance of the sector through the greater accountability of providers and the stronger voice of beneficiaries.

Markets and the macroeconomy

Markets are central to shaping the potential for people to convert their assets into outcomes. When market transactions are influenced by the wealth or status of participants, they are both inequitable and inefficient—and can also influence the incentives for different groups to expand their assets (chapter 9).

Financial markets. Captured banking systems exchange favors: market power is protected for a few large banks, which then lend favorably to a few selected enterprises, which may not be those with the highest expected risk-adjusted returns. This may lie behind a cross-country association between greater financial depth and lower income inequality. Achieving more equal access to finance by broadening financial systems thus can help productive firms that were previously beyond the reach of formal finance.

These relations are only suggestive, however, so the report draws on case studies from middle-income economies, such as the Republic of Korea, Malaysia, Mexico, and the Russian Federation, and poorer economies, including Indonesia and Pakistan, to provide more concrete evidence. These studies suggest an apparent paradox. Societies with extensive inequalities in power and wealth, weak institutions, and controlled financial systems typically suffer from narrow financial sectors that are oriented to the influential and hide weak asset quality. Opening the financial system would seem to be an obvious solution. Liberalization, however, has also often been captured by the influential or wealthy, in countries ranging from Mexico (in the early 1990s) to transition economies such as the Czech Republic and Russia.

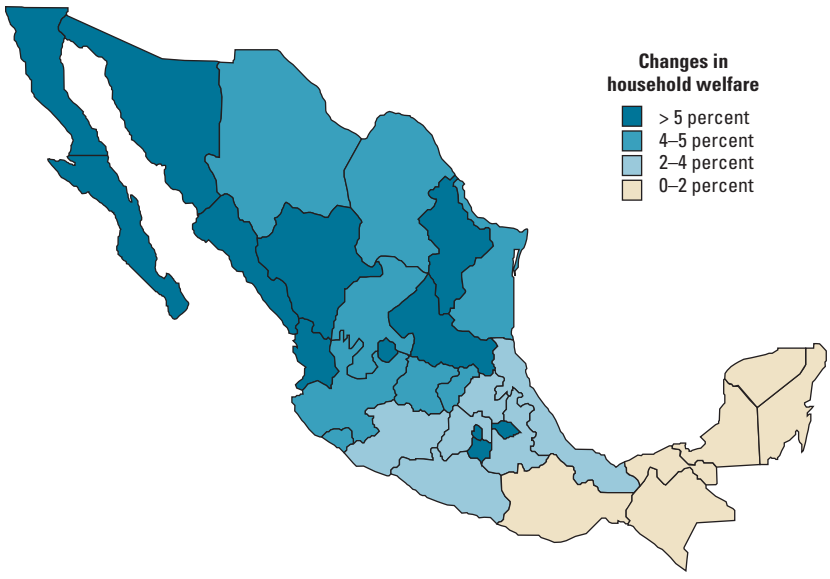
Gradual deepening and broadening thus needs to be combined with stronger horizontal accountability (in regulatory structures), greater openness to societal accountability, and, where feasible, external commitment devices (such as the entry of Central European and Baltic states to the European Union). Programs targeted to the poor—such as microcredit schemes—can help but are no substitute for the overall broadening of access.

Labor markets. Leveling the playing field in labor markets consists of seeking the right (country-specific) balance between flexibility and protection to provide more equal access to equal employment conditions to as many workers as possible. Many countries have fairly extensive regulations and provisions for formal sector workers, and far fewer for "outsiders" in the unregulated (and often less safe) informal sector. There is usually a degree of voluntary movement between the sectors, and great diversity within the informal sector itself, ranging from microentrepreneurs and some of the self-employed with incomes above formal sector workers to many with much worse employment conditions. This mix leads to inadequate protection for poorer workers, while regulations for formal workers can reduce the flexibility of employment and often are a poor deal for the workers themselves, such as when job-related social security systems are inefficient.

Two broad labor market approaches are relevant for equity. First, interventions in the labor market should ensure effective application of the core labor standards across the whole market, implying no slave or indentured work, no dangerous forms of child labor, and no discrimination. Workers should be free to assemble and form associations, and their unions should be free to have an active role in bargaining. Second, in all areas the policy mix needs to be assessed in ways that balance protection (for all workers) with allowances for the restructuring so central to dynamic growth and employment creation.

Worker security is often provided by various excessively stringent forms of employment protection legislation, which, in general make it costly to hire and, in some cases, make it even costlier to hire unskilled, young, and female workers—exactly those the laws seek to protect. For many countries, less distortionary and more inclusive policy alternatives are available, which may make the playing field more even in labor markets. These alternatives include unemployment insurance schemes (more likely in middle-income countries) and low-wage employment schemes (ideally with an employment guarantee), which can be applied successfully even in poor countries or states.

Figure 7 Better to be close to economic opportunities
Changes in household welfare in Mexico, following trade liberalization in the 1990s



Source: Nicita (2004).

Product markets. There is substantial heterogeneity in the effects of opening a country's product markets to trade, at least in the short to medium term. This can be due to geographic location, as illustrated by the varying impact of trade liberalization in Mexico (figure 7). This illustrates the importance of interactions between domestic product markets and patterns of infrastructure provision. There are also often strong interactions with skills in the labor market. In many countries, opening to trade (often coinciding with opening to foreign direct investment) has been associated with rising inequality in earnings in the past two decades. This is especially so for middle-income countries, notably in Latin America. Opening to trade often boosts the premium on skills as firms modernize their production processes (skill-biased technical change, in the jargon of economists). This is bad for equity if the institutional context restricts the capacity of workers to shift into new work—or limits future cohorts' access to education.

Macroeconomic stability. This report argues that there are two-way relationships between inequitable institutions and macroeconomic crises, with mostly bad effects for equity and

long-run growth. Weak and captured institutions are associated with a greater propensity for countries to experience macroeconomic crises. When crises occur, they can be costly for the poor, who have weaker instruments to manage shocks. In addition, crisis resolution is often regressive, through a variety of mechanisms (most of them not captured in traditional household survey instruments): declines in the labor share, at least for formal workers; capital gains for those who get their money out; and fiscal workouts that bail out the influential at substantial cost. Such bailouts must be paid for through some combination of higher taxes and lower spending. Because taxes are typically proportional and spending is often progressive at the margin (notably in Latin America), the cost of bailouts is borne disproportionately by poorer groups. High inflation has also been found to be both bad for growth and regressive in its impact.

A concern for equity would lead, in general, to a highly prudent stance on macroeconomic management and financial regulation. Populist macroeconomic policy, sooner or later, is bad for equity and bad for growth. Policy design can increase equity through the pursuit of countercyclical fiscal policy, building safety nets before a crisis, reducing risky lending, and supporting only smaller depositors in bailouts. But, as in other policy areas, these responses need to be underpinned by institutional designs that combine greater institutional freedom from political influence (such as independent central banks and autonomous financial regulatory agencies) with greater information and debate in society.

The global arena

One predetermined circumstance that most powerfully determines a person's opportunities for leading a healthy and productive life is his or her country of birth. Global inequities are massive. Reducing them will depend primarily on domestic policies in poor countries through their impact on growth and development. But global action can change external conditions and affect the impact of domestic policies. In this sense, global and domestic actions are complementary.

We live in an integrated world in which people, goods, ideas, and capital flow across countries. Indeed, most policy advice given to poor countries over the last several decades—including that by the World Bank—has emphasized the advantages of participating in the global economy. But global markets are far from equitable, and the rules governing their functioning have a disproportionately negative effect on developing countries (chapter 10). These rules are the outcome of complex negotiating processes in which developing countries have less voice. Moreover, even if markets worked equitably, unequal endowments would limit the ability of poor countries to benefit from global opportunities. Leveling the global economic and political playing fields thus requires more equitable rules for the functioning of global markets, more effective participation of poor countries in global rule-setting processes, and more actions to help build and maintain the endowments of poor countries and poor people.

The report documents some of the many inequities in the functioning of global markets for labor, goods, ideas, and capital. Unskilled workers from poor countries, who could earn higher returns in rich countries, face great hurdles in migrating. Developing-country producers face obstacles in selling agricultural products, manufactured goods, and services in developed countries. Patent protection restricts access to innovations (particularly drugs) for poor countries, while new research is strongly oriented to the diseases of richer societies. Rich-country investors often get better deals in debt crises. In most cases, more equitable rules would bring benefits to developed- and developing-country citizens. Benefits vary across markets and countries, with those from greater legal migration likely to be greatest (and to accrue directly to migrants) and those from trade likely to accrue mostly to middle-income rather than the least developed countries.

The report discusses options to reduce inequities in the functioning of global markets, including the following: allowing greater temporary migration into OECD countries, achieving ambitious trade liberalization under the Doha Round, allowing poor countries to use generic drugs, and developing financial standards more appropriate to developing countries.

The international laws that govern global markets are the product of complex negotiations. In some cases, as for human rights covenants, the processes generating the laws are perceived to be fair. In other cases, processes and outcomes are perceived as unfair, even though the formal regulations are equitable. Within the World Trade Organization (WTO), for example, each country has a vote and each can block proceedings. Even so, WTO processes are at times perceived as unfair because of the underlying power imbalance between strong commercial interests and the public interest, in both developed and developing countries. These imbalances manifest themselves, for instance, in the number of staff employed in Geneva by different WTO members. More effective representation of poor countries in global institutions would help improve processes and may lead to more equitable rules.

The impact of reducing imperfections in global markets varies by country. The larger and fast-growing developing countries stand to benefit significantly from freer global trade, migration, and capital flows, helping them sustain fast growth (while equitable domestic policies both help underpin long-run growth and the broad internal sharing of this growth). Countries left behind in the global economy stand to benefit much less from global markets in the short run and will continue to rely on aid. For them, global action that helps compensate for unequal endowments is truly essential. Action to build endowments is primarily domestic, through public investments in human development, infrastructure and governance structures. But global action can support domestic policies through resource transfers in the form of aid, which is not offset by debt repayments, and investments in global public goods, particularly global commons.

Aid levels need to be bolstered in line with the commitments rich countries made at the 2002 Monterrey Conference and concrete plans should be made to reach the target of devoting 0.7 percent of gross national income to aid. Larger volumes of aid will only help, however, if aid is effective in alleviating constraints and spurring development in the recipient countries. Greater effectiveness can be achieved by emphasizing results, moving away from ex ante conditionality, and progressively shifting design and management from donors to recipients. Aid should not be undermined by debt, for debt reduction that is not financed by additional resources can actually undercut effective aid programs. Innovative mechanisms to expand development assistance should be explored, including global taxes and private contributions.

Equity and development

Bringing equity to the center of development builds on and integrates the major emphases in development thinking of the past 10 to 20 years—on markets, on human development, on governance, and on empowerment. It is noteworthy that this year equity is the focus of both this World Development Report and the Human Development Report of the United Nations Development Programme. The plea for a more level playing field in both the politics and the economies of developing countries serves to integrate the World Bank's twin pillars of building an institutional climate conducive to investment and empowering the poor. By ensuring that institutions enforce personal, political, and property rights for all, including those currently excluded, countries will be able to draw on much larger pools of investors and innovators, and be much more effective in providing services to all their citizens. Greater equity can, over the long term, underpin faster growth. This can be helped by greater fairness in the global arena, not least through the international community's meeting its commitments made at Monterrey. Faster growth and human development in poorer countries are essential to reducing global inequity and to reaching the Millennium Development Goals.