

Towards a dynamic public economics[☆]

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1. Introduction

Public economics has a history that covers centuries, rather than the past 30 years.¹ The giants of the field — if we confine ourselves to those writing before 1950 — include Adam Smith, Jules Dupuit, Knut Wicksell, Alfred Marshall, A.C. Pigou, Frank Ramsey and Paul Samuelson. Those working in the last 30 years, the period surveyed in this volume, have stood on the shoulders of those giants. This period has seen a surge in activity; indeed, the launch of the *Journal of Public Economics* in 1972 reflected the founders' recognition of this growth in the field.

The views I shall offer here are based in large measure on the type of research published in the Journal. But they are also influenced heavily by my work in international financial institutions and by my research on development economics, particularly applied microeconomics and the analysis of structural change. These views have also been shaped through my work with many collaborators over the years. Of special significance is the influence of Tony Atkinson, the founding editor of the Journal. It was his foresight that led to the creation of the Journal; his boundless energies that fueled its growth; his extraordinarily high standards in his own research that set the standards for the profession; and his standards of integrity and morality that have always reminded us all that our analysis should not just increase our understanding, but also make the world a better place. I have learned enormously from him.

A great deal has changed in the world and in the profession in the past 30 years, but the approach that has driven the Journal since its founding has, I believe,

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¹Indeed, if we go back to Plato, it covers millennia.

retained its strength and relevance. This approach has two key elements. The first is that good public policy should be guided by principles founded on explicit theoretical analysis, and further that formal modeling can play a central role in this analysis. The second is that the choice of policies should be informed by the careful analysis of data, particularly microeconomic data, to determine the incentive and distributional impacts of different policy options. In the formal modeling associated with the first element, explicit government objectives played a central role; in the second, micro theory, micromodeling, and micro-econometric analysis took center stage. I have no doubt that the careful development and application of this approach has improved greatly the standards of debate and analysis of public policy.

2. Changing perspectives on government and policy over the past 30 years

In parallel with the development of this academic approach — and the two were very much connected — was a broad change in public views on public policies. Until the 1960s, much of public economics was characterized by a strong implicit confidence in government — a view that the government could both decide on what was necessary and act directly to make it happen. But during the course of that decade and continuing into the 1970s, confidence began to erode in both developed and developing countries. In the formal modeling efforts, this recognition of the limitations of public action was reflected in assumptions that the government's policy tools were constrained, with a focus on taxes and prices as means of influencing behaviour. In the developing world, it meant a growing disenchantment with central planning and government controls.

By the 1980s, this loss of confidence had mutated into something else. In many cases, it took the form of outright hostility to government. Instead of seeing government as responsible for identifying and taking charge of policy problems, many argued that the public sector was itself the problem and should get out of the way. In many countries in the 1980s, political arguments and actions — here we think particularly of the Thatcher and Reagan administrations — ran well ahead of the academic analysis.

During the same period, the field of public economics saw a major revival of interest in political economy. In this line of research, the decisions of government were no longer modeled as reflecting an explicit public objective; instead, they were viewed as resulting from the political interaction of many private objectives, each motivated by self-interest.

Both approaches, that of an explicit government objective and of political economy, are in my view of great value. In fact, they are highly complementary. The political economy approach tells us a great deal about policy formulation in practice, about pitfalls and challenges in administration and bureaucracy, and about the constraints on public action. The approach embodying a government

objective, such as using an explicit social welfare function based on household welfare, provides a direct analysis of the trade-offs and the choices involving incentives and distribution in public policy. This is a crucial aspect of decision-making across the whole spectrum of public economics, and we must understand its logic. This approach also provides a benchmark for assessing policy options. Further, it provides valuable and general principles to guide choices in public policy, such as the balance between direct and indirect taxes, and the economic analysis of externalities.

3. Recent years and the challenges of going forward

We have by now moved well beyond the simplistic and often dogmatic (even fundamentalist) approaches that, in a number of countries, dominated both policy and politics in the late 1980s and early 1990s. That approach could be summarized in the following mantra: ‘Privatize, get the government out of the economy, and let markets determine allocations and make decisions wherever possible.’ For many of us in the profession, this fundamentalism was surprising, to put it mildly. It is true that our appreciation of the problems of government failure had grown strongly over the previous decades, but also our understanding of market failure, and particularly problems of information, had deepened over the same period. And many of us spoke out against naïve triumphalism at the time of the fall of communist governments at the end of the 1980s. Indeed, the clearest and most important lesson of the transition from command to market economies is that well-functioning markets need effective government and supporting institutions. Happily, this position is now widely accepted.

With this background of experience and changing perspectives, I would emphasize three challenges going forward. The *first* is to examine and understand how to build and develop governance and institutions to support entrepreneurship and well-functioning markets — or, to put it another way, how to build a business environment or investment climate that will generate growth and development. Further, we should ask how to ensure that these institutions and markets involve poor people more directly in the processes of growth and development.

This is a dynamic perspective on the classic problem of public economics — how to strike the right balance between increasing the size of the pie and sharing it equitably. The World Bank has recently expressed its strategy for fighting poverty in terms of two pillars of public action: building an investment climate for investment, growth, and jobs, and empowering and investing in poor people so that they may participate in growth. Processes and institutions are at the heart of both elements. The investment climate notion focuses our attention on the factors that influence an entrepreneur’s or a farmer’s decisions on whether and how much to invest, as well as the returns to that investment. Metaphorically, we can think of work on the investment climate as being aimed at improving the link between

sowing and reaping. The second pillar concentrates on ensuring that poor people can participate effectively in growth. This includes helping them to augment the assets and resources that they bring to the market, particularly their human resources, and their ability to participate in crucial decisions shaping their lives.

It is possible to develop a serious analytical investigation into these two pillars, and this goal is currently driving much of our research at the World Bank. Useful research on investment climate issues relies heavily on microeconomic data on firms, particularly small and medium-sized enterprises. Among poor people who are able to find employment, the vast majority work in these enterprises, rather than in the state sector or large firms. The analysis of firm-level data, including analysis of the business environment and the process of private-sector decision-making, will play an increasing role in public economics.

On the second pillar, I think that we are seeing closer attention not just to household data but also to the link between households and the institutions relating to markets. Of particular importance here is the involvement of households in the delivery of basic services, such as education, health, water, and power. Examples include the involvement of communities in managing schools, the participation of water users associations in irrigation schemes, and the processes enabling households to assert rights to land and to gain access to credit.

We now know that the delivery of basic services involves much more than the allocation of resources. Equally important is ensuring that those resources are used effectively, and good institutions are key to achieving this goal. There is a vast array of possible ways — the ‘real world’ has been very creative, providing a myriad of examples — in which public and private sectors and civil society can combine in this process. I think that public economics has a great deal to contribute here. One strand of work will be the analysis of regulation. Here we cannot simply offer a universal cry of de-regulation, which can often be misguided; instead, we have to assess what sort of regulation is appropriate in a given environment. However, the contribution of public economics to service delivery must run much deeper than regulation: it should in large measure be about how public, private, non-governmental, and community institutions interact.

This emphasis on the combination of institutions and policies, however, misses a crucial element: behavior. This constitutes the *second* challenge that I would identify for future research. Too often the analysis of ‘behavior’ in economics involves simply writing down a utility function and the constraints or price structures and then deriving demand and supply functions. Research on development and public policy should look more deeply into how behaviour develops. Behaviors within institutions can be altered dramatically by changing participants’ perceptions of reality, of what an individual is capable of, and of probabilities. Examples of ‘endogenous behaviour’ cover drugs, peer group pressures, education, reaction to insurance (for example, large numbers choose default options until they discuss it with someone), trust, and so on.

An important example concerns the experience of Russia in its transition from command to market. In this story, the terms ‘institutions’ and ‘institutional failure’

seem to me to miss or misrepresent key aspects of the evolution. Part of what happened was a marked deterioration in behavior and trust, as a result of what was perceived as (and was) looting and corruption on a large scale by those in positions of power. An examination of interactions between policies, institutions, and behavior would, I suggest, provide a major and fruitful program for both theoretical and applied work.

The issue of behavior is related to the *third* and final challenge — attaining a deeper understanding of the objectives of public policy. Much of public economics has taken a fairly simple view (for understandable reasons, in the case of formal modeling). By contrast, much of development economics is taking a broader view of the objectives of public policy. The World Development Report of 2000/2001, *Attacking Poverty*, defined poverty as a lack of opportunity, empowerment, and security for poor people. This definition embodies but goes beyond simply lack of income. It includes deprivations in education and health, and in fact goes further to ask about effective participation in decisions that affect the lives of families and individuals. This definition was in large measure based on discussions of poverty with over 60 000 poor people surveyed in over 60 countries. An important challenge for both theoretical and applied research is to build these ideas into more formal analyses of poverty and public objectives. These concepts relate strongly to those that Amartya Sen has emphasized in his work — see, for example, his book *Development as Freedom*, which defines development as an enhancement in the ability of people to shape their own lives.

If we rise effectively to these three challenges, then we will have gone a long way toward creating a dynamic public economics.

4. Concluding comments

The central approaches of the public economics of the last 30 years — with careful theoretical and empirical modeling of public objectives, of individual incentives, and of distribution — have been both sound and fruitful. There is a creative avenue for further research that builds on this foundation and learns something from modern development economies. I have tried to sketch out a program that will respond to the three key challenges described above.

In carrying forward the program, I would stress the role of processes. This has little to do with models of long-run growth, endogenous or otherwise. It is about the processes of investment and productivity growth, in the tradition of Schumpeter, and the processes shaping the participation of poor people in growth and development, a tradition that has yet to be established. I have tried to identify a research program that also involves a deeper understanding of the determinants of behavior and of the objectives of development and policy. In carrying out this program, we would do well to be guided by the same approaches as motivated the original launching of the Journal.