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A. CLASSIFICATION

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B. SUBJECT: Memo to Mr. Wolfensohn from Joseph Stiglitz, dated March 3, 1997, entitled "Green Cover Draft of the 1997 World Development Report"
with reports:
- WDR 1997 "The State in a Changing World" Overview"
- WDR 1997 Part A "Rethinking the State - the World Over"
- WDR 1997 Part B "Matching Role to Capability"
- WDR 1997 Part C "Reinvigorating Institutional Capability"
- WDR 1997 Part D "Removing Obstacles to Change"

DATE: 03/02/97

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THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

DEADLINE IS MARCH 14 -

DATE: March 3, 1997

TO: Mr. James D. Wolfensohn

FROM: Joseph E. Stiglitz

EXTENSION: 33774

SUBJECT: **Green Cover Draft of the 1997 World Development Report**

No time to read - go ahead & print

1. Accompanying this memorandum are copies of the Green Cover version of the 1997 World Development Report for your review.

2. This draft was revised in response to comments received at the Bankwide meeting which Mr. Lyn Squire chaired on February 6, 1997, and to comments from regional and sectoral staff, and other parts of the Bank, IFC, and IMF. The revisions have mainly involved the Overview, Chapter 4 where we have added a section on 'Privatization' (after our discussion on February 26), and the last Chapter where a new section on 'Collapsed States' has been added. As far as I am aware, there are no outstanding issues with other Vice Presidencies.

3. We look forward to your comments so that we may proceed with revisions for the Gray Cover version which is scheduled for distribution to the Board on March 28, 1997.

Attachments

cc: Messrs./Mmes. Gautam Kaji, Sven Sandstrom, Caio Koch-Weser, Atsuko Horiguchi, Hany Assaad, Orsalia Kalantzopoulos, Yasmin Saadat, Joanne Salop

DRAFT
(NOT FOR QUOTATION)
March 3, 1997

WORLD DEVELOPMENT REPORT 1997
THE STATE IN A CHANGING WORLD

Overview

This draft has been prepared by a team led by Ajay Chhibber and with principal authors Simon Commander, Alison Evans, Harald Fuhr, Cheikh Kane, Chad Leechor, Brian Levy, Sanjay Pradhan, and Beatrice Weder. The work was carried out under the direction of the late Michael Bruno, Lyn Squire, and Joseph Stiglitz.

The authors would be most grateful if this draft were neither cited nor made available to others. The published version will be available on June 27, 1997.

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Overview

1. Around the globe, the state is in the spotlight. Far-reaching developments in the global economy have us revisiting basic questions about government's role: what it should, what it can, and what it cannot do.

2. The last fifty years have shown more clearly than ever before how governments can be a force for good. Governments have helped to wipe out crippling diseases such as polio, bilharzia, and malaria, and to save precious rain forests. But government actions have led to poor outcomes as well. And even where governments have worked well, there is concern that they will not adapt to the demands of a globalizing world. Four recent factors have crystallized the rethinking on the role of the state:

- the collapse of state command and control economies of the former Soviet Union and Eastern Europe.
- the important role of the state in the 'miracle' economies of East Asia.
- the fiscal crisis of the welfare state in most OECD countries.
- the collapse of states and the explosion in huminatarian emergencies in several parts of the world.

3. This Report shows that the determining factor behind these contrasting developments is the effectiveness of the state: an effective state is vital for the provision of the goods and services—and the rules and institutions—that allow markets to flourish and people to lead healthier, happier lives. Sustainable development—economic and social—needs an effective state.

4. But what makes the state effective differs enormously across countries at different stages of development. What works in New Zealand, say, may not work in Nepal. Even among countries at the same level of income, differences in size, ethnic makeup, culture, and political systems make every state unique. But this very diversity enriches our inquiry into *why* and *how* some states are better than others at sustaining development, eradicating poverty, and responding to change.

5. As we look forward into the twenty-first century, we see then the pendulum of our thinking shifting once more to the central and critical role of the state in development. But with a difference. When people said fifty years ago that the state was central to economic development, they meant state-provided development. Today we are again realizing that the state is central to economic and social development but more as a partner, catalyst, and facilitator.

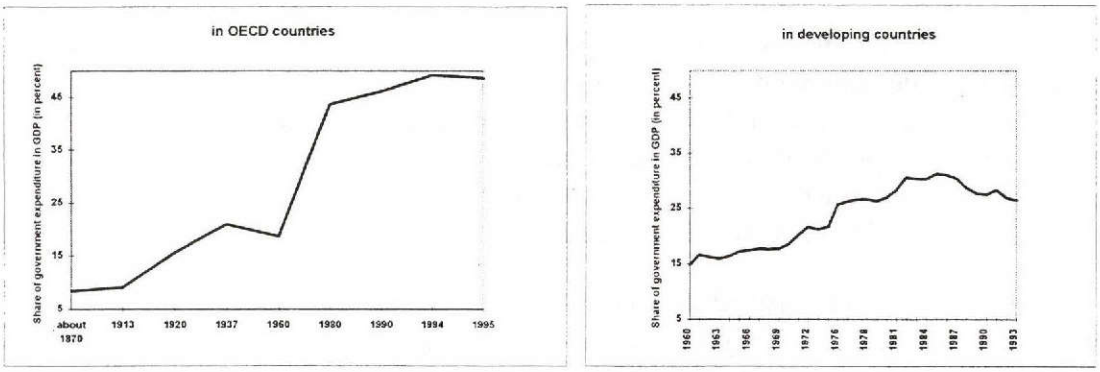
Rethinking the state—the world over

6. Today's intense focus on the state's role is reminiscent of an earlier era, when the world was emerging from the pain of the Great Depression and World War II. Then the challenge of development seemed more easily surmountable and largely technical. The tools of economics seemed adequate to the task. Good economists would formulate good policies, which good governments would then implement for the good of society. Good policy is indeed indispensable. But the institutional assumptions implicit in this worldview were too simplistic. Flexibility to implement the policies devised by technocrats was accorded pride of place. Accountability through checks and balances was regarded as an encumbrance.

7. In a few countries, blessed with farsighted leaders, things have indeed worked out more or less along these lines. But in many countries outcomes have been very different. Governments embarked on fanciful schemes. Private players, lacking confidence in public policies or in the steadfastness of leaders, withheld investment. Powerful rulers acted arbitrarily. Corruption became endemic. Development faltered and poverty endured.

8. People also looked to government to do more. Industrial economies created the welfare state, and much of the developing world embraced state-led development strategies. The result was a tremendous expansion in the size and reach of government worldwide. State spending now constitutes almost half of total income in the established industrial countries, and around a quarter in developing countries (Figure 1). But this very increase in the state's influence has also shifted the emphasis—from the quantity of the state's actions to its effectiveness.

Figure 1 The growth of the state



9. As in the 1940s today's renewed focus on the state's role and effectiveness has been inspired by dramatic events in the global economy, which have fundamentally changed the environment in which states operate. The global integration of economies and the spread of democracy have narrowed the scope for political leaders to engage in arbitrariness and capricious behavior. Leaders in some states may choose to ignore the

costs of such arbitrariness, but they are increasingly restrained by the economic parameters of a globalized world. States are under pressure even where governments have previously seemed to perform well. Many European countries find themselves grappling with a welfare state that has grown unwieldy, and having to make difficult choices about the services and benefits people can expect from governments. Markets—domestic and global—and citizens vexed by state weaknesses have come to insist on transparency in the conduct of government and on other changes to strengthen the ability of the state to meet its assigned objectives. Intermediary and grassroots organizations have sprung up to demand better government.

10. The resulting *crisis of government effectiveness* has taken an extreme form in many developing countries, where the state has failed to deliver even such basic public goods as property rights, roads, and basic health and education. There a vicious circle has taken hold: people and businesses respond to deteriorating public services by avoiding taxation, leading to further deterioration in services. In the former Soviet Union and Eastern Europe it was the state's long-term failure to deliver on its promises that led, finally, to its overthrow. But the collapse of central planning has created problems of its own. In the vacuum created by its fall, citizens are sometimes deprived of basic public goods such as law and order. At the limit, as in Afghanistan, Liberia, and Somalia, the state crumbles entirely, and individuals and international agencies are left trying to pick up the pieces.

A two-part strategy

11. How can we cut through this maze of issues and pressures on the world's states? By starting with a simple conceptual perspective. The state is fundamentally an institution to aid the provision of public and collective goods—breathable air, safe water, an ozone layer, sound currency, law and order, defense, and (in an information-based world) public information. It has the coercive power to tax, set rules, and allocate resources. History and recent experience tell us that capable state institutions facilitate collective actions at the lowest cost to society. But history also tells us that there must be mechanisms—external and internal—to restrain the arbitrary and capricious use of state power and motivate public servants to provide better services.

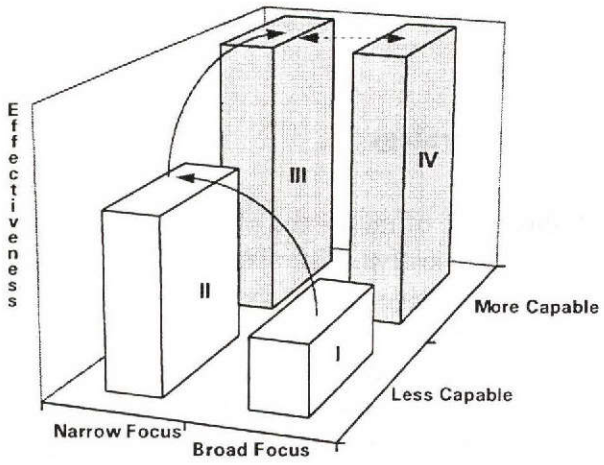
12. How can this be achieved? No one-size-fits-all approach is suggested here. The range of differences among states is too enormous. Instead, we provide a framework for addressing the issue of the state's effectiveness. This Report suggests that there are ways to resolve the growing disjunction between the demands on states and the dearth of capability to meet these demands. Getting societies to accept a redefinition of the state's responsibilities which reduces their scope must be part of the solution. Another is strategic selection of collective goods that states try to deliver (the focus of "first generation" reforms) combined with greater efforts to take the burden off the state by involving citizens and communities in the delivery of essential collective goods.

13. But even with more selectivity and greater reliance on the citizenry and private firms, resolving the crisis of capability must also depend on improving the functioning of the state's central institutions. Unless the state's capability—*defined as the ability to deliver collective goods at the lowest cost to society*—can be enhanced, human well-being will decline.

14. This basic message translates into a two-part strategy to make every state a more credible, effective partner in its country's development:

Matching the state's role to its capabilities is the first element in this strategy. Where state capability is weak, how the state intervenes—and where—should be carefully assessed. Many states try to do too much with few resources and little capability, and often do more harm than good. A sharper focus on the fundamentals would improve effectiveness. The state may then take on more as its capability grows and as the society chooses (Figure 2).

Figure 2 Matching roles with capabilities to improve the state's effectiveness



We distinguish between *capability* and *effectiveness*. *Capability* is the ability to provide collective goods at the lowest cost to society. *Effectiveness* is an outcome of the correct use of that capability. Countries in Zone I pursuing activities in a wide area with low focus and with low capability leads to ineffective outcomes. A large number of developing countries are in Zone 1 and had taken on many functions—but are not even delivering on the fundamentals well. Countries cannot move to Zone IV overnight as building state capability takes time. The first stage involves moving to Zone II to improve effectiveness by focusing the state's activities on the fundamentals and leveraging the catalytic effect of its actions by better partnerships with the business community and civil society. Countries can gradually move to Zone III by strengthening institutional capability and may eventually move to Zone IV as they choose to become more active. Countries can also move back from Zone IV to Zone III as their society's requirements change (for example, Japan's government is being asked to now play a less active role).

The second element is ***raising state capability*** **by reinvigorating public institutions**. This means designing effective rules and restraints, to check arbitrary state

actions and combat entrenched corruption. It means making the state more responsive to people's interests by bringing government closer to the people through participation and decentralization. And it means subjecting state institutions to greater competition, to increase their efficiency.

15. The Report, not only, refocuses our attention to the state's effectiveness but shows how countries might begin a process of rebuilding the state's capability. The term government refers to the agencies of the state, which includes all branches—judicial, executive, and legislative—and various levels of government—local, regional. The state is defined more broadly to include the institutional framework of rules and norms within which the agencies of government operate. But the term state and government are used interchangeably throughout, this Report, as in colloquial usage in different parts of the world.

Matching role to capability

The first job of states: Getting the fundamentals right

16. Four fundamental tasks lie at the core of every government's mission, without which sustainable, poverty-reducing development is impossible:

- establishing a foundation of law and property rights
- maintaining a non-distortionary policy environment
- investing in basic social services and infrastructure
- protecting the vulnerable.

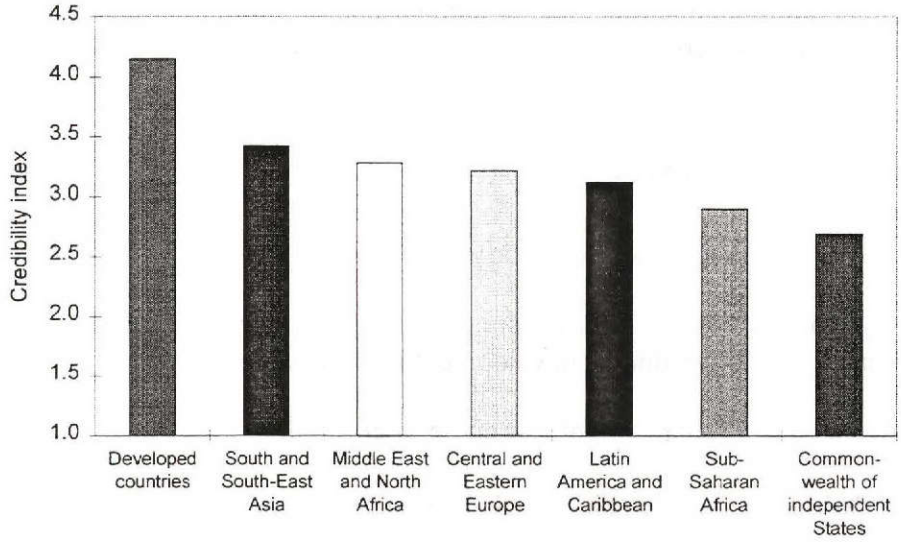
Although the importance of these fundamentals for development has long been widely accepted, some new insights are emerging as to the appropriate mix of market and government activities in achieving them. Markets and governments are complementary: government is essential for putting in place the appropriate institutional foundations for markets, and government's credibility—the conviction that the government will be able to sustain good policies—can be as important for attracting private investment as the content of the policies themselves.

17. A survey specially commissioned for this World Development Report of local entrepreneurs in sixty-nine countries shows that many countries lack the basic institutional foundations for market development (Box 1). High levels of crime and personal violence and an unpredictable judiciary add up to produce what we define as the "lawlessness syndrome." Weak and arbitrary state institutions often compound the problem with unpredictable, inconsistent behavior. Far from assisting the growth of markets, such actions squander the state's credibility and hurt market development.

Box 1 Credibility, investment, and growth

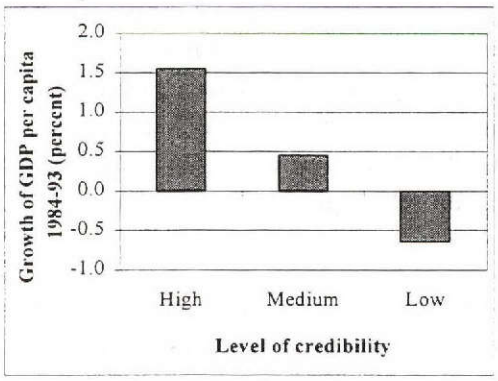
A survey of local entrepreneurs in sixty-nine countries shows that many states are performing their core functions poorly: they are failing to ensure law and order, protect property, and apply rules and policies predictably. Such states are not credible, and growth and investment suffers as a consequence. Firms were asked to rank each indicator on a scale from one (extreme problem) to six (no problem). Averaging the answers, as is done in the upper figure for each world region, yields an overall indicator of the reliability of the institutional framework as perceived by private entrepreneurs—we call it credibility. The lower figure shows that there is a strong correlation between countries' credibility rating and their record of growth and investment, once income and education are controlled for.

Credibility and its impact

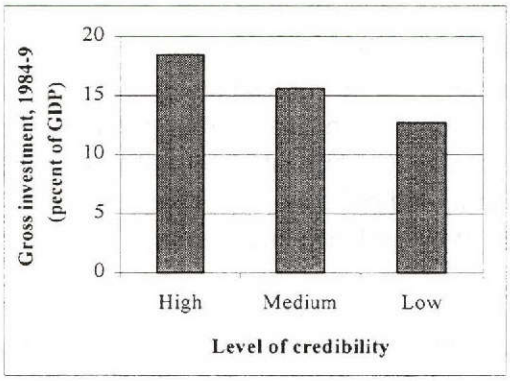


Impact of credibility on growth and investment*

Growth



Investment



* Partial associations controlling for initial income and human capital.

18. To make development stable and sustainable, the state has to devote adequate attention to the social fundamentals of development. Lawlessness is often related to a sense of marginalization: indeed, breaking the law can seem the only way for the marginalized to get their voices heard. Public policies can ensure that growth is

shared and that it contributes to reducing poverty and inequality, but only if governments put the social fundamentals high on their list of priorities.

19. Too often policies and programs divert resources and services from the people who need them most. The political clout of the more affluent in society leads governments to spend many times more on rich and middle-class students in universities than on basic education for the majority and scholarships for the less well off. In many regions, poverty and inequality are often biased against ethnic minorities or women, or concentrated in disfavored geographic areas. Marginalized from public discussion and excluded from the broader economy and society, such groups are fertile ground for violence and instability. The recent eruption of civil conflict in Chiapas, Mexico, is a case in point.

20. Public policies and programs must aim not merely to deliver growth, but to ensure that the benefits of market-led growth are shared, particularly through investments in basic education and health. They must also ensure that people are protected against material and personal insecurity. Where poverty and economic marginalization originate in ethnic and social differences, policies must be carefully crafted to manage them, as Malaysia and Mauritius have done.

Going beyond the basics: The state need not be the sole provider

21. There is growing recognition that, in many countries, monopoly public providers of infrastructure, social services, and other goods and services are unlikely to do a good job. Meanwhile, technological and organizational innovations have created new opportunities for competitive, private providers in activities that hitherto had been wholly in the public domain. To take advantage of these new opportunities for private participation—and to better allocate scarce public capability—financing of infrastructure and services is beginning to be separated from delivery, competitive segments of utility markets are being unbundled from the monopoly segments, and programs of social insurance, designed to manage health and employment insecurity for all, are being unbundled from programs of social assistance, intended to help the poorest in society.

22. *Coping with household insecurity.* It is now well established that the state can help households cope with certain risks to their economic security: it can insure against destitution in old age through pensions, against devastating illness through health insurance, and against job loss through unemployment insurance and shelter. But the idea that the state must alone carry this burden is changing, and even in many established industrial countries the welfare state is now undergoing reform. Emerging economies from Brazil to China will be unable to afford even pared-down versions of the European system, especially with their rapidly aging populations. Innovative solutions that involve businesses, labor, households, and community groups are needed to achieve greater security at lower cost. This is especially important for those developing countries not yet locked into costly solutions. Chile is showing how innovative market-based solutions for retirement pensions can provide some answers.

23. *Effective regulation.* Well-designed regulatory systems can help societies influence market outcomes for public purposes. Regulation can help protect consumers, workers, and the environment. It can foster competition and innovation, while constraining the abuse of monopoly power. Thanks to regulatory reforms initiated in the early 1980s, Chile's telecommunications industry has enjoyed sustained private investment, increasing service quality and competition, and declining prices. By contrast, until some recent reform initiatives, dysfunctional regulation led the Philippine telecommunications industry—long privately owned—to underinvest. The result was poor and often high-priced service, imposing a high cost on citizens and other firms. New options are emerging for private provision of infrastructure and social services, especially where a good regulatory framework exists.

24. *Industrial policy.* When markets are underdeveloped, the state can reduce problems of coordination and information and encourage market development. Many of today's wealthier countries used various mechanisms to encourage the growth of markets in their early stages of development. More recently, Japan, Korea, and other countries in East Asia used a variety of mechanisms for market enhancement, in addition to securing the economic, social, and institutional fundamentals. Sometimes these interventions were quite elaborate—for example, the strategic use of subsidies. Other times they were less intrusive, taking the form of export promotion, tax breaks, and special infrastructure benefits. But the ability to choose wisely among these interventions and use them effectively is critical—ill-considered trade, credit, and industrial policies can cost countries dearly. Indeed where activist industrial policy has worked well institutional capability has been relatively strong.

25. *Managing privatization.* Carefully designed regulations and other active government initiatives can enhance the growth of markets. But in many countries this can take time as private initiative is held hostage to the historical baggage of state-owned enterprises (SOEs) and antagonistic state-market relations. Generally privatization becomes much easier when the business environment for private sector development becomes supportive and countries like Taiwan (China), China, and Korea have opted not to give top priority to privatization, but to allow private sector to develop around them. But this option may not be open where the fiscal burden is very high, and where the presence of SOEs hurts overall restructuring. When privatizing process is vital. The key factors are transparency of process, winning the acquiescence of employees, generating broad-based ownership, and appropriate regulatory reform. Where privatization has been managed carefully it is showing positive results as in Chile and the Czech Republic. So its timing may vary, but for many developing countries privatization must be kept on the front burner of the strategy of scaling back the over-extended state.

Knowing the state's limits

26. The key to predictable and consistent implementation is a good fit between the state's institutional capabilities and its actions. In well-developed states, administrative capabilities are normally strong, and institutionalized checks and balances

restrain arbitrary action, even as they provide government organizations the flexibility to pursue their mandates. By contrast, states with weaker institutions need to give special attention to signaling credibility to firms and citizens that they will refrain from arbitrary actions. This can be done in two ways:

- through self-restricting rules, which precisely specify the content of policy and lock in it through mechanisms that are costly to reverse. In the arena of monetary policy, regional common-currency arrangements such as the currency zone in Francophone Africa or currency boards as in Argentina, provide examples. In the arena of utility regulation, "take-or-pay" contracts with independent power producers, enforceable offshore, serve a similar function.

- through working in partnership with firms and citizens to design and implement new policies. In industrial policy, foster private-to-private collaboration. In financial regulation, give bankers an incentive to operate prudently. And in environmental regulation, use information to encourage "bottom-up" citizen initiatives.

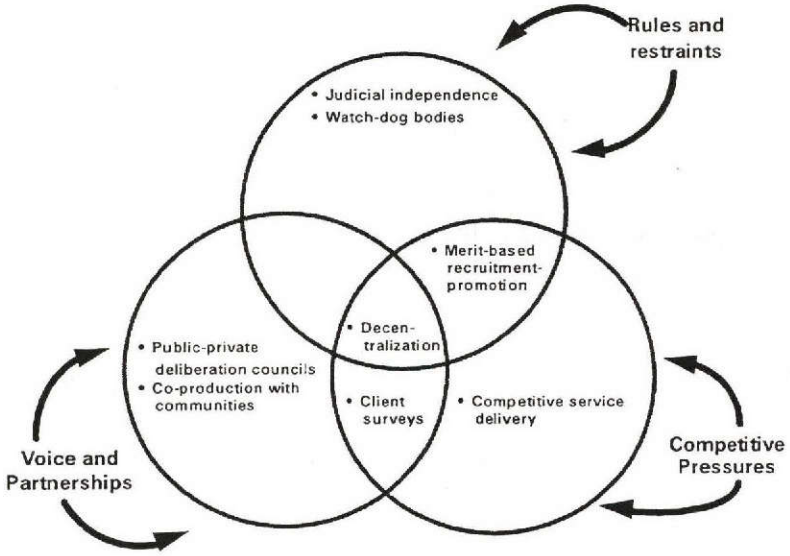
Reinvigorating the state's institutional capability

27. Realism is not fatalism. Acknowledging the state's present meager capabilities does not mean accepting them for all time. The second key task of state reform is therefore to reinvigorate the state's institutional capability, *by providing incentives to public officials for better performance while keeping arbitrary action in check.* Countries struggle to build institutions for an effective public sector. Yet in many countries the public sector is ineffective or, worse, corrupt. Why this persistence?

28. Part of the reason is politics. Depending on the political dynamic, political preferences can translate into public sectors with very different degrees of effectiveness. Politicians and their constituencies may have an incentive to maintain an inequitable and inefficient status quo, while those who lose out from this arrangement may be unable to exert effective pressure for change. In other cases the private interests of political leaders may run counter to the public interest, but effective institutional mechanisms may not exist to restrain the arbitrary actions of politicians or hold them accountable for results.

29. But the problem is not entirely political. Often politicians have strong incentives and a sincere interest in improving public sector performance. But managing a public bureaucracy is a complex business that does not lend itself to clear, unambiguous solutions. Building institutions for an effective public sector requires addressing a host of underlying behavioral problems that distort incentives and ultimately lead to poor outcomes. Three basic incentive mechanisms can be used in a variety of settings to make the state more capable (Figure 3).

Figure 3 Mechanisms to enhance state capability



Effective rules and restraints to limit arbitrary state actions

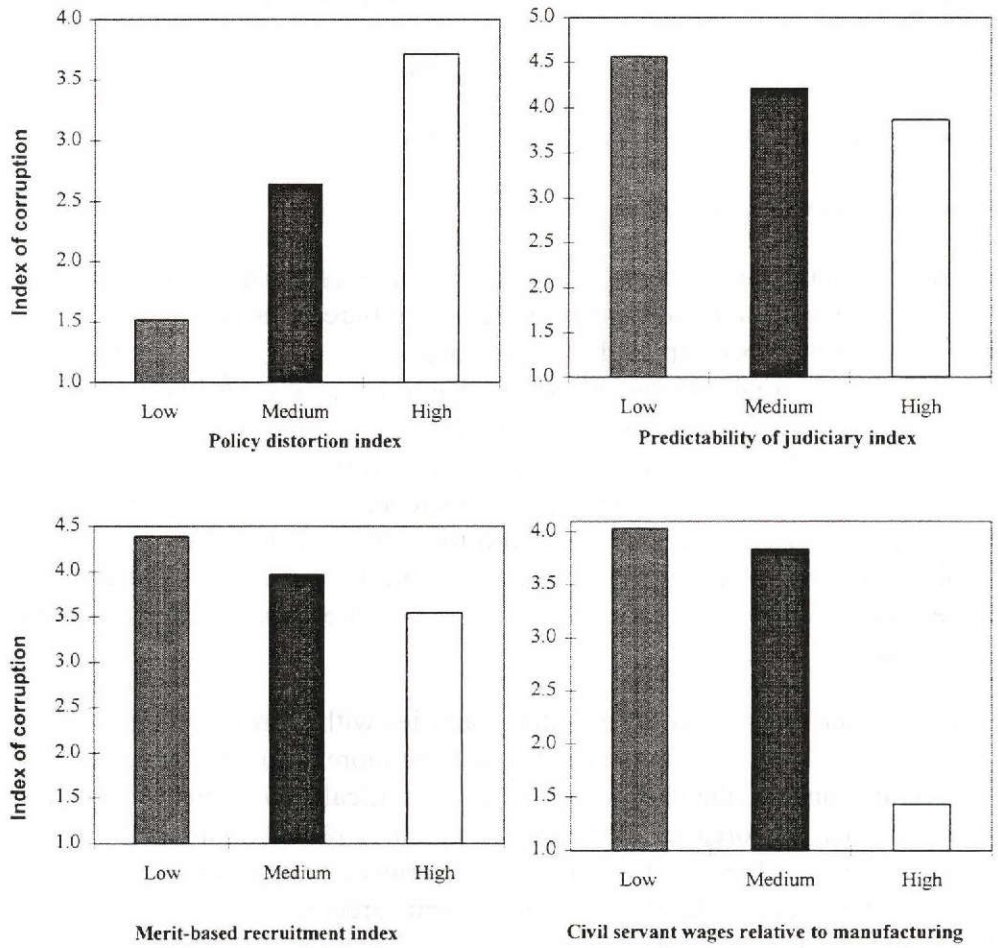
30. Over the long term, building accountability generally calls for formal mechanisms of restraint, anchored in core state institutions. Power must be divided—whether among judicial, the legislature, and executive branches of government or between central, provincial, and local authorities. The broader the separation of powers, the greater the number of veto points needed to check arbitrary state action. But multiple veto points can be a double-edged sword—they can make it as hard to change the harmful rules as the beneficial ones.

31. In many developing countries legislative and judicial oversight of the executive is weak. The setting of goals and the links to policy are diffuse, legislatures operate with limited information and capacity, and judicial independence is compromised. But an independent judiciary is vital to ensure that the legislative and executive authorities remain fully accountable to the law, and to interpret and enforce the terms of any written constitution. Writing laws is the easy part; they need to be enforced if a country is to enjoy the benefits of a credible rule of law. International commitment mechanisms can serve as a short-term substitute while these institutions are being built up.

32. Formal checks and balances can also help to reduce official corruption, but they are seldom enough. Civil service reforms, restraining political patronage, and improving pay levels have also been shown to reduce corruption by giving public officials more incentive to play by the rules (Figure 4). But another thrust of any effective anticorruption strategy will be to reduce the opportunities for corruption, by cutting back on discretionary authority. Policies that lower controls on foreign trade,

remove entry barriers for private industry, and privatize state firms in a way that ensures competition—all of these will fight corruption.

Figure 4 Factors correlated with corruption



33. Where corruption is deeply entrenched, more dramatic efforts will be needed to uproot it. These efforts should be focused on better monitoring of official action—both by formal institutions and individual citizens—and rigorous punishment of wrongdoing in the courts. Hong Kong's independent commission against corruption provides one successful example. Recent reforms in Uganda have incorporated several elements of the anticorruption strategy outlined here—with some encouraging results. The same mechanisms could be applied around the globe: corruption, despite claims to the contrary, is not culture specific.

Subjecting the state to more competition

34. *Governments can improve their capability and effectiveness by introducing much greater competition in a variety of areas: in hiring and promotion, in policymaking, in how they get services delivered.*. Whether making policy, delivering

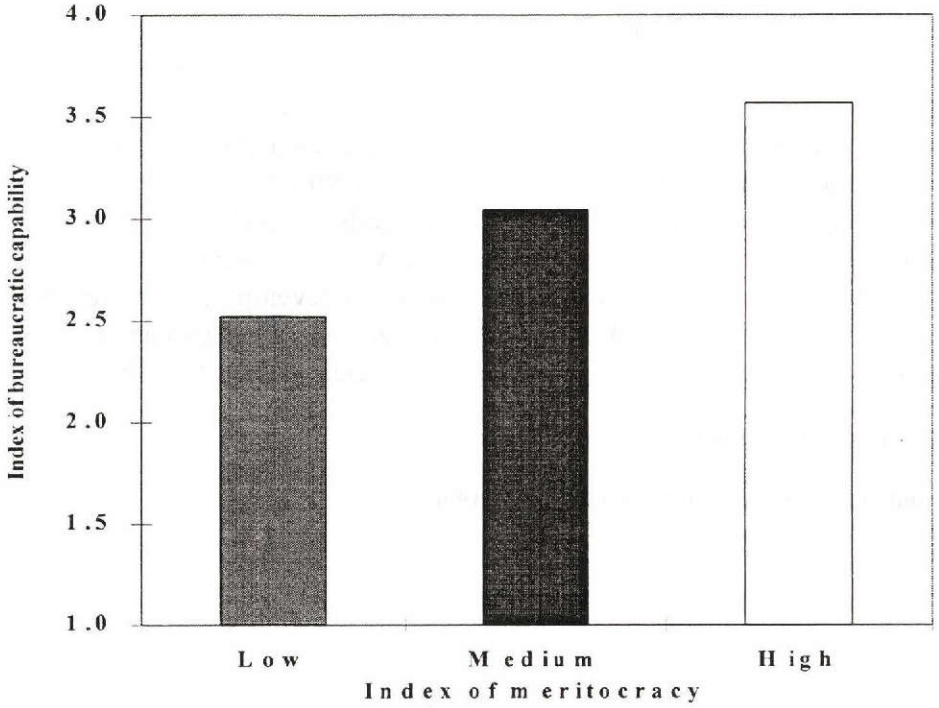
services or administering contracts, capable, motivated staff constitute the lifeblood of an effective state. How can civil servants be motivated to perform effectively? Through a combination of mechanisms that encourage competition:

- a recruitment system based on merit—not favoritism
- a merit-based internal promotion system
- reduced day-to-day political interference
- adequate compensation.

35. Starting in the nineteenth century, all of today's established industrial countries used these principles to build modern professional bureaucracies. More recently, these principles have been applied in many countries in East Asia. Many of these countries transformed weak, corrupt, patronage-based bureaucracies into reasonably well-functioning systems. But many developing countries do not even need to look overseas or to history for role models: they exist at home. Central banks, for example, often continue to work effectively and retain their competence even when all other institutions have declined. These agencies work well for all the reasons listed above. They are less subject to political interference. They have limited but clear objectives. They are provided adequate resources and training. And they are usually better paid than other parts of government.

36. Cross-country evidence reveals that countries with more competitive, merit-based recruitment and promotion and better pay have more capable bureaucracies (Figure 5). In several countries (the Philippines, Kenya) political appointments run quite deep, while countries such as Korea rely on highly competitive recruitment and a promotion system that explicitly rewards merit. The experience of high performing East Asian countries also shows that meritocracy and long-term career rewards help build an esprit de corps, or an identification with collective goals. This reduces the transactions costs of enforcement and builds internal partnerships and loyalty.

Figure 5 Meritocracy enhances bureaucratic capability



Source: Evans and Rausch 1996.

37. In many developing countries, erosion of civil servant's wages has been fueled by expanding public employment at lower skill levels and fiscal constraints on the total wage bill (Figure 6). The result has been a significant compression of the salary structure and highly uncompetitive pay for senior officials, making it difficult to recruit and retain capable staff. But some countries such as Uganda are undertaking far-reaching reforms that have dramatically reduced overstaffing, raised average pay and decompressed the salary structure.

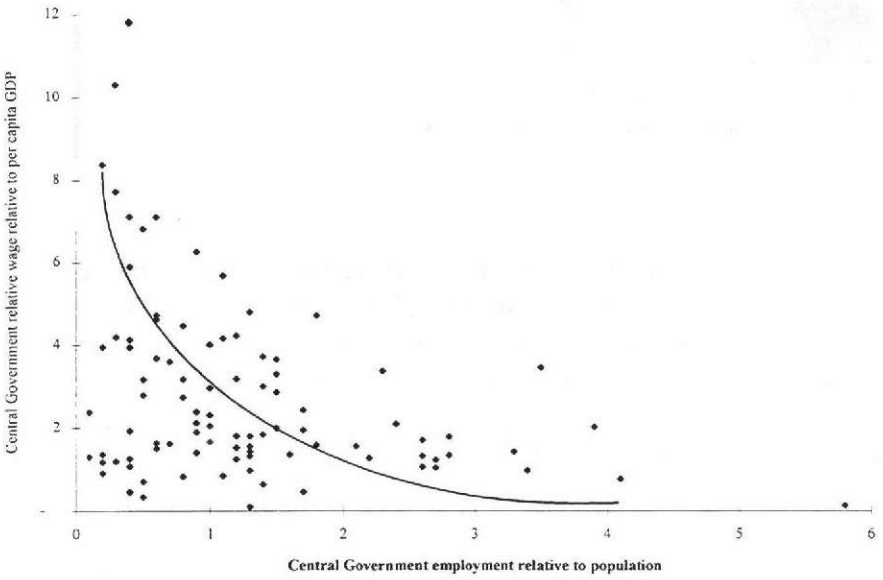
38. Instituting a professional bureaucracy will take considerable time. In the meantime some other measures can be implemented more quickly, and some of these can even generate early payoffs. Public sector capability can be enhanced by promoting more competitive pressures and partnerships in policymaking and service delivery.

39. *Faced with fiscal constraint and citizen dissatisfaction, governments are exploring a range of alternative means of delivering public goods and services, which aim to introduce greater competition through markets or market surrogates.* In many developing countries services are delivered badly or not at all. Politicians often intervene in the day-to-day operations of public agencies, and managers have limited flexibility. There is limited probity or accountability for results. And in many countries the public sector has assumed a monopoly in delivery, eliminating pressures for better performance.

40. Building an effective public sector will mean opening up core government institutions to improve incentives in areas that the public sector has long monopolized. Dozens of countries throughout the Americas, Europe and Asia have capitalized on changes in technology and introduced competition in telecommunications and power generation. This has resulted in significantly lower unit costs and a rapid expansion of services provided. Some countries are also introducing greater competition through vouchers, for instance in education (Chile, Colombia). Competition is also being enhanced by contracting out services through competitive bids and auctions. This is a significant trend in industrial countries (United Kingdom, Victoria State in Australia), but such mechanisms are also being used to improve efficiency in developing countries (road maintenance in Brazil). Faced with weak administrative capacity, some countries (Bolivia, Uganda) are also contracting out the delivery of social services to NGOs.

Figure 6 Higher public employment leads to lower salaries

Pay and employment in 103 countries, early 1990's



Source: Schiavo-Campo, De Tommaso, and Mukherjee 1996.

41. There is a growing trend to set up focused, performance-based public agencies with greater clarity of purpose and greater managerial accountability for outputs or outcomes. New Zealand is the most dramatic example among the high-income countries. It broke its conglomerate ministries up into focused business units, headed by chief executives on fixed-term, output-based contracts and with the authority to hire and fire. Singapore has long followed a broadly similar approach through its performance-based statutory boards. Ghana set up a performance-based tax agency, and was able to double its revenue collection during the 1980s. Other developing countries are following suit, such as Jamaica with its executive agencies based on the British model.

42. But countries with inadequate controls over inputs and weak capacity need to proceed with caution. For these countries providing greater managerial flexibility will only increase arbitrariness and corruption without commensurate improvements in performance. And writing and enforcing contracts, particularly for complex outputs, requires specialized skills that are scarce in many developing countries. These countries need to first strengthen rule-based compliance and financial accountability (Argentina, Bolivia), provide greater clarity of purpose and task, and introduce performance measurement (Colombia, Mexico, Uganda). As output measurement and ex-post input controls are strengthened, agencies can be provided more flexibility in exchange for greater accountability for results.

Bringing the state closer to people

43. Governments are more effective when they listen to businesses and citizens and work in partnership with them in deciding and implementing policy. Devolving power from the center can be part of this effort—if it is done right. Where governments lack mechanisms to listen, they are not responsive to people's interests, especially those of minorities and the poor. There is mounting evidence that government programs work better when they seek the participation of potential users, and when they tap the community's reservoir of social capital rather than work against it. The benefits show up in smoother implementation, greater sustainability, and better feedback and evaluation to government agencies. Higher returns from water-borne sanitation systems in Recife, Brazil; housing schemes for the poor in Port Elizabeth, South Africa; management efforts in Gujarat, India, and health care in Khartoum, Sudan, are all testament to the power of partnership—the participation of local people.

44. In successful countries policymaking has been embedded in consultative processes which provide civil society and private firms opportunities for input and oversight. In East Asia public-private deliberation councils—such as Korea's monthly export promotion meetings, Thailand's National Joint Public and Private Consultative Committee, the Malaysian Business Council—have provided mechanisms for feedback, information-sharing and coordination.

45. Partnership involves bringing the voice of the poor and marginalized groups into the very center of the policymaking process. In many societies, voice is distributed as unequally as income. Only the voices of the rich, the powerful, or the very vocal are heard; the result is a distortion of public policy. The state has an obligation to listen to a broad range of voices in deciding its priorities. Greater information and transparency are important for informed public debate and for increasing popular trust and confidence in the state—whether in setting expenditure priorities, designing, pension and unemployment programs, or managing forests and other resources. Client surveys (in India, Nicaragua, and Tanzania) and citizen charters (in Malaysia) are providing new options to make voices heard.

46. One well-established mechanism for voice is the ballot box. In 1974 only thirty-nine countries—one in every four countries in the world—were independent democracies. Today, 117 countries—nearly two of every three—use open elections to choose their leaders. But the use of the ballot does not always mean the state is more responsive. Other mechanisms are needed as well to ensure that the concerns of minorities and the poor are reflected in public policies. Getting genuine intermediary organizations represented on policymaking councils is an important first step in articulating citizen interests in public policymaking. Even more effective in local and provincial government, these organizations have recently become very active in developing countries—especially where the state has not delivered and where such organizations are not suppressed.

47. *Devolving power from the center can help bring the state closer to the people and increase competitive pressure within government, but there are risks.* The typical developing country is more centralized than the typical industrial country. But the past thirty years, with some significant exceptions, has seen a small shift in public spending power in developing countries from the national to lower levels. The industrial economies have seen an opposite trend, with spending power moving to the center. Neither of these facts, of course, takes into account the decentralization implicit in recent market reforms, which have clearly reduced the direct power and resources of central government in a broad range of countries.

48. Decentralization is bringing enormous benefits in China, India, much of Latin America, and many other parts of the world. It can improve the quality of government. It can improve the representation of local business and citizens' interests. Competition among provinces, cities, and localities can also spur the development of more effective policies and programs. But there are three big pitfalls:

- *Rising inequality.* The gap between regions can widen—an issue of considerable concern in China. Labor mobility provides a partial solution, but it is seldom easy, especially in ethnically diverse countries where migrants are not always welcome.

- *Macroeconomic instability.* Governments can lose control of macroeconomic policy if local and regional fiscal indiscipline leads to frequent bailouts from the center as in Brazil.

- *Risk of local capture.* There is the serious danger of local governments falling under the sway of special interests, leading to misuse of resources and of the coercive power of the state.

49. These dangers show, once again, how central government will always play a vital role in sustaining development. The challenge is to find the right division of labor between central and local government.

50. Building a more responsive state requires working on mechanisms that increase openness and transparency, increase incentives for participation in public affairs, and, where appropriate, lessen the distance between government and the citizens and communities it is intended to serve. The main policy implications are the following:

- Ensure broad-based public discussion of key policy directions and priorities. At a minimum this includes making available information in the public interest, and establishing consultative mechanisms—such as advisory councils, deliberation councils, and citizen committees—to gather the views and make known the preferences of affected groups.

- Encourage, where feasible, the direct participation of users and other beneficiaries in the design, implementation, and monitoring of local public goods and services.

- Where appropriate, adopt a carefully staged and/or sectoral approach to decentralization in priority areas. Introduce strong monitoring mechanisms and make sure sound intergovernmental rules are in place to restrain arbitrary action at the central and the local level.

- At the local level, focus on the processes (and horizontal incentives) for building accountability and competition.

51. Of course, a strategy of more openness and greater decentralization has its dangers. On the one hand, the more opportunities exist for participation, the greater the demands that will be made on the state. This can increase the risk of capture by vocal interest groups, or of gridlock. On the other hand, without clear-cut rules to impose restraints on different tiers of government, and without incentives to encourage local accountability, the crisis of governance that afflicts many centralized governments will simply be passed down to lower levels. However, there are some clear ways forward, including rendering reform intelligible to citizens and the business community through communication and consensus building.

Beyond national borders: Facilitating global collective action

52. Globalization is a threat to weak or capricious states. But it also opens the way for effective, disciplined states to foster higher levels of development and economic well-being, and it raises the need for international cooperation in pursuit of global public goods. The state may still define the policies and rules for those within its jurisdiction, but global events and international agreements are increasingly affecting its choices. People are now more mobile, more educated, and better informed about conditions elsewhere. And membership in the global economy tightens constraints on arbitrary state action, reduces the state's ability to tax capital, and brings much closer financial market scrutiny of monetary and fiscal policies.

53. Some argue that the end-result of this process of integration will be a withering away of the nation-state. The worry is that, instead of being catalysts for their country's development, governments are being reduced to impotent bystanders, beholden to global forces they cannot control. Indeed, fear of the effects of closer integration can partly explain why globalization is not yet truly global—it has yet to touch a large chunk of the world economy. Roughly half of the developing world's people have been left out of the much-discussed rise in the volume of international trade and capital flows since the early 1980s.

54. Experience has shown that greater openness can dramatically increase the pace and depth of an economy's development. But governments' hesitance to open up to the world economy is partly understandable. Joining the global economy, like devolving power from the center, carries risks as well as opportunities. For example, it can make countries more vulnerable to external price shocks or to large, destabilizing shifts in capital inflows. This makes the state's role all the more critical, both in handling such shocks and in helping people and firms grasp the opportunities of the global marketplace. But the difficulties should not be exaggerated, particularly when laid against the risks of being left out of the globalization process altogether.

55. The cost of not opening up will be a widening gap in living standards between those countries that have integrated and those that remain outside. For lagging countries the route to higher incomes will lie in pursuing sound domestic policies and building the capability of the state. Integration gives powerful support to such policies—and increases the benefits from them—but it cannot substitute for them. In that sense, globalization begins at home.

56. Global integration also gives rise to demands for states to cooperate to combat international threats such as terrorism and global warming. Economic, cultural, and other differences between countries can make such cooperation difficult—even, at times, impossible. But stronger cooperation is clearly needed for at least five major concerns that transcend national borders:

- *Managing regional crises.* The threat of nuclear war between the superpowers has given way to a mushrooming of smaller conflicts, entailing costly problems of refugee relief and rehabilitation. No solid international framework exists for managing these conflicts or helping avoid them. A more integrated assessment of how state policies (and international assistance) help manage nascent conflict is needed in designing economic and social policy. Malaysia and Mauritius provide positive examples.

- *Promoting global economic stability.* Concern has been growing about the destabilizing effects of large and rapid flows of portfolio capital, particularly when a crisis in one country can spill over into other markets. A variety of international mechanisms have been

suggested to guard against such problems, including coordinated actions by central banks to ward off speculative attacks and a tax on portfolio transactions. The International Monetary Fund has recently created a new facility to help members cope with sudden financial crises.

- *Protecting the environment.* Urgent global environmental issues include climate change, loss of biodiversity, and protection of international waters. International collective action can help through better coordination, greater public awareness, more effective technological transfer and better national and local practices. With progress so slow, the worry is that it will take a major environmental catastrophe to goad countries into concerted action.

- *Fostering basic research and the production of knowledge.* Now being revitalized to meet renewed challenges in food production, the Consultative Group on International Agricultural Research has shown how technology can be developed and disseminated through international collective action. Similar consultative mechanisms need to be developed to tackle other pressing research problems in the domains of environmental protection and health.

- *Making international development assistance more effective.* To become more effective, foreign aid needs to be tied more closely to the policies of the recipient countries. A high priority for aid agencies is to systematically channel resources to poor countries with good policies.

Removing obstacles to state reform

57. The history of state reform in today's established industrial countries offers hope—and gives pause—to today's developing countries. Until the last century many of the problems that now appear to have reduced the effectiveness of the state in the developing world were in plain evidence in Europe and Japan. But the problems were addressed, and modern states with professional systems emerged. This gives us hope. But it also gives us pause, because institutional strengthening take time. The reforms of the Meiji restoration that launched Japan onto the path of development took almost twenty-five years to take root. Building a more capable state is possible, but it will be slow and will require immense political commitment. It is urgent to act now because the luxury of gradual evolutionary reforms is not one that the developing world can afford.

58. Over the past fifteen years many governments have responded to internal and external pressure by launching far-reaching reforms to improve their performance. Typically, changes in macroeconomic policy—dealing with exchange rates, fiscal policy, and trade policy—have come fastest. These reforms have political implications but do

not require the overhaul of institutions. They can be undertaken quickly, often through decree, by a small group of competent technocrats. All it takes is the political decision to make the change (Table 1).

Table 1 First and second generation reforms

	First generation	Second generation
Main objectives	Crisis management: reducing inflation and restoring growth	Improving social conditions and competitiveness, and maintaining macroeconomic stability
Instruments	Drastic budget cuts, tax reform, price liberalization, trade and foreign investment liberalization, deregulation, social funds, autonomous contracting agencies, some privatization	Civil service reform, labor reform, restructuring of social ministries, judicial reform, modernizing of the legislature, upgrading regulatory capacities, improving of tax collection, large-scale privatization, restructuring of central-local relationships.
Actors	Presidency, economic cabinet, central bank, multilateral financial institutions, private financial groups, foreign portfolio investors	Presidency and cabinet, congress, civil service, judiciary, unions, political parties, media, state and local governments, private sector, multilateral financial institutions
Main challenge	Macroeconomic management by an insulated technocratic elite	Institutional development highly dependent on middle management in the public sector

Source: Adapted from Moises Naim, 1996.

59. But other state reforms dealing with regulation, social services, finance, infrastructure, and public works cannot be accomplished so rapidly because they involve changing institutional structures established for different purposes, to fit different rules of the game. This kind of institutional reform involves wrenching changes in the way government agencies think and act and often a complete overhaul of long-established systems of patronage and corruption. But such change is absolutely essential if the capability of the state is ever to improve.

60. Comprehensive reform along these lines will take enormous time and effort in many developing countries and the regional agenda varies enormously (Box 2). And it will encounter considerable political opposition. But reformers can make a good start by strengthening central agencies for strategic policy formulation, introducing greater transparency and contestability in decisionmaking, hiving off activities and agencies with easily specified outputs, and seeking more feedback from clients about the delivery of services.

Box 2 The regional agenda

The key features and challenges of improving the effectiveness of the state in the various developing regions are summarized below. These are of necessity broad generalizations, and each region includes several countries with experiences entirely different from those sketched out below.

- In many parts of **Africa** an immediate need is to rebuild the rule of law through fortified and more independent judicial systems. Where the links between the state and civil society are fragile and

underdeveloped, improving the delivery of public and collective services will require closer partnerships with the private sector and civil society.

- Clearly the capability of the state in most **East Asian** countries cannot be considered a problem; indeed, it is an important part of the solution to their other problems.

- The main issue in **South Asia** is overregulation, both a cause and an effect of bloated public employment and the surest route to corruption. Regulatory simplification and public enterprise reform, and the resulting contraction of the role of the state, will be complex and politically difficult.

- The job of reorienting the state toward the task of "steering, not rowing" is far from complete in **Eastern Europe**. But most countries have made progress and are on the way to improving capability and accountability.

- Low state capability in many countries of the **Commonwealth Independent States** (CIS) is a serious and mounting obstacle to further progress in most areas of economic and social policy. In the CIS, the process of reorienting the state is still at an early stage, and a host of severe problems have emerged from general lack of accountability and transparency.

- Decentralization of power and of spending, coupled with democratization, has dramatically transformed the local political landscape, in what some have called a "quiet revolution." A new model of governance is emerging in **Latin America**. Court systems in most Latin American countries have suffered from major inefficiencies, widespread corruption, and political interference.

- In the **Middle East and North Africa**, unemployment is by far the single greatest economic and social problem and makes government downsizing especially difficult. Because the political and social difficulties of reform are probably greater in the Middle East and North Africa than in any other region, a promising approach might be to follow Latin America's decentralizing strategy.

When do reforms occur?

61. Distributional conflicts and constraints embedded in state institutions are not immutable. Change ultimately comes when the incentives to remaining with old policies and old institutional arrangements is no longer beneficial to society. An economic crisis or an external threat may provide the impetus for reform. But reform can be delayed if those in power stick with outdated policies because it is in their (or their allies') interest to do so. Sometimes the delays can be painfully long, as in Haiti under the Duvaliers, or in Zaire today.

62. Neighbors, too, can be a powerful motivator for change. There is a clear domino effect at work in the wave of reform sweeping East Asia, Latin America, and much of Eastern Europe and the former Soviet Union. The threat of being left behind can goad countries to improve the functioning of their bureaucracies. But research has yet to explain why some countries respond to crises and others do not. Why, for example, does popular tolerance of inflation seem to be much lower in Asia than in parts of Latin America? And why can some countries endure a long period of economic decline before responding, while others take action much sooner?

63. Often the analysis of winners and losers yields a prediction of when—or at least whether—reforms will be undertaken. Reforms have little appeal if the winners cannot compensate the losers. Even when the potential gains are such as to allow compensation, reform can be hard to achieve because the gains are spread over many people whereas the losers, although smaller in number, are powerful and articulate. A further problem is that the benefits are often realized in the future, whereas the losses are immediate. Sometimes, however, conditions have deteriorated so far that the winners far outnumber the losers. Then reform can produce immediate economic and political benefits.

How can reforms be sustained?

64. Reform-oriented political leaders and elites can speed reform by making decisions that widen the options, articulate the benefits clearly, and ensure that policies are more inclusive. In recent years farsighted political leaders have transformed the options for their people through decisive reform. They were successful because they made the benefits of change clear to all, and built coalitions that gave greater voice to often silent beneficiaries. They also succeeded—and this is crucial—because they spelled out a longer-term vision for their society, allowing people to see beyond the immediate pain of adjustment. Effective leaders give their people a sense of owning the reforms—a sense that reform is not something imposed from without.

65. Compensation of groups adversely affected by reform helps secure their support. These groups may not necessarily be the poorest in society. Although compensation may be economically costly in the short run, it will pay off in the long run. Reforming the state requires cooperation from all groups in society. Deep-seated differences and mutual suspicions among groups can delay reform. There are no quick fixes for removing age-old enmities, but social pacts, such as Spain's Moncloa Pacts and Benin's National Economic Conference can help.

66. International agencies can encourage and help sustain reform in four ways. First, they can provide important technical advice on what to do and what not to do. This assistance is often invaluable, especially for the smaller states that lack the resources to handle all the technical issues internally. But it must be complemented by local expertise to adapt reforms to local conditions and institutions. The World Trade Organization plays a major role in trade reform, the World Health Organization on health issues, and the International Labour Organization on labor legislation. Second, international agencies can provide a wealth of cross-country experience on a wide range of issues. Often staffed by people from all over the world, they can bring in experts from different backgrounds. Third, the financial assistance these agencies provide can help countries endure the early, painful period of reform until the benefits kick in. Fourth, they can provide an external commitment mechanism, making it more difficult for countries to reverse reforms.

Good government is not a luxury—it is a vital necessity for development

67. The approach of the twenty-first century brings great promise of change and reason for hope. We know that state-led development has failed. But there is growing recognition that development needs an effective state. In a world of dizzying changes in markets, civil societies, and global forces, the state is under pressure to become more effective, but it is not yet changing rapidly enough to keep pace. Not surprisingly, there is no unique model for change, and reforms will often come slowly because they involve a fundamental rethinking of the roles of institutions and the interactions between citizens and government. Reform of state institutions is long, difficult, and politically sensitive. But the issues raised in this Report are now an integral part of the thinking and rethinking of the state in many parts of the world and are on the agenda of the international organizations that assist them.

68. People living with ineffective states have long suffered the consequences in terms of postponed growth and social development. But an even bigger cost may now threaten states that postpone reforms: political and social unrest and, in some cases, disintegration with tremendous tool on stability, productive capacity, and human life. The enormous toll has naturally turned attention to prevention as a preferable and potentially less costly course of action—but there are no shortcuts to prevention. Once the spiral into collapse has occurred, there are no "quick-fixes."

69. Instances of state collapse are both extreme and unique but are growing. As the Report elaborates there are no simple generalizations about their causes or effects, each instance produces its own challenges for individual nations and for the and for the international system as a whole. The consequences are, however, almost uniformly borne by ordinary people, illustrating once again how fundamental an effective, responsive state is to the long term health and wealth of society.

70. The quest for a more effective state even in the established industrial countries suggests that the returns to small improvements are high. This is especially true in countries where the effectiveness of the state is low. Even smallest increases in the capability of the state have been shown to make a vast difference to the quality of people's lives over time, not least because reforms tend to produce their own virtuous circle. Small improvements in the state's effectiveness lead to higher standards of living, in turn paving the way for more positive reforms and further development.

71. A tour of the world's economies in 1997 would turn up countless examples of these virtuous circles in action. But it would provide equally plentiful evidence of the reverse: countries and regions caught in vicious cycles of poverty and underdevelopment set in train by the chronic ineffectiveness of the state. Such cycles can all too easily lead to social violence, crime, corruption, and instability, all of which undermine the state's capacity to support development—and even to function at all. The crucial challenge facing states is to take those steps, both small and large, to better government that set economies on the upward path using the two-part framework

suggested in this Report. Reform may impose heavy costs at first, but postponing reform would be costlier still. Without an effective state the basic foundations for market and social development are unattainable—even more so in a rapidly changing world.

DRAFT
(NOT FOR QUOTATION)
March 3, 1997

WORLD DEVELOPMENT REPORT 1997
THE STATE IN A CHANGING WORLD

Part A Rethinking the State—the World Over

1. The Evolving Role of the State

2. Refocusing on the Effectiveness of the State

This draft has been prepared by a team led by Ajay Chhibber and with principal authors Simon Commander, Alison Evans, Harald Fuhr, Cheikh Kane, Chad Leechor, Brian Levy, Sanjay Pradhan, and Beatrice Weder. The work was carried out under the direction of the late Michael Bruno, Lyn Squire, and Joseph Stiglitz.

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Part A Rethinking the State—The World Over

A.1 The state—what it is, what it should do, how it should do it—has undergone intense examination and wrenching identity shifts throughout history. In this century our concept of the state's role has expanded enormously. But in the past decade or so that concept has had to adjust to dramatic changes: the end of the Cold War and the collapse of command-and-control systems, the fiscal crises of welfare states, the dramatic success of some East Asian countries in accelerating economic growth and reducing poverty, and the crisis of failed states in parts of Africa.

A.2 Reconciling the role of the state to these political and economic upheavals has forced changes in intellectual perspectives. But the demise of central planning as an alternative to the mixed economy, the state's contribution to growth and to the eradication of poverty in East Asia, and the limitations of state intervention when institutional capability is weak are only a few of the changes forcing conceptual shifts. Added to them are the rapid diffusion of technology, growing demographic pressures, an increased awareness of environmental problems, greater global integration of markets, and a shift to more democratic forms of government. And amid all these changes, some formidable, long-standing challenges remain: reducing poverty and fostering sustainable development.

A.3 It is not surprising, then, that demand is building throughout the world for a reexamination of the role of the state in human welfare and economic development. Within many countries, the debate is not only about *what* should be the appropriate role of the state, but also about *how* the state should play out that role. This Report explores why and how some states have been more effective than others at playing a catalytic and sustainable role in economic development and poverty eradication. Part A provides a broad historical and conceptual introduction (in Chapter 1) and examines the empirical evidence of the impact of state policies and institutions on development (Chapter 2). It conveys three principal messages:

- State-led development has failed, but development without an effective state is impossible. For developing countries the model of state-led development of the 1960s and 1970s was replaced by the 1980s' model of a much smaller role for the state. But today this shift is undergoing some correction. We are recognizing again that an effective state—not a minimal one—is central to economic and social development, but more as partner and facilitator than as director. State should work to complement markets and households, not replace them. And the emphasis is shifting toward finding ways to make the state more effective.

- We need a deeper understanding of why some states are better than others at providing the framework for development. A rich body of evidence documents the importance, for broad-based and sustained

growth and the elimination of poverty, of good economic policies (such as those that promote macroeconomic stability), well- developed human capital, and openness to the world economy. But as our understanding of the ingredients of development improves, a deeper set of questions emerges: Why have some societies pursued these actions with greater success than others? And what precisely is the role of the state in those differences?

- The historical record suggests the importance of building on the relative strengths of the market, the state, and civil society to improve the state's effectiveness. This entails a two-part strategy of matching the role of the state to its capability, and improving that capability. Capability can be improved by fostering partnerships with markets and civil society, by subjecting the state to more competitive pressures in policymaking and service delivery, and by improving the enforceability of rules in society more broadly as well as within the state.

Chapter 1 The Evolving Role of the State

1.1 A century ago, a Korean farmer and a Brazilian farmer, although living continents apart, would both have felt the presence of their governments primarily through such classic public goods as law and order and investment in basic infrastructure. Today, in contrast, their descendants send their children to government-run schools, receive medical treatment from publicly supported clinics, rely on an array of publicly provided utilities, and enjoy public price supports on their inputs or their final products. And despite the gulf between their incomes and in the quality and coverage of the public services they receive, these later generations of Koreans and Brazilians probably share a common concern for the effectiveness with which their government functions and the checks and balances on its decisions.

1.2 The expansion of national and global communications and the opening of markets have made people aware not just of each other but also of how they and others are governed—for good or ill. The Korean farmer of century ago might not even have been aware of the other's life. His descendants are likely to have an idea of what public services are offered in Brazil and elsewhere and how their own state stacks up against others. Radio and television, private sector activists and public extension agents, and friends and relatives traveling to foreign lands as tourists or migrant laborers have made them far more aware of what they can and should expect from the state.

1.3 It is not hard to find examples of the power of the state to improve the quality of people's lives. Public institutions have been instrumental in achieving breakthroughs in public health, from clean water and sanitation systems in ancient Rome, to public health boards in the medieval city-states of Italy, to the polio vaccine and the elimination of smallpox in this century. States have long played a vital role in stimulating lasting development gains by providing infrastructure, security, and a stable macroeconomy. The Internet is only the latest in a long line of remarkable scientific and technical advances made possible by early and significant public support (Box 1.1).

1.4 Yet every beneficial public action seems to have as its counterpart some undesirable consequence of bad government, from the abuse of citizens' rights, to the debasement of currencies, to imprudent spending that fuels inflation, to failure to provide a stable economic environment within which citizens can carry on their daily affairs. Thomas Hobbes's 1651 treatise on the state as Leviathan proceeds from the assumption that the state's failure to provide a stable environment for its citizens would render their lives "solitary, poor, nasty, brutish, and short."

1.5 These humbling words ring as true today as they did in the middle of the seventeenth century. Nothing is as crushing as the collapse of a state from within, leaving its citizens bereft of even the basic conditions of a functional polity: law and security, trust in contracts, and a sound medium of exchange. In Afghanistan, Liberia, and Somalia—to name a few recent examples—the consequence of a collapsing state has been a precipitous decline in all measures of well-being. Less extreme, but still troubling, have been the consequences when states in transition from socialism abandoned their traditional roles in housing, health care, and

other social services before alternative private provision was in place. Their citizens pay the price of this desertion in declining life expectancy and the reemergence of once-controlled contagious diseases. Despite these difficulties, the record shows that dozens of countries have achieved development success by capitalizing on the intrinsic strengths of state power—and by finding ways to balance flexibility in achieving the state's goals with restraints on its arbitrary action.

Box 1.1 Building the Internet: Fruitful interaction between public and private agency

The Internet was launched in 1969 with four interconnected computers in the United States. It is now accessible in 174 countries and on all seven continents. By mid-1996 the Internet comprised nearly 13 million host computer systems worldwide. By 2000 there will be some 100 million.

The economics of defense research in the 1960s led to the creation of the ARPANET, the seed network of the Internet. In 1968 the U.S. Department of Defense sent proposals to 140 private companies to design and build the first four interface message processors, or routers, to link different computers and avoid costly duplication of publicly financed computing resources. Public contracts with leading universities then led to development of the crucial set of protocols that could link diverse computer networks and that later spawned the Internet.

Complementary to this public financial support has been the partnership of academia, business, and government led by the U.S. National Science Foundation (NSF). Initially this partnership primed the connection of university computer science departments, but its influence soon expanded. NSFNET replaced ARPANET in 1990. Besides the critical finance for a high-speed backbone infrastructure, the NSF provided grants to universities to encourage them to form regional networks that would feed into the NSFNET system. But the networks were also told that they would have to become self-sustaining.

The involvement of the private sector has deepened over time. The NSF encouraged private commercial carriers of electronic mail to link to the Internet. Private companies also began to create their own backbone facilities, and the number of firms supplying access to the Internet multiplied. These trends were accelerated by the growth of the multimedia part of the Internet—the World Wide Web. Developed at the laboratories of the European Organization for Nuclear Research in Switzerland—another publicly supported agency—the Web drew in talent from universities and the private sector, leading to yet another explosion in use: from 130 sites in July 1993 to over 230,000 in June 1996.

In 1995 the NSFNET was replaced by a fully commercial system. Major telephone companies now provide not only backbone facilities but also Internet access to their customers. Cable and direct broadcast satellite companies are also entering the market. The public sector is still involved in some advanced research, but its focus has shifted to questions of how to ensure equitable access (including pricing rules), freedom of expression, protection from fraud, and privacy.

1.6 This chapter provides a broad historical and conceptual introduction and context for the Report. It first examines some historical antecedents, focusing on the expansion of the state in the twentieth century and shifts in the role of the state in industrial and developing countries. Building on the historical record, the rest of the chapter lays out a simple framework for rethinking the state and proposes a two-part strategy for improving its effectiveness.

1.7 In this Report, we recognize the distinction between *state* and *government* (Box 1.2). But while keeping these distinctions in mind, we also use the terms colloquially and sometimes interchangeably—as they are often used in discussion and writing around the world.

Box 1.2 State and government: some concepts

State, in its wider sense, refers to a set of institutions that possess the means of legitimate coercion, exercised over a defined territory and its population referred to as society. The state monopolizes rulemaking within its territory through the medium of an organized *government*.

The term *government* is often used differently in different contexts. It can refer to the process of governing, to the exercise of power. It can also refer to the existence of that process, to a condition of "ordered rule." Government often means the people who fill the positions of authority in a state. Finally, the term may refer to the manner, method, or system of government in a society, to the structure and arrangement of the offices of government and how they relate to the governed.

Government is normally regarded as consisting of *three* distinct sets of powers, each with a particular role. One is the *legislature*, whose role is to make the law. A second is the *executive* (sometimes referred to as "the government"), which is responsible for implementing the law. The third is the *judiciary*, which is responsible for interpreting and applying the law.

Classifications of government are many but have tended to concentrate on two criteria: the arrangement of offices, which is more narrow in conception; and the relationship between government and the governed.

The first classification is based on the relationship between the executive and the legislature. In a *parliamentary* system the executive's continuance in office depends on its maintaining the support of the legislature. Members of the executive are commonly also members of the legislature. A prime minister may be the most powerful member of the executive, but important decisions within the executive are usually made collectively by a group of ministers. In a *presidential* system the executive's position is independent of the legislature. Members of the executive are not normally also members of the legislature, and ultimate decisionmaking authority within the executive lies with one person, the president.

The second classification concentrates on the distribution of power between levels of government. In a unitary state, all authority to make laws is vested in one supreme legislature whose jurisdiction covers the whole country. Local legislatures may exist, but only with the sufferance of the main legislature. In a federal state, local legislatures are guaranteed at least a measure of autonomous decisionmaking authority. In a confederation a group of sovereign states combine for specified purposes, but each state retains its sovereignty.

Some historical antecedents

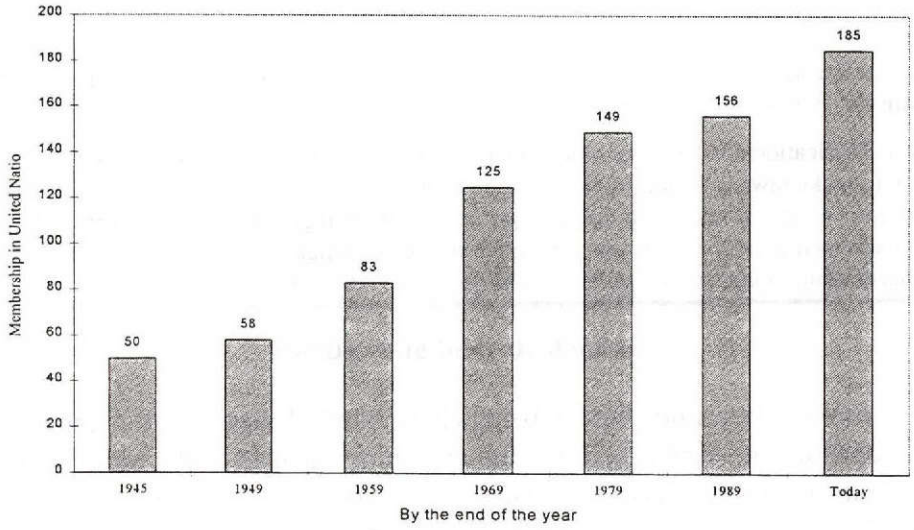
1.8 From earliest times human beings have banded together into larger associations, starting with household and kinship groups and extending through to the modern state. For states to exist, individuals and groups have had to cede authority in key areas, such as defense, to a public agency. That agency has had to possess certain primary or coercive powers over all other organizational forms within a given territory.

1.9 The organizational and territorial bases of states have been diverse, shaped by a constellation of factors including culture, natural endowments, opportunities for trade, and distribution of power. The Athenian state of classical antiquity owed its thriving urban culture and small government to the underpinnings of slavery and colonial spoils. Eventually, however, these underpinnings proved Athens' undoing: without an imperial bureaucracy its conquests and colonial revenues were short-lived; slavery inhibited technical and economic progress at home. In Europe, the history of the state has been complex, but one constant thread has been that, over time, the absolute powers of rulers were brought under check—although exceptions remain even in the twentieth century.

1.10 Further East, elaborate state structures were built from early times on the basis of state ownership of land. States in Mughal India and Imperial China were based on highly developed systems of administration and tax collection. When these were impaired or challenged, states disappeared or dynasties gave way to rivals. The combination of public ownership of land and a complex bureaucracy impeded the emergence of modern market-based economies.

1.11 Despite this diversity of origins, states over time came to acquire several common and defining features worldwide. Modern states have a consolidated territory and population, and within these they play a centralizing and coordinating role. Sovereign authority commonly encompasses a separate judicial, legislative, and executive functions. Since the eighteenth century, through conquest and colonization, nation-states have incorporated most of the world into their own mutually exclusive territories. As empires disintegrated and minority groups established claims to statehood, the number of nations increased sharply. Membership in the United Nations jumped from fifty independent countries in 1945 to 185 in 1996 (Figure 1.1).

Figure 1.1 Membership in the United Nations



Modest beginnings

1.12 The configuration of states has varied widely across continents and centuries, but arguments about the respective roles of the public and the private sphere have cut across these differences in space and time. Whether in Niccolo Machiavelli's *The Prince*, Kautilya's *Arthashastra*, Confucius' writings, or the Koran, the mutual rights and obligations of states and citizens are the heart of the discussion. Whatever the weights accorded to public goals, almost all these traditions have included a role for the state in providing basic collective goods. Using public resources to provide critical public goods and to raise private productivity is nothing new.

1.13 Beyond these minimal functions, however, there has been much less agreement on the appropriate role of the state in promoting development. Seventeenth-century mercantilists

saw a major role for the state in guiding trade. Not until Adam Smith wrote *The Wealth of Nations* in the eighteenth century was it more generally argued that the market was the best instrument for realizing growth and improving welfare. The state was best held to certain core functions—providing public goods such as defense, ensuring the security of persons and property, educating the citizenry, and enforcing contracts—that were essential for the market to flourish.

1.14 But even then, state intervention played a catalytic role in the development and growth of markets in many parts of Europe, in Japan, and in the Americas. In the United States, where involvement by the state has historically been more limited than in Europe or Japan, government was instrumental in constructing the first telegraph line, which spurred development of the telecommunications industry, and in agricultural research and extension, which stimulated productivity gains (Box 1.3).

Box 1.3 A history of U.S. government action to support market development

The United States is the country that produced and believes in the dictum that "That government is best that governs least." Whereas in many parts of the world the role of the government has evolved gradually, the United States was founded on a revolution. The framers of the Constitution explicitly asked, What should be the role of the government?

Yet even in the United States, where laissez-faire and distrust of government are central to the framing of the state's role in society, governments have often played a critical role in the growth and development of markets. For example:

- The telecommunications industry has its roots in U.S. government support for the first telegraph line between Washington and Baltimore in 1842.
- The enormous increase in agricultural productivity in the nineteenth and twentieth centuries can be traced to the federally supported program of research and extension services dating from the Morrill Act of 1863.
- The Northwest Ordinances of 1785 and 1787 committed the government to supporting education, and to devoting the revenues of the sales of certain lands to that purpose. And in 1863 the Federal government helped establish the public university system.
- In 1863, in the midst of the Civil War, the Congress recognized the need for a national financial system and passed the National Banking Act, establishing the first nationwide bank supervisory agency. In later years the government created the Federal Reserve System (the U.S. central bank) as well as a series of financial intermediaries.
- The interstate highway system and federal support for the establishment of railroads are cases of vital public involvement in transport infrastructure that helped the development of markets in the United States.

1.15 The role of the state in redistributing income was still quite limited in the nineteenth century. In Europe, redistribution was achieved primarily through private charity and other voluntary action, and taxation was restricted largely to customs, excise, monopoly, and commodity taxes. France and Britain had introduced income taxation by the end of the eighteenth century, but this was not a major source of revenue. The first stirrings of a state hand in welfare programs were seen in Germany at the end of the nineteenth century, when Chancellor Otto von Bismarck concluded that development of the modern market economy required a counterbalancing social agenda of the state.

The expanding state in industrial countries

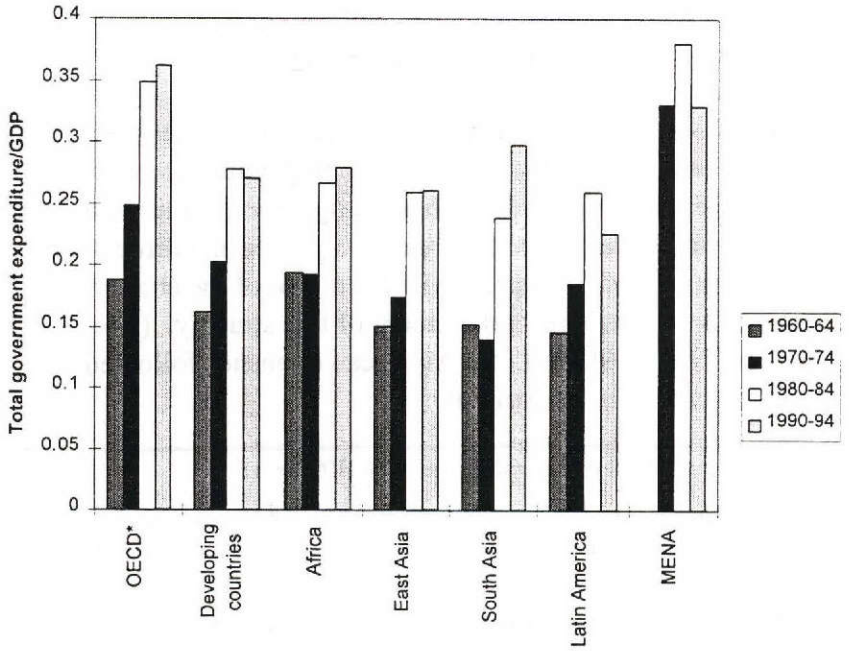
1.16 Despite these new justifications for a greater state role, states remained relatively small by today's standard until well into this century. A series of dramatic events in the aftermath of World War I marked a major a turning point in the role and size of the state. The first was the Russian Revolution of 1917, which led to the abolition there of most private property and put the state in control, through central planning, of all economic activity. The second was the Great Depression of the 1930s, which caused such economic devastation in the non-Communist world that states were spurred to experiment with countercyclical policies to restore economic activity. The third event, unleashed by World War II, was the rapid breakup of European empires. That geopolitical change—as well as the clamor for social insurance in industrial economies—ushered in thirty years of policy debate on a more activist role for government.

1.17 In this intellectual and political ferment, the postwar shift in preferences and opinion coalesced around several basic premises. One was the desire to provide welfare benefits to citizens suffering from transitory income loss or deprivation. There was also consensus on the desirability of a mixed public-private economy, and this motivated nationalization of a range of strategic industries. Finally, there was agreement on the need for a coordinated macroeconomic policy, on the grounds that, without such intervention, macroeconomic outcomes would not necessarily be consistent with individuals' objectives, strategic considerations could reduce voluntary cooperation, and the private sector could generate instability. In time, the goals of macroeconomic policy were explicitly widened to include full employment, price stability, and balance of payments equilibrium. This consensus remained largely undisturbed until the first oil price shock of 1973.

1.18 States thus took on new roles and expanded existing ones. By mid-century the range of tasks performed by public institutions included not only wider provision of infrastructure and utilities, but also much wider support for education and health care. Public transfer programs, such as unemployment benefits, mushroomed, and state involvement in production and asset ownership spread. In the three and a half decades between 1960 and 1995 governments swelled to twice their starting size (Figure 1.2).

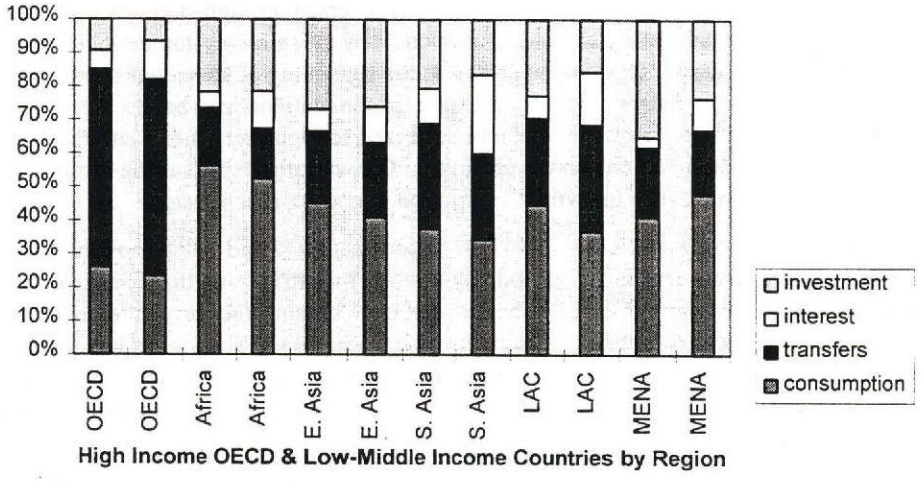
1.19 Much of the expansion of government in the major industrial economies was driven by increases in transfers and subsidies. By the early 1990s, spending on traditional public goods—defense, law and order—had shrunk to some 10 percent of general-government outlays, while over half of all tax revenues collected were transferred to individual beneficiaries (Figure 1.3). Demographics accounted for some of the shift, as aging populations forced an increase in outlays for pensions and health care. But national preferences also made a difference. Thus, despite similar levels of current income and roughly equivalent starting values in 1960, the size of the Swedish state was almost double that of the United States by 1995, in terms of both spending as a share of income and public employment as a share of the population.

Figure 1.2 Central government spending 1960-94



Source: World Bank.

Figure 1.3 Composition of government expenditure in 1975-79 and 1990-94 by region



The expanding state in developing countries

1.20 Governments in developing countries were also reaching into new areas. They, too, increased in size very dramatically in the second half of the twentieth century (Figure 1.2). Initially, much of the growth came from state and nation building after the collapse of colonialism. The ups and downs in international commodity markets also had an impact.

Resource-rich economies such as Mexico, Nigeria, and Venezuela tended to use the revenue bonanzas from the two oil price rises of the 1970s and other commodity booms to expand their public sectors, sometimes with reckless abandon. Oil-importing countries, under the imperative of fiscal austerity, were less able to expand their spending.

1.21 Perhaps more significant than these forces has been the shift in thinking about the role of the state over the past fifty years. Most developing countries in Asia, the Middle East, and Africa came out of the colonial period with a strong belief in state-led economic development. The state would mobilize resources and people and direct them toward rapid growth and the eradication of social injustice. State control of the economy, following the example of the Soviet Union, was a central element of this strategy. (Box 1.4 describes how one country followed this strategy.) Many Latin American countries followed this postwar pattern of state-led, import-substituting industrialization.

Box 1.4 Evolution of the role of the state in India: the past fifty years

When India became independent in 1947, income per capita had been stagnating for half a century, and modern industry was minimal. Indian leaders viewed export orientation as a tool of colonial exploitation, and free trade as Britain's ploy to force its manufactures on India and stifle domestic industry.

The Nehru years, 1947-64. India's first prime minister, Jawaharlal Nehru, believed that industrialization was the key to alleviating poverty and that a powerful state with a planned economy was essential to industrialize rapidly, accelerate public saving and investment, and reduce the role of foreign trade and achieve self-sufficiency. Unlike many East Asian countries, which used state intervention to build strong private sector industries, India opted for state control over key industries. Believing the potential of agriculture and exports to be limited, Indian governments taxed agriculture by skewing the terms of trade against it and emphasizing import substitution. They saw technical education as vital for industrialization, but primary education as a social need of less importance.

The abolish poverty "Garibi hatao," 1966-77. Under Prime Minister Indira Gandhi, two major shifts took place in the role of the state. First, the neglect of agriculture was reversed through state activism in subsidizing new seeds and fertilizers, agricultural credit, and rural electrification. The green revolution took off, and by the mid-1970s India was self-sufficient in grain. The second shift was the tightening of state control over every aspect of the economy. Under the slogan of garibi hatao "abolish poverty", Gandhi nationalized banks, increased controls on trade, imposed price controls on a wide range of products, squeezed foreign investment, and took over foreign oil companies. The state achieved a stranglehold on the economy. Growth of gross domestic product (GDP) in this period remained at 3.5 percent a year. The growth of corruption was, alas, much faster.

The spending boom and rising fiscal deficits, 1977-91. Between 1977 and 1991, most stringent controls on imports and industrial licensing were gradually relaxed, stimulating industrial growth. The government expanded antipoverty schemes, especially rural employment schemes, but only a small fraction of the rising subsidies actually reached the poor. Competition between political parties drove subsidies up at every election. The resulting large fiscal deficits (8.4 percent of GDP in 1985) contributed to a rising current account deficit. India's foreign exchange reserves were virtually exhausted by mid-1991, when a new government headed by Narasimha Rao came to power.

The reform phase, 1991 to the present. Rising interest payments on India's foreign debt meant that neither the central nor the state governments could finance both subsidies and heavy public investment. The former won out, and the government began to woo private and foreign investment. Thus bankruptcy drove the reform process and changed the state from principal investor to facilitator of entrepreneurship. This shift was expected to free up government finances for more social spending, but in practice the fiscal crunch prevented a significant increase.

Rao's government abolished most industrial and import licensing, devalued the rupee, drastically reduced import tariffs, liberalized the financial sector and foreign investment, and allowed private investment in areas earlier reserved for the government. The new coalition government led by Dewe Gowda, which came to power in 1996, has by and large sustained these reforms.

Thus the old national consensus on socialism has given way over the course of a few years to a new consensus on liberalization. But formidable challenges remain. All parties agree on the need for a welfare state, yet no party is eager to retrench surplus labor or close unviable factories. The reforms so far are a positive step but must be extended and accelerated if India is to catch up with the East Asian tigers.

1.22 This belief was reinforced by the popularity of state activism worldwide. The Great Depression was seen as a failure of capitalism and markets, while state interventions—the Marshall Plan, Keynesian demand management, and the western welfare state—seemed to record one success after another. The interventionist stance adopted by many developing countries at independence had its logic in the development paradigm of the day, which emphasized the prevalence of market failures and accorded a central role to the state in correcting these. The popularization of planning under the firm grip of the state, corrective interventions in resource allocation, and a heavy state hand in infant industry development were part and parcel of the development strategy. Economic nationalism was added to the mix, to be promoted through state enterprises and encouragement of the indigenous private sector. And as in the industrial countries, the state began to assume more responsibility for a range of social services formerly provided privately.

1.23 Soon the state was involved in virtually every aspect of the economy. During the 1960s and 1970s, governments were administering prices and increasingly regulating labor, foreign exchange, and financial markets. In many countries public monopolies were created to market agricultural produce. The public sector's share in the economy as producer and employer increased tremendously, in most cases competing with the private sector for scarce resources.

1.24 By the 1970s the costs of this state-led development were beginning to come home to roost. The oil price shocks were a last gasp for state expansion. For the oil exporters they created a bonanza, which many threw into even greater expansion of state programs. As long as resources were flowing in, the institutional weaknesses stayed hidden. The oil-importing countries, for their part, got caught up in a cycle of heavy borrowing of recycled petrodollars to keep the state growing. The underlying costs of this development strategy were suddenly exposed when the debt crisis hit in the 1980s and oil prices plunged. The collapse of the Soviet Union—by then no longer an attractive model—sounded the death knell for a developmental era.

1.25 The slow shift in strategies had begun well before this, however, jolted by the oil price shocks, their accompanying fiscal crises, and the poor outcomes of activist policies in many developing countries. Evidence was mounting that states not only tend to enlarge themselves beyond their optimal size but that in doing so they crowd out private activity. Suddenly, government failure—including the failure of publicly owned firms—seemed everywhere glaringly evident. Governments began to adopt policies designed to reduce the scope of the state's intervention in the economy. States curbed their involvement in production, prices, and trade. Market-friendly strategies took hold in large parts of the developing world. The pendulum had swung from a state-led developmental model in the 1960s and 1970s to a minimalist state.

1.26 As often happens with such radical shifts in perspective, there was sometimes a tendency to overshoot the new mark—or to place it incorrectly. The pattern of fiscal adjustment

has been uncoordinated, and the good was as often cut as the bad. Countries mired in debt and heavy interest payments squeezed critically important programs in education, health, and infrastructure as often as—or more than—they cut low-priority programs, bloated civil service rolls, and money-losing enterprises. Cuts came primarily in capital budgets and, in Africa, in operating and maintenance outlays, further reducing the efficiency of investments. The state's vital functions were being neglected, threatening social welfare and eroding the foundations for market development. Africa, the former Soviet Union, and even parts of Latin America show the effects of such behavior most starkly.

1.27 Attention has shifted from the debate on the state versus the market to the crisis in state effectiveness. In some countries such as Liberia and Somalia the crisis has been stronger than the state itself and has led to its collapse. In others where the state's effectiveness has been eroded, nongovernmental and people's organizations—civil society more broadly—have emerged to take its place. But the market and civil society cannot supplant the state. If there is one lesson of development history, it is that an effective state is vital for an effective development strategy. State-led development has failed, but development without an effective state is impossible.

Rethinking the state: A framework

1.28 Changes in the global political economy have also significantly affected the debate on the role of the state. Pressures for globalization and democratization have reduced the ability of political leaders to behave in arbitrary and capricious ways. Other changes include more rapid diffusion of technology, growing demographic pressures, an increased awareness of environmental considerations, growing concern over human rights, and large international movements of capital. And formidable challenges remain for many developing countries: to reduce poverty and foster sustainable development. Thus, throughout the world, the reexamination of the role of government goes on.

1.29 How have global, economic, and social forces changed the way we think about the state? The state retains a distinctive role in the provision of public goods that promote economic and social development. And market failures continue to provide powerful economic arguments for state intervention (Box 1.5). But changes in technology are transforming the nature of market failure: in infrastructure, technological change has created new scope for competition in telecommunications and power generation. And many of the most successful examples of development in recent and past history entail states working in partnership with markets to correct their failures, not replacing them.

1.30 Equity also remains a central concern of the state. New evidence, especially from East Asia, is showing that tradeoffs between growth and equity are not inevitable as was once thought. Appropriately designed policies in basic education and health care can reduce poverty and increase equity while promoting economic growth. Neglecting these social fundamentals of development can be fatal.

1.31 But the mere fact of market failure and other problems of inequality and insecurity does not mean that only the state can—or should—resolve these problems. States are

unique because they have a monopoly over the legitimate use of force within a given territory, and they often possess other unique powers of compulsion, such as the exclusive right to levy taxes or to control or forbid production of goods. The state's coercive authority over everyone residing within its boundaries gives it unique strengths—and poses unique challenges.

Box 1.5 The economic rationale for state intervention and some definitions

Market failures and equity concerns provide the economic rationale for government intervention. But there is no guarantee that any such intervention will benefit society. Government failure may be as common as market failure. The challenge is to see that the political process and institutional structures get the incentives right, so that they prompt interventions that actually improve social welfare.

Market failure refers to the set of conditions under which a market economy fails to allocate resources efficiently. There are many sources of market failure and many degrees of failure. The implications for the role of the state and the form of public intervention can be quite different in each case.

Public goods are goods that are *nonrival* (consumption by one user does not reduce the supply available for other users) and *nonexcludable* (users cannot be prevented from consuming the good). For these reasons it is not feasible to charge for the consumption of public goods, and therefore private suppliers will lack the incentive to supply them. National public goods, such as defense, benefit an entire country; local public goods, such as rural roads, benefit a smaller area. *Private goods* are those that are both rival and excludable, *common property goods* are nonexcludable but rival (such as groundwater irrigation), and *club goods* are nonrival but excludable (such as interurban highways and toll roads).

Externalities arise when the actions of one person or firm hurt or benefit others without that person or firm paying or receiving compensation. When externalities are present, the allocation of resources by the market will not be efficient. Pollution is an example of a *negative externality*; the broader benefit to society at large of a literate population is a *positive externality* of primary education. Governments can curb negative and promote positive externalities through regulation, taxation or subsidy, or outright provision.

A natural monopoly occurs when the unit cost of providing a good or service to an additional user declines over a wide range of output, reducing or eliminating the scope for competition. Monopoly providers can restrict output to increase prices and profits. Governments have addressed this problem by regulating private monopolists or providing the good or service themselves. Changes in technology have created new scope for competition in services once considered natural monopolies, such as telecommunications and power generation.

Incomplete markets and *imperfect or asymmetric information* are pervasive problems and can result in inefficient market outcomes. Markets are incomplete whenever they fail to provide a good or service even though the cost of providing it would be less than what individuals are willing to pay. Imperfect information on the part of consumers can lead to systematic undervaluation of some services, such as primary education or preventive health care. Asymmetry of information—when consumers know more than suppliers, or vice versa—can lead to excessive or supplier-induced demand, for example in the provision of medical care. Problems of *adverse selection* and *moral hazard* can lead to the failure of insurance markets. Health insurance provides an example of adverse selection: those who are more likely to need care are more like to buy insurance. The tendency of health care consumers as well as providers to seek overtreatment when a third party, the insurer, is paying most of the cost, is an example of moral hazard. Governments have attempted to address these problems by ensuring widespread coverage and holding down costs by regulating private insurance, financing or mandating social insurance, or directly providing health care.

Equity may prompt state intervention even in the absence of market failure. Competitive markets may distribute income in socially unacceptable ways. Persons with few assets may be left with insufficient resources to achieve acceptable living standards. Government action may be required to protect the vulnerable.

1.32 The state's unique strengths are its powers to tax, to prohibit, to punish, and to require participation. The state's power to tax enables it to finance the provision of public goods. Its power to prohibit and punish enables it to protect personal safety and property rights. And its

power to require participation enables it to minimize free riding by persons who would reap the benefits of public goods without paying the costs. The same power can help resolve problems of collective action that could reduce the social benefits from insurance markets or prevent mutually complementary private investments from being made, to take just two examples. Of course, used for ends other than development, these same powers can radically disrupt an economy or a society.

1.33 Set against these advantages, the state confronts unique challenges in clarifying objectives and ensuring that its employees pursue them:

- Even though elections and other political mechanisms help mediate between the interests of citizens and the objectives of state organizations, citizens' mandates can remain vague—and powerful special interests continually try to direct the focus of government in their favor.

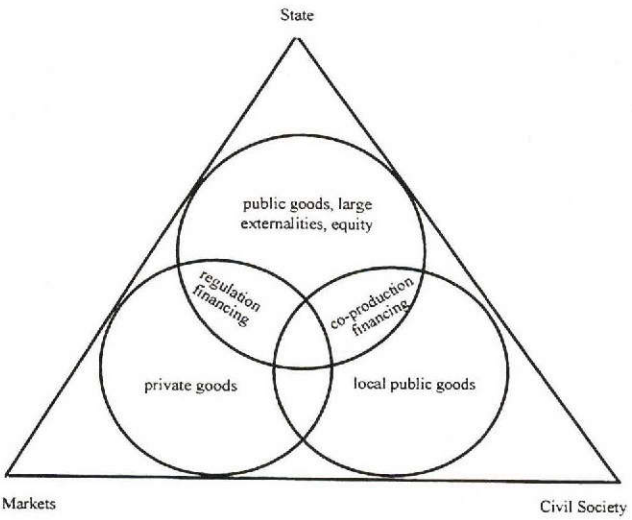
- Government activities such as primary education, environmental protection, defense, operation and maintenance of infrastructure, and preventive health care are activities for which monitorable standards of performance are especially difficult to devise.

- These difficulties in specifying objectives and devising mechanisms of accountability can lead to the state bureaucracies being granted enormous flexibility, and at most modest restraints on their behavior. In consequence, state officials at all levels can pursue agendas of their own. When this power is used arbitrarily, for personal profit rather than for the social good, it can be very harmful—as for example in Haiti under the Duvalier regime.

1.34 The voluntary sector has stepped in to address some problems of collective action, responding to both market and government failure and other historical and social dynamics. The voluntary sector brings its own strengths and weaknesses to the table. Local self-help organizations are sometimes preferred for providing local public goods and services, because of their closeness to local concerns. But their concern is often for certain religious or ethnic groups, not society as a whole, and their accountability is limited and their resources are often constrained. The challenge for the state is to build on the relative strengths of private markets and the voluntary sector to provide collective action, while taking into account and improving its own institutional capability (Figure 1.4).

1.35 This suggests a two-part strategy to improve the effectiveness of the state in enhancing economic and social welfare. The first task is to match the state's role to its capability—to establish the institutional rules and norms that enable the state to provide collective goods and services at lowest cost to society. The second is to reinvigorate the state's capability through rules, partnerships, and competitive pressures outside and within the state.

Figure 1.4 Improving effectiveness requires building on the individual strengths of markets, civil society, and the state



Matching role to capability: What states do and how they do them

1.36 Part B of this Report discusses strategies for matching the state's role to its capability, to improve the effectiveness and efficiency of public resource use. It advocates ways in which states can provide the fundamentals for development, especially where capability is low (Chapter 3). Chapter 3 also includes a short discussion on social insurance. Chapter 4 looks at other state functions, such as regulation and industrial policy, and shows how getting the right fit between roles and capabilities is vital for improving the state's effectiveness in these more complex areas. Table 1.1 presents framework for thinking about these issues. It classifies the functions of government along a continuum, from activities that will not be undertaken at all without state intervention to activities in which the state plays an activist role in coordinating markets or redistributing assets:

- Countries with low state capability need to focus first on basic functions: the provision of pure public goods such as property rights, macroeconomic stability, control of infectious diseases, safe water, roads, and protection of the destitute. In many countries the state is not even providing these basic services. Recent reforms have emphasized economic fundamentals. But social and institutional (including legal) fundamentals are equally important to avoid social disruption and ensure sustained development.

- Going beyond these basic services are the intermediate functions, such as management of externalities (pollution), regulation of monopolies, and the provision of social insurance (pensions, unemployment benefits, family allowances). Here the government cannot choose whether, but only how best

to intervene; and it is here that the government can work in partnership with markets, civil society to ensure that they are provided.

- States with strong capability can take on more activist functions, dealing with the problem of missing markets by helping coordination. East Asia's experience has renewed interest in the state's role in promoting markets through active industrial and financial policy.

Table 1.1 Functions of the state

Market failures			Equity
Minimal functions			
Pure public goods			Protecting the poor
• Defense • Law and order • Property rights • Macroeconomic management • Public health			• Antipoverty programs • Disaster relief
Intermediate functions			
Externalities	Monopoly	Imperfect information	Social insurance
• Basic education • Environment	• Utilities (water, power) • Antimonopoly	• Insurance (health, life, pensions • Finance • Consumer protection	• Redistributive pensions • Sickness • Family allowances • Unemployment
Activist functions			
Coordination			Redistribution
• Fostering markets • Cluster initiatives			• Asset redistribution

1.37 Matching role to capability involves not only *what* the state does but also *how* it does it. Rethinking the state also means exploring alternative or new instruments that can enhance state effectiveness. For example:

- In most modern economies the state's regulatory role is now broader and more complex, covering such areas as the environment and the financial sector, as well as more traditional areas such as monopolies. The design of regulation needs to fit the capability of state regulatory agencies and the sophistication of markets, and give greater emphasis to personal responsibility.

- Although the state still has a central role in ensuring the provision of basic social services—education, health, infrastructure—it is not obvious that the state must be the provider or the only provider. The state must make choices about provision, financing, and regulation of these services that build on the relative strengths of markets, civil society, and state agencies.

- In protecting the vulnerable, countries need to distinguish more clearly between *insurance* and *assistance*. *Insurance* aims to help smooth income

and consumption over the inevitable ups and downs of a market economy, whereas *assistance* seeks to provide some minimum level of support to the poorest in society.

Reinvigorating the state's capability

1.38 Reinvigorating the state's capability is vital. Part C of this Report focuses on strategies to improve capability. Its thesis is that such improvements are possible only if the incentives under which states and state institutions operate are changed. Capability is not synonymous with effectiveness. The elite bureaucracies that helped rebuild postwar Japan are today under pressure to reform—they are considered an obstacle to a more competitive economy. Their capability has not diminished, but their effectiveness has. Improving capability is not easy. The modest successes and many failures of technical assistance over the decades underscore that this is a matter of incentives as much as it is one of training and resources. Improving capability requires enabling rules and norms that create incentives for state agencies and officials to act in the collective interest, while restraining arbitrary action. Incentives can be changed by making the state more rule-based, subjecting it to competitive pressure, and making it more transparent and open, working in partnership with private organizations.

- **Rules and restraints**. Mechanisms for enforcing the rule of law, such as an independent judiciary, are critical foundations for sustainable development. They along with appropriate separation of powers and watch-dog bodies also restrain arbitrary behavior.

- **Voice and partnership**. The means to achieve transparency and openness in modern society are many and varied—business councils, interaction groups, and consumer groups, to name a few. Institutional working arrangements with community groups are also needed. Partnership with lower levels of government and with international bodies can help in the provision of local and global public goods.

- **Competitive pressure.** Competitive pressure can come from within the state bureaucracy, through meritocratic recruitment of civil servants; it can come from the domestic private sector, through contracting out and allowing private providers to compete directly with public agencies, or it can come from the international marketplace, through trade and the influence of global bond markets.

1.39 Chapter 5 looks at rules and competition that can be used as building blocks for a more effective core public sector. But as history tells us, an important part of building effectiveness comes from restraints on arbitrary action. These issues are taken up in Chapter 6, which analyzes the checks and balances in the constitutional structure of the state and controls over rent seeking and corruption. Reinvigorating of the state requires bringing it closer to people. A remote, imperious, and nontransparent state often leads to arbitrary rule and

eventually to ineffectiveness. Chapter 7 looks at how voice, participation, and decentralization can improve the functioning of the state and the provision of collective action. But it also signals some critical pitfalls. Facilitating collective action involves issues not just within a country but beyond it as well. An important function of the state is to facilitate global collective action—especially in a rapidly integrating world. Chapter 8 discusses how to do this.

Initiating and sustaining reforms

1.40 Matching role to capability also means shedding some roles, including some that benefit powerful constituencies. Improving capability is also often difficult because it is in someone's interest to keep it weak. Nevertheless, politicians have an incentive to undertake reforms if they result in net gains to important constituencies. Windows of opportunity occasionally open in response to crisis or external threat, and politicians have adopted strategies for building consensus or compensating losers.

1.41 Part D explores the challenge of initiating and sustaining reforms of the state (Chapter 9). Its central argument is that constraints to reform are largely political and institutional. Hence fundamental institutional reform is likely to be long-term. But windows of opportunity arise, can be created, and should be seized upon. The prospects for change and the agenda for each developing region are laid out in Chapter 10. The special challenge of collapsed states is also discussed here.

Chapter 2 Refocusing on the Effectiveness of the State

2.1 Fifty years ago, World War II had ended, and reconstruction was under way in much of Europe, the Soviet Union, and Japan. Many developing countries had just emerged from colonialism, and the future seemed full of promise. The difficulties of economic development were not yet haunting us. Improvement in people's lives seemed so easily possible through the application of ideas, technical expertise, and resources. In some cases things did work out well. But in others they did not. Despite five decades of enormous progress we still see enormous disparities in the quality of life of people around the world. Indeed, some even argue that the disparities have increased.

2.2 Explanations of differences in living standards across countries have changed over the years. For a long time access to natural resources—land and minerals—was considered the prerequisite for development. Much of Africa, Asia, and the Americas were colonized to acquire resources, and countries went to war over them. Gradually thinking shifted, and physical capital—machines and equipment—came to be identified as the key to development. "Industrialized" became synonymous with "developed." But about the middle of this century it was recognized that this explanation was too simplistic. Embodied in machines and equipment was technology—knowledge and ideas. And no straightforward explanation offered itself for why technology developed better and faster in some parts of the world. A large residual in unexplained growth remained.

2.3 Since then other factors, such as human capital, have commanded a lot of attention in explaining differences in income and in the ability of poorer countries to catch up with the richer ones. Investment in human capital leads to new knowledge and ideas, and it increases the speed with which they are absorbed, disseminated, and used in a country.

2.4 Since the 1980s attention has begun to focus on the importance of sound policies in explaining why countries accumulated human and physical capital at different rates. More recently the focus has shifted further, toward the quality of a country's institutions. These shifts in thinking reflect a search for deeper sources of differences in development outcomes. New, more complex questions have emerged. What institutional arrangements best allow markets to flourish? What is the role of the state both as a direct agent (mostly in the provision of services) and as a shaper of the institutional context in which markets function? How do policies and institutions interact in development?

2.5 With the demise of central planning the institutional arrangements under which markets flourish have become more evident. Although protection of property rights, appropriate regulation, and in some cases even active industrial policy are necessary for markets to grow, the institutional arrangements under which these have occurred has varied widely. The regulation of utilities, for example, has taken a variety of forms and differs considerably even in the industrial world. Likewise the legal systems under which property rights are established and enforced take very different institutional designs.

2.6 The answers to these questions are central to our understanding of why the response to economic reforms often varies so widely from one country to another. They help explain, for example, why investment and economic activity have revived more strongly in Poland than in Russia. They also explain why many countries in Africa and Latin America still do not see as much investment and growth, and improvements in the quality of life, as was expected when they began their economic reforms a decade ago. In all these arrangements the state plays a critical role, not only because the state is the arbiter of rules, but also because, through its behavior, it shapes the overall environment for business and economic activity.

2.7 This chapter makes the empirical case for refocusing attention on the quality of a country's institutions and the capability of the state—for bringing institutions into the mainstream of our thinking about development. That case is supported by three sets of findings.

2.8 The first consists of panel data covering thirty years and ninety-four countries, developed and developing. It shows that policies, and the institutional capability matter for economic growth and for other indicators of the quality of life, such as infant mortality.

2.9 The second investigation takes the measurement of institutional capability a step further. The results of a special survey done for this Report of over 3,700 local firms in sixty-nine countries are reported. These findings show that institutional capability affects both growth and investment.

2.10 The third investigation turns to how institutional capability affects not just the business environment, but also the overall environment for effective development. We take the results from the survey on institutional capability and show that they explain quite significantly the variation of rate of return to development projects financed by the World Bank.

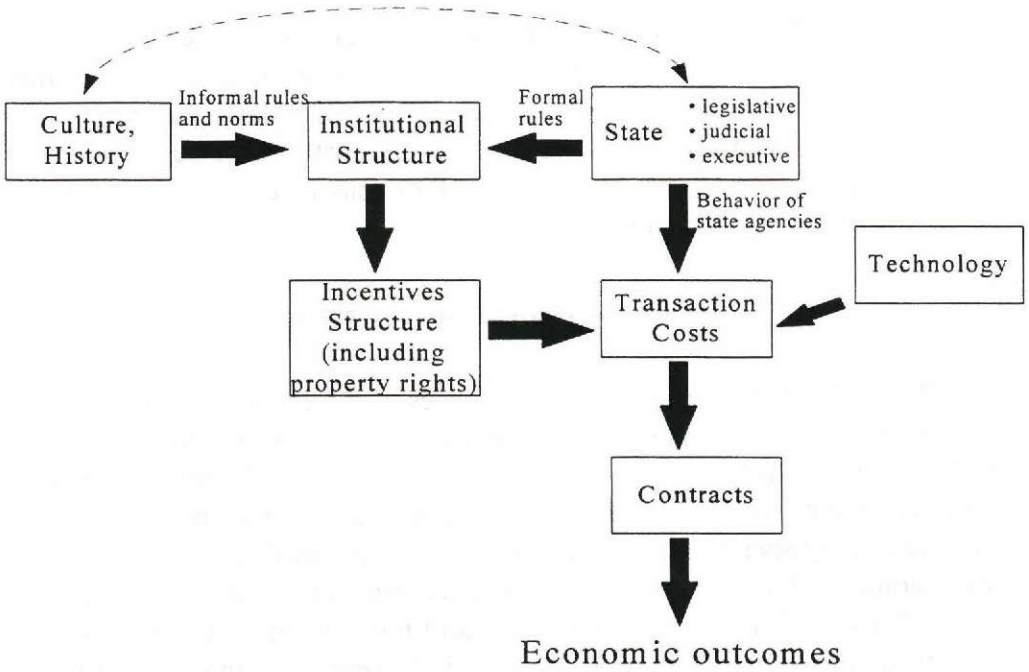
Institutions, the state, and economic outcomes

2.11 It is useful to distinguish between institutions and organizations. *Institutions* are the formal and informal rules that affect human behavior. *Organizations*—firms, nongovernmental organizations, central banks, government agencies—produce goods and services which are used by society. Through most societies and much of history, a well-functioning state has played a central role in establishing the institutional framework for the creation of wealth. However, economic prosperity and the creation of wealth do not necessarily need a strong state. Sometimes informal rules are enough. For example, the combined income of the overseas Chinese community exceeds that of all but two countries in the world. That community transacts business and contracts according to its own informal rules. But such cases are the exception.

2.12 The state produces goods and services on its own or jointly with other organizations. But at the same time it sets the formal rules that are part and parcel of an institutional environment (Figure 2.1). These formal rules, along with society's informal rules, make up the institutional environment. The state is therefore unique in that it must establish,

through a social and political process, the formal rules by which all organizations must abide, but it must also play by these rules as an organization itself.

Figure 2.1 State, institutions, and economic outcomes



2.13 The state can affect development outcomes in a number of ways :

- by providing a macroeconomic and a microeconomic environment that sets the right incentives for efficient economic activity
- by providing the institutional infrastructure—property rights, peace, law and order, and rules—that encourage efficient long-term investment
- by providing basic education, health care, and physical infrastructure required for economic activity

2.14 The state must constantly try to provide public goods at the lowest possible cost to society. If it does not, it taxes society too heavily. This trade-off between the desire to get the state to provide these public goods must be constantly weighed against the costs of providing them.

2.15 History also teaches us that the state can do enormous harm:

- First, the state may establish inadequate rules for the creation of wealth. For example, it may apply an unnecessarily heavy tax on private wealth through misaligned prices such as a too high exchange rate, or through agricultural marketing boards that tax agricultural output.

- Second, the state can do damage not by the impact it has on the institutional environment, but by the manner in which its organizations apply them. It can exact huge transactions costs on the setting up of new business, or the restructuring of old business, and it can require business owners to pay bribes.

- Third, the state can impose an even heavier cost on society through the uncertainty its actions can create. If it changes the rules often or does not clarify the rules by which the state itself will behave, uncertainty arises. Businesses and citizens must then adopt costly strategies to protect themselves against uncertainty. For example, they may enter the informal economy, hide their wealth, or send capital abroad.

Economic growth and the state

2.16 The stark differences in the consequences of government are well illustrated by contrasting the economic performance of developing countries in Sub-Saharan Africa and with those in East Asia. In 1960 incomes per capita in East Asia were little different from those in Africa. Their governments were also similar in size, although not in composition: African governments were already spending more on consumption, primarily on public employment. By the mid-1990s incomes in East Asia were more than five times those in Africa, and government consumption in Africa had ballooned to one and a half times that in East Asia. Although the factors behind this divergence are complex, it is widely believed that the superior performance of the state in East Asia, in terms of the limits it set on its own growth, the quality of the policies it adopted, and the effectiveness with which it delivers services, has been a powerful contributor.

2.17 In considering the effect of government size on growth, it is useful to distinguish between government consumption and government investment. Where spending on government consumption is very high, it has generally been found to be a drag on growth—a net tax on society with few corresponding benefits. Still, some types of government consumption spending—teachers' salaries, purchase of medicines, operations, and maintenance—can affect people's lives for the better and raise the efficiency of investment (Box 2.1). On the other hand, certain types of public investment spending particularly on infrastructure, have tended to exert a positive effect on growth, in part by raising the returns to private investment.

2.18 But government size is only part of the explanation. Governments are also a key component of the overall institutional environment, encompassing the rule of law, the protection of property rights, and the quality of government, including the functioning of bureaucracy. Institutions are important because they affect transactions costs and because they are part of the incentive structure to which economic agents respond. How well these institutions work is critical to the private sector's ability to function effectively.

2.19 We examine this trade-off between what the state does and how well it does it in this section by reporting on the impact of policies, and its institutional capability.

Box 2.1 Measuring the state—its size, its policies, and its institutional capability

A common measure of government size is the ratio of government expenditure to the economy's total expenditure or total output. But such data are generally not comprehensive, and coverage of public enterprises is especially sketchy in many developing countries. This measure of size also tends to ignore important off-budget items, such as tax concessions. Government expenditure itself can be broken down into consumption and investment. Government consumption—which mostly consists of the public wage bill—gives a narrow but more precise indicator of consumers' current benefits from government spending. Transfers, such as pensions or social security benefits, can be included in a measure of government expenditure, but transfers only redistribute resources. Further complicating matters, nominal and real ratios for expenditure will vary significantly over time. An alternative approach that avoids problems in measuring government output is to use government employment, but this too has its drawbacks. For example, it ignores government changes in labor productivity or substitution between inputs.

The results reported in this chapter use data on real government consumption, because the concern is mainly with how the division of output across public and private goods affects performance. Information on physical investment is also used, but this is normally available only as an aggregate of public and private investment. To facilitate cross-country comparisons over time, these ratios are translated into international or purchasing-power-parity values—a not entirely innocuous transformation, particularly for low-income countries with large labor-intensive components in government consumption. For these countries, using international prices substantially increases the government consumption ratio.

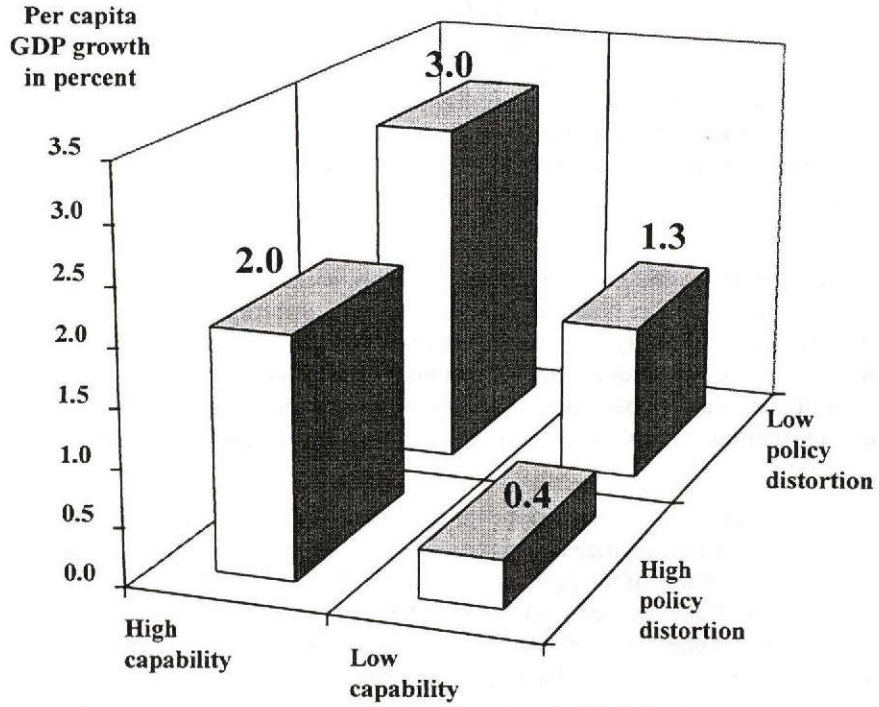
A more inclusive picture requires a measure that captures key government interventions through policy and institutions, in addition to fiscal interventions. We summarize a government's policy stance over time through an index that combines three key indicators: the openness of the economy (the share of trade in GDP), overvaluation of the currency (the black market exchange rate), and the gap between local and international prices. We attempt to evaluate the quality of a key component of government, its bureaucracy. This evaluation is drawn from survey responses by foreign investors (in the next section we evaluate the responses of local investors) that focus on the amount of red tape involved in any transaction, the regulatory environment, and the degree of autonomy from political pressure.

2.20 Figure 2.2 shows the combined impact of all these factors on income growth over the last three decades across ninety-four industrial and developing countries. In countries with weak state capability and poor policies, income per capita grew only about 0.4 percent per year. In contrast, in countries with strong capability and good policies, income per capita grew at an average rate of about 3 percent per year. Over a thirty-year period, these differences in income growth have made a huge difference to the quality of people's lives. A country with an average income per capita of $300 in 1965, with distorted policies and weak institutional capability, would after thirty years have reached an average income of only about $338 at 1965 prices. On the other hand, a country with strong institutional capability and good policies would have more than doubled its average income, to $728 at 1965 prices. In fact many countries in East Asia have done even better than that.

2.21 Good policies by themselves also produce beneficial outcomes, but these benefits are magnified in countries where institutional capability is also much higher—where policies and programs are implemented better and where citizens and investors have greater certainty about government's future actions. Good policies alone, such as those now being pursued by many countries in Latin America and Africa, would increase growth in income per capita by around 1.4 percent per year. Such a country starting with an average income of $300 in 1965 would see its income rise to around $450 after thirty years—but not by as much in a country with good

policies and strong institutions. Reform should focus both on improvements in policies and on institutional strengthening.

Figure 2.2 Institutional capability improves economic growth in ninety-four countries: 1964-93



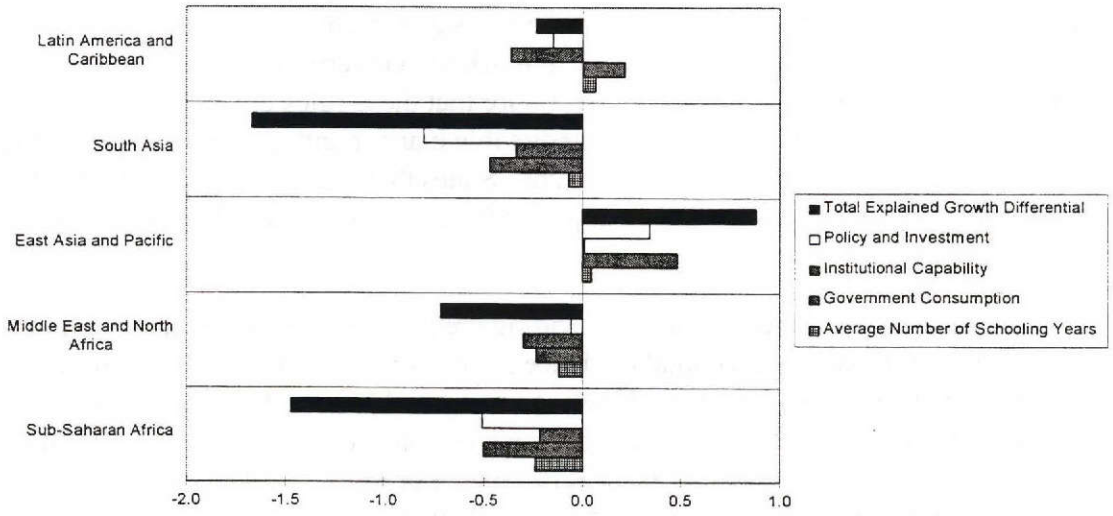
Note: Controlling for income, and education.

2.22 How do these results differ by region? Excessive government consumption has contributed to the relatively poor performance of countries in Africa, the Middle East and North Africa, and South Asia, but differences in policy, investment, and institutional capability are also important in explaining differences in performance (Figure 2.3). Sub-Saharan Africa's poor performance over the past three decades can be attributed not only to low educational attainment, rapid population growth, but also to poor policies, underinvestment, and weak institutions. Together, government consumption and low institutional capability have had a strong negative effect on growth in this region. By contrast, East Asian growth has benefited from good policies, and better institutions.

2.23 As important as growth in income is, it is only one of several measures of well-being. Concern with improving peoples' ability to function implies that countries' performance should also be judged on other standards of well-being, such as infant mortality. The quality of government institutions also lowers infant mortality by improving the outcome for each unit of social spending (Figure 2.4). The quality of institutions is therefore an important determinant not only of economic growth but also of a broader array of indicators that affect the quality of human life. These results show clearly why countries at the same income level can have large differences in indicators of the quality of life. They explain why Sri Lanka, for example, had an infant mortality rate of only 18 per 1,000 live births, whereas some countries with higher incomes per capita had substantially higher rates: 67 per 1,000 live births in Egypt, and 68 per

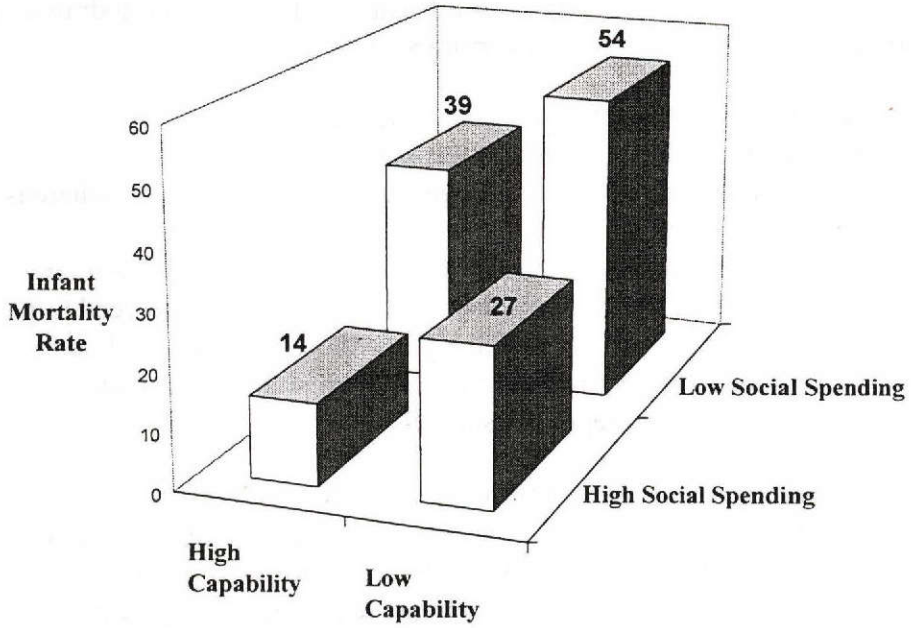
1,000 live births in Morocco, for example. The amount of social spending as well as the care with which services are delivered makes a huge difference.

Figure 2.3 Sources of per capita growth, 1964-93 (deviation from world average)



Note: Total explained growth differential is net of initial per capita GDP, population growth rate, and terms of trade.

Figure 2.4 Institutional capability of government and the infant mortality rate, 1964-93



Understanding institutional capability: the private investor's view

2.24 An essential condition of a capable state - besides its ability to provide collective goods - is it's ability to provide the rules of the game for functioning of markets. Anonymous markets will not develop without the foundation of formal rules which support property and contract rights. While private arrangements can sometimes supplement formal rules they can usually not support the development of large and deep markets. Governments must not only provide sound rules of the game, they must also make sure that these rules are enforced in a consistent manner, that new rules are created in a predictable manner and give private actors the confidence that existing rules will not change overnight. States that change the rules frequently and unpredictably, announce changes but fail to implement them, or enforce rules arbitrarily lack credibility.

2.25 How capable are governments at providing credible rules of the game which foster the development of markets? Anecdotal evidence suggests that credibility problems are pervasive, especially in developing countries. However, hard evidence of their importance for economic performance has been difficult to come by. One reason is that credibility is difficult to measure: it depends as much on perceptions as on hard facts. For instance, at first blush the number of times a country has changed its government—whether in regular or irregular fashion—would appear to be a good indicator of uncertainty about changes in rules and therefore of credibility. Yet, businesses in Thailand generally consider their environment to be relatively stable, despite numerous coups and changes in government. And the environment for business can be highly volatile and unpredictable even if the government does not change. Entrepreneurs in Peru in the 1980s reported widespread credibility problems because rules were being drawn up hastily, implemented by presidential decree, and often overturned soon thereafter.

2.26 Measures of corruption might seem reasonable to quantifying credibility. However, measures of corruption, like measures of political instability, may not reflect entrepreneurs' concerns. Some forms of corruption entail large uncertainties and risks, whereas others may be more predictable and act more like speed money. In the words of one entrepreneur: "There are two kinds of corruption. The first is one where you pay the regular price and you get what you want. The second is one where you pay what you have agreed to pay and you go home and lie awake every night worrying whether you will get it or if somebody is going to blackmail you instead." This shows that in order to better understand the private sectors' problems it is most promising to ask entrepreneurs directly.

2.27 To better understand the relationship between the private sector and the state a large scale private sector was conducted for this report. The aim of the survey was to capture the full array of uncertainties that entrepreneurs face and to build an overall measure of the credibility of rules in a specific country. The responses of entrepreneurs show that private investors in many countries perceive states as not very credible.

Credibility: How private investors perceive the state

2.28 The private sector survey covered sixty-nine countries and over 3,700 firms. Entrepreneurs were asked about their subjective evaluation of different aspects of the institutional framework in their country including the security of property rights, predictability of rules and policies, reliability of judiciary, problems with corruption and discretionary power in the bureaucracy and disruptions because of government changes.

2.29 Sometimes the source of uncertainty is in the stability of the rules to which firms are subject. Two key indicators are:

- *Predictability of rule making,* or the extent to which entrepreneurs have to cope with unexpected changes in rules and policies: whether they expect their government to stick to announced major policies, whether they are usually informed about important changes in rules, and whether they can voice concerns when planned changes affect their business.

- *Perception of political stability:* Whether changes in government (constitutional and unconstitutional) are usually accompanied by far-reaching policy surprises that could have serious effects on the private sector.

2.30 At other times, uncertainty relates to the extent to which entrepreneurs can rely on these rules being enforced and, more broadly, on their property rights being protected. Relevant indicators here include:

- *Crime against persons and property*: Whether entrepreneurs feel confident that the authorities would protect them and their property from criminal actions, and whether theft and crime represent serious problems for business operations.

- *Reliability of judicial enforcement*: Whether the judiciary enforces rules arbitrarily, and whether such unpredictability presents a problem for doing business.

- *Freedom from corruption*: Whether it is common for private entrepreneurs to have to pay some irregular additional payments to get things done; and whether, after paying a bribe, they have to fear blackmail by another official.

2.31 The following picture emerges when we look at the responses of local investors from the survey:

- *Unpredictable changes in laws and policies.* In some areas of the world entrepreneurs constantly have to fear policy surprises and unexpected changes in rules which can seriously affect their business. In the CIS, almost 80 percent of entrepreneurs report that unpredictable changes in rules and policies seriously affected their business. In the CEE, Latin America and Africa

around 60 percent of entrepreneurs complained about this problem. In developed countries and South-South East Asia (SSEA), only about 30 percent of respondents thought that this was a problem for their business (Figure 2.5a). One reason why entrepreneurs feel that rules change unpredictably is because a large majority cannot participate in the process of developing new rules or policies which affect their business and are not even informed beforehand. This problem appears to be particularly severe in the CIS, CEE and in Africa, whereas in Asia entrepreneurs feel that they are well informed—even better than in developed countries. Also, small companies on average, are less informed about and involved in the drafting of new regulations and are therefore more subject to policy surprises.

- *Disruptive government changes.* In many areas of the world the private sector perceived the institutional framework not to be stable and entrenched enough to withstand changes in government without causing serious disruptions. In the CIS, Africa and the Middle East and North Africa (MNA) over 60 percent of entrepreneurs said that they constantly feared government changes accompanied by far-reaching policy surprises with significant impact on their business (Figure 2.5b.)

- *Insecurity of property and persons.* In many countries private entrepreneurs feel that not even the most basic institutional infrastructure for a market economy is in place. All over the world they report that crime and theft are serious problems which substantially increase the cost of doing business. In some countries there appears to be an institutional vacuum: Crime, violence and a generalized insecurity of property rights are the consequence. In Latin America, Africa, the Commonwealth of Independent States (CIS) and Central and Eastern Europe (CEE) almost 80 percent of entrepreneurs reported that they did not feel confident that the state authorities would protect their person and property from criminal actions (Figure 2.5c.)

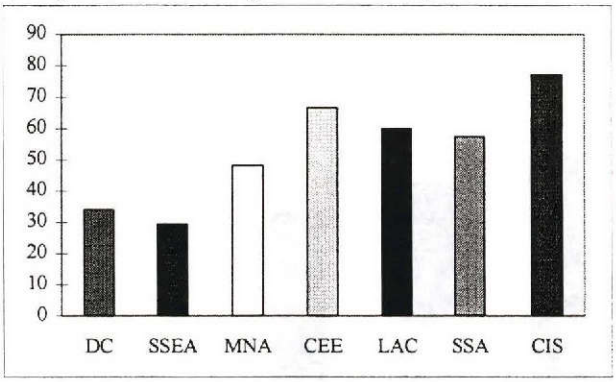
- *Unreliable judiciaries.* A well working judiciary is a central pillar of a system of rule of law but unreliable judiciaries seem to be the rule rather than the exception in many countries of the world. In the less developed countries over 70 percent of entrepreneurs feel that unpredictability in the judiciary presents a major problem for their business operations (Figure 2.5d). Moreover, in most regions of the world entrepreneurs think that their problems with the judiciary have increased over the last 10 years.

- *Corruption.* The survey confirms that corruption is an important problem for investors and that corruption is widespread. Overall, more than 40 percent of entrepreneurs reported of being obliged to pay bribes in order to get things done was common in their line of business. In developed countries about 15 percent of entrepreneurs thought so, in Asia about 30 percent and in the CIS over 60 percent of all firms (Figure 2.5e). Furthermore, in all regions of the

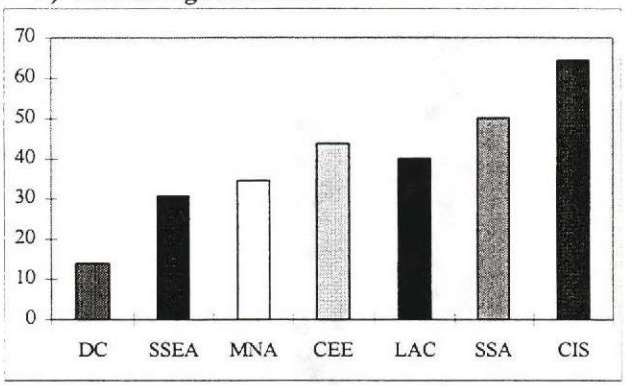
developing world more than half of all entrepreneurs thought that paying a bribe was not a guarantee that the service would actually be delivered as agreed, and many had to fear that they would be asked for more by another official.

Figure 2.5 Institutional factors affecting credibility of the state*

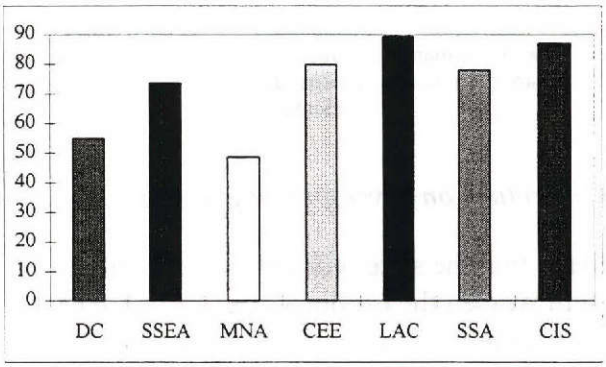
a) Unpredictable changes in laws and policies *



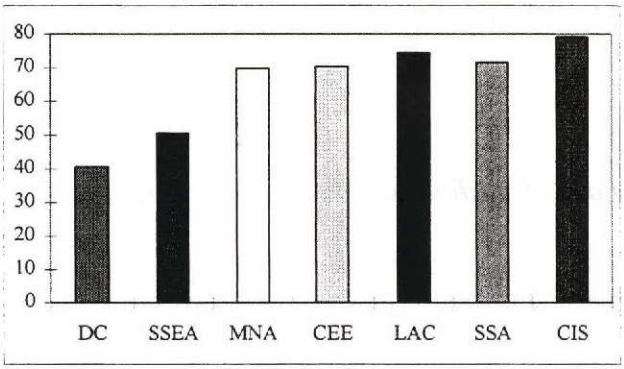
b) Unstable government*



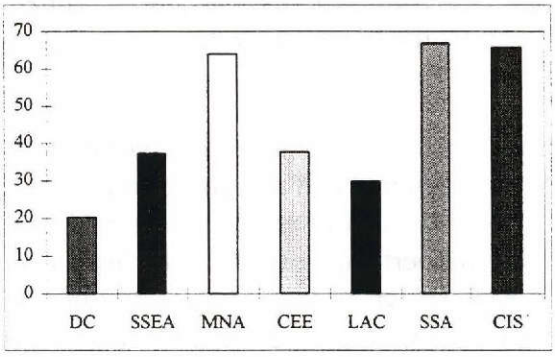
c) Security of property *



d) Unreliable judiciaries*



e) Corruption*



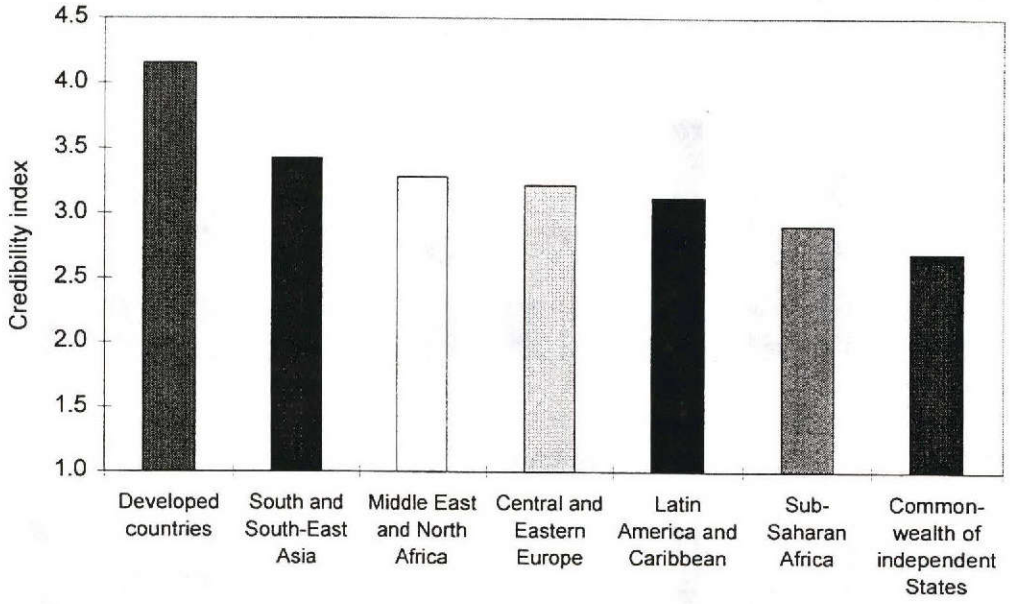
DC: Developed Countries
SSEA: South and South-East Asia
MNA: Middle East and North Africa
CEE: Central and Eastern Europe
LAC: Latin America and the Caribbean
SSA: Sub-Saharan Africa
CIS: Commonwealth of Independent States

* percent of entrepreneurs who responded that this is a problem for their business

2.32 To gain an overall picture of the capability of the state in relation to the private sector one summary indicator of the credibility of rules—which encompasses all the issues discussed above—was compiled. Figure 2.6 shows the regional results: Local entrepreneurs perceive credibility as highest in the developed countries, followed by Asian countries; in the CIS and Africa investors have least confidence in the state as a provider of effective and stable

rules. Although before embarking on its transition to a market economy, the CEE was not high in investors' favors, now on average it is perceived as more credible than the Latin American region.

Figure 2.6 Overall credibility index (1 low, 6 high)



Lack of credibility reduces investment, growth and the return on development projects

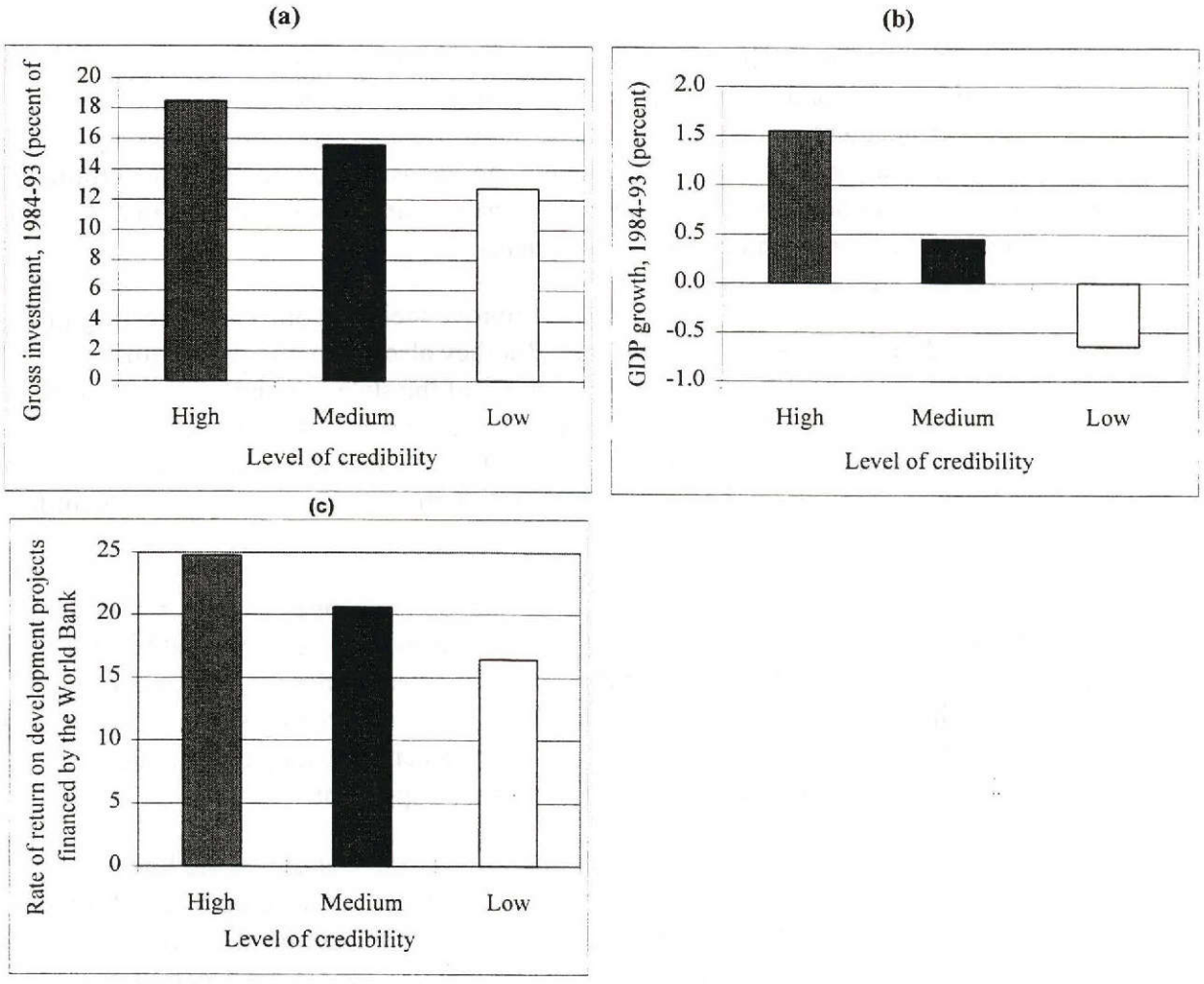
2.33 When the private sector does not believe that the state will enforce the rules of the game it responds in a variety of ways—and all of them worsen the economic performance of the country. Unreliable judiciaries constrain entrepreneurs to rely on informal agreements and enforcement mechanisms. A discretionary and corrupt bureaucracy creates incentives for engaging in rent seeking rather than productive activities. A generalized environment of crime and insecurity of property rights prompt entrepreneurs to enlist the help of private security agents or forces them to pay dues for "protection" to organize crime.

2.34 Investment suffers because entrepreneurs choose not to commit resources in highly uncertain and volatile environments. In particular investments will remain low that require some up front commitment of resources which will be difficult to recover if the business environment turns unfavorable. Where even the most basic property are not protected investors move their resources to other countries or invest them in projects which lower returns but that do not require much commitment of capital. Trade and services may flourish even in low credibility environments but manufacturing. industry and high tech projects are unlikely to surge. A similar distortion occurs when highly talented people choose to become tax inspectors of customs officials instead of learning to be engineers. Therefore, credibility affect not only the level of investment in physical and human capital but also its quality. As a consequence, in a low credibility environment growth suffers.

2.35 Figure 2.7 shows the association of credibility with investment and growth in the surveyed countries for the period 1985-1995. After controlling for other economic variables, high credibility countries have had up to 10 percent higher investment rates than low credibility countries and a shift from a low credibility to a high credibility environment makes a difference of around two percentage points in growth. Low credibility may also help explain why many countries do not see the expected private sector response after implementing stabilization and structural adjustment programs.

2.36 Finally, the credibility of rules affects not only the business environment, but also the environment for implementation of development projects more generally. The same factors—crime, corruption, uncertainty about policy and judicial behavior—affect the outcome for all development projects. One reason is that these concerns are part and parcel of any contractual environment. If corruption affects the private sector, it is likely to affect the outcome of development projects as well. A second reason is that many public projects are implemented

Figure 2.7 Credibility and economic performance go hand in hand



Source: See notes.

by private contractors who are subject to the same behavioral problems implicit in an environment of weak institutions. The contractor is awarded a project, pays off corrupt officials,and gets more projects even if the first is not effectively implemented. Pilferage, theft, and the problems of enforcement are even more widespread in many public projects than in the private sector. Many projects are delayed because of poor coordination and are subject to cost overruns.

2.37 Figure 2.7c shows the impact of credibility on rates of return for 293 projects in twenty-eight countries. On average, a shift from a low credibility to a high credibility environment makes a difference of around eight percentage points in the economic rate of return of World Bank-funded projects. These results control for economic policies and other project and country variables and show how strongly institutions matter in determining project outcomes.

Refocusing on the state's institutional capability

2.38 This brief review of international evidence on the relationship between institutional capability and economic growth, and infant mortality has emphasized the importance of refocusing attention on the ingredients of institutional capability. In many developing countries, weak and arbitrary governments can intensify the climate of uncertainty that comes from weak and underdeveloped markets. In many parts of the world an institutional vacuum now threatens economic and social development.

2.39 Citizens, households, and firms try to improve their outcomes by investing in economic activity within a given set of institutions. But they also try to change institutions through the political process, seeking to alter the behavior of the state. Social protest, capital flight, emigration, and the defeat of governments at the ballot box are all responses to dissatisfaction with the state. Dissatisfaction with the state and with the institutional environment can result in political and social instability, which also affects the environment for the creation of wealth.

2.40 Institutional change is difficult because it involves changes in the formal rules—and informal norms change even more slowly. Typically, the groups in society that benefit from the existing rules and that control the power of the state will resist changes in the formal rules. Hence institutional change is a slow, deliberate process—or else occurs in discrete jumps through war, revolution, or other upheaval. But even when institutions change, they do so amid the rubble of older institutions. Change is therefore always path-dependent.

2.41 The state's capability—its ability to provide collective action at the lowest cost to society—is key to the provision of a viable institutional framework for development. But the state's effectiveness in providing the right institutional infrastructure can be improved over time, through matching the state's role to its capabilities, and rebuilding the state's capabilities by focusing on the incentives that drive the behavior of the state. We turn to these issues in Parts B and C.

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WORLD DEVELOPMENT REPORT 1997
THE STATE IN A CHANGING WORLD

Part B Matching Role to Capability

3. Economic and Social Fundamentals

4. Fostering Markets: Regulation and Industrial Policy

This draft has been prepared by a team led by Ajay Chhibber and with principal authors Simon Commander, Alison Evans, Harald Fuhr, Cheikh Kane, Chad Leechor, Brian Levy, Sanjay Pradhan, and Beatrice Weder. The work was carried out under the direction of the late Michael Bruno, Lyn Squire, and Joseph Stiglitz.

The authors would be most grateful if this draft were neither cited nor made available to others. The published version will be available on June 27, 1997.

Part B Matching Role to Capability

B.1 As Part A highlights, an effective state is vital for the provision of collective goods that are needed for development. But there is no guarantee that the state will provide them. State authority can be used effectively or it can be misused. Part B argues that states can achieve better development outcomes by giving more attention to matching what they do—and how they do it—on their institutional capabilities than by trying to follow some idealized model.

B.2 Chapter 3 explores the appropriate relation between role and capability with respect to some core economic and social fundamentals for development. Chapter 4 explores the appropriate focus in relation to specific regulatory and industrial policies designed to foster markets. Four primary messages:

- States at all levels of institutional capability should respect, nurture and take advantage of private and voluntary initiative and competitive markets.
- States with weak institutional capabilities should focus on providing the pure public goods and services that markets cannot provide (and voluntary collective initiatives underprovide) and goods and services with large positive externalities—property rights, safe water, roads, and basic education.
- Credibility is vital for success. States with weak institutional capabilities should also focus on tools for policymaking and implementation that give firms and citizens confidence that state officials and organizations will not act arbitrarily and will live within their fiscal means.
- As institutional capability develops, states can take on more difficult collective initiatives (initiatives to foster markets for example), and use efficient but difficult to manage tools for collective action (sophisticated regulatory instruments).

Chapter 3 Economic and Social Fundamentals

3.1 Four core economic and social fundamentals are necessary for sustainable poverty-reducing development, and comprise the focus of this chapter. The four are:

- A foundation of law and property rights
- A benign policy environment
- Investment in people and infrastructure
- Protection of the vulnerable

While the importance of these fundamentals for development has long been widely accepted, some new insights are emerging on the appropriate mix of market and government activities for achieving them.

3.2 There is more clarity that markets and governments are complementary—that government actions can be vital in putting in place appropriate institutional foundations for markets and that faith in governments ability to sustain good policies can be as important for attracting private investment as the policies themselves. Also, there is growing recognition that monopoly public providers of infrastructure, social services, and other public goods are unlikely to do a good job. Technological and organizational innovations, meanwhile, have created new opportunities for competitive, private providers in activities once wholly in the public domain. To take advantage of these opportunities for private participation—and to better apply scarce public capability—public financing of infrastructure and services is beginning to be unbundled from public delivery, competitive segments of utility markets are being unbundled from monopoly segments, and programs of social insurance for handling health and employment insecurity are being unbundled from programs of social assistance to help the poorest in society.

3.3 Today, however, only a few countries are pushing out the frontier of institutional innovation. Overall, the track record of developing countries in managing the fundamentals has been very mixed. Many countries in East Asia—plus others such as Botswana, Chile, and Mauritius—have done a good job. But others have not. As Box 3.1 highlights, in many regions weaknesses in some key fundamentals seriously constrain the activities of private firms.

3.4 Political and institutional difficulties are the primary sources of poor performance. Yet, as Chapter 9 explores, windows of opportunity for reform can open and widen, even in the seemingly most inhospitable of settings. The challenge—introduced in this chapter and examined throughout this Report—is to identify and implement approaches to reform that are appropriately aligned with countries' capabilities.

Box 3.1 Weaknesses in fundamentals constrain firms the world over

In many countries the fundamentals needed to allow firms to proceed with wealth-creating private activity are not in place. The survey of business people described in Chapter 2 asked firms to rank the relative importance of eight distinct obstacles to economic activity in order to identify which aspects of government action that most need improving. As Box Table 3.1 shows:

- Obstacles associated with uncertain property rights—corruption or crime and theft—rank among the top three in all regions other than the OECD. Regulation does not emerge directly as a major obstacle.
- Policy-related problems—notably with taxation and the operation of financial markets—also tend to rank high (except in Latin America). It is impossible to tell from the survey results alone however, whether these widespread perceptions reflect the universal desire of firms to pay lower taxes and to borrow more at lower interest rates, or whether they are symptomatic of some fundamental shortcomings in fiscal and financial policies. More telling is the perception in countries of the Commonwealth of Independent States (CIS) that policy instability is a major constraint.
- Infrastructural problems emerge as the leading constraint in South Asia and the Middle East and North Africa, and as one of the top three constraints in Latin America and Africa.

Box Table Obstacles to doing business

Obstacle	Africa	Latin America	Asia	Middle East & North Africa	Common-wealth of Independent States	Central Europe	OECD
Property rights							
• corruption	1	1	3	2	3	3	5
• crime and theft	5	3	8	8	4	6	6
• regulations	8	8	7	7	8	8	4
Policy							
• taxes	2	5	2	3	1	1	1
• financing	6	4	5	4	5	2	2
• inflation	4	7	4	6	6	4	8
• policy instability	7	6	6	5	2	7	7
Public investment							
• infrastructure	3	2	1	1	7	5	3

Source: WDR private sector survey

Ranking: 1—region's largest obstacle 8—region's lowest obstacle

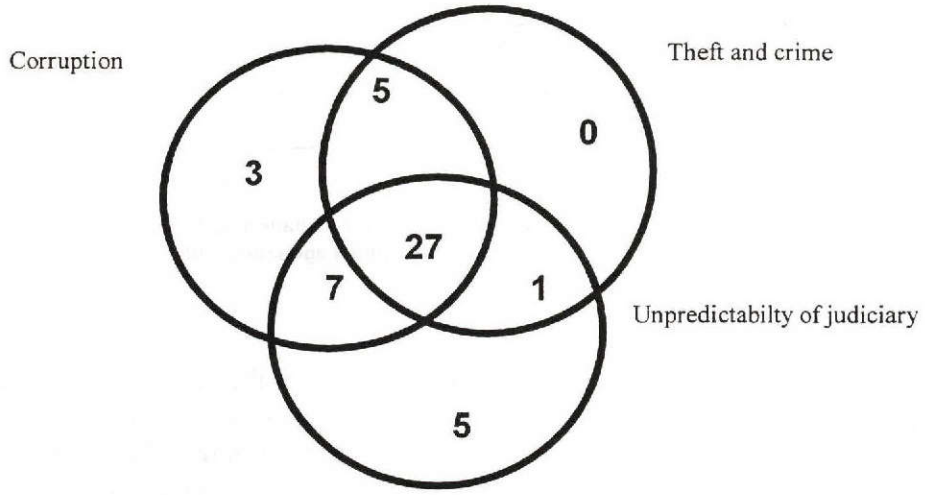
Establishing a foundation of law and property rights

3.5 Markets rest on a foundation of institutions. The functions of these institutions—which can be viewed as public goods—range from providing the basic rudiments of social order necessary for economic activity to proceed to adjudicating disputes and enforcing agreements and facilitating complex contracting (in, say, financial instruments and intellectual property.)

The lawlessness syndrome

3.6 Unless two basics that underpin property rights are adequately provided, markets will remain underdeveloped. The first is protection from theft, violence, and other acts of predation. The second is protection from arbitrary actions by public officials—ranging from ad hoc regulations and taxes to outright corruption—that disrupt business activity. Unhappily, as is evident in Figure 3.1 and as the country-specific patterns in Figure 3.2 highlight, neither of these basic requisites is in place in many countries. Firms in twenty-seven of sixty-nine countries surveyed—including more than three-fourths of those in the CIS, and about half the surveyed countries in Latin America and Africa, but none in the OECD—are subject to a threefold syndrome of lawlessness: corruption, crime, and an unpredictable judiciary that offers little prospect of recourse.

Figure 3. 1 The lawlessness syndrome



Countries are included in the diagram if 50 percent or more of sample firms assign the problem a score of 1 or 2 on a scale of 1 to 6, or (for intersections) if 40 percent or more of firms assign a score of 1 or 2 to each individual component and the average exceeds 50 percent.
Source: WDR private sector survey

3.7 The consequences of corruption often do not end with paying off officials and getting on with business. Government arbitrariness entangles firms in a web of time-consuming and economically unproductive relations. More than half of senior managers in firms surveyed in the CIS—but fewer than 10 percent of those in OECD countries—reported spending more than 15 percent of their time negotiating with government officials over laws and regulations. (Figure 3.2). The burden of red tape is less in other developing countries—though still consistently worse than in the OECD countries. Interestingly, in some countries where corruption and time-consuming negotiations are costly to firms, regulations and controls score low as an obstacle to business—suggesting that in these countries firms are not bothered so much by the red tape itself (perhaps because they do not comply with the rules), as by the opportunities it provides

government officials for opening up "negotiations." Chapter 6 examines in some detail how the scourge of corruption can be tamed.

Figure 3.2 Negotiating with government officials can be time consuming

Source: WDR private sector survey.

3.8 The high ranking of the two other elements of the lawlessness syndrome—theft and crime and judicial unpredictability—is in part a reflection of the institutional vacuum as the transition economies move away from tightly controlled economies and societies. Yet indicators from other regions suggest that institutional decay may be a widespread phenomenon. In Latin America, for example, between 1980 and 1991 the murder rate rose from 12.8 per 100,000 people in 1980 to 21.4 in 1991, with increases evident in virtually all countries and subregions. Much remains to be learned about how to reverse lawlessness among private citizens; the solution is likely to require success along many of the dimensions examined in this report—including protecting the vulnerable and strengthening the overall capability of state institutions. Box 3.2 describes one initiative in an unlikely setting that has received widespread attention.

Box 3.2 Standing up to crime in Cali, Colombia

A community's descent into lawlessness can evoke a sense of helplessness among its law-abiding citizens. Yet even under the most difficult of circumstances, civic action can start a reversal from despair to hope. Witness the case of Cali, Colombia. One of the centers of the illegal world trade in cocaine, the city saw its homicide rate leap from 23 per 100,000 in 1983 to over 100 murders per 100,000 citizens in the early 1990s. While many murders could be directly attributed to drug-trafficking, many more seemed to be the result of a spreading culture of violence. Fed up with lawlessness, in 1992 the city elected as mayor a respected medical doctor who put combating violent crime at the center of his political platform.

Within months the mayor had mounted a Program for the Development of Safety and Peace, DESEPAZ. Starting from the principle that prevention should take precedence over repression—and after an exhaustive analysis of the patterns of crime—the program worked to combat crime across a variety of fronts:

- The organizations of civic order were upgraded. Special education and housing programs were established for police officers and improvements were made in the quality of services (including legal aid and conciliation services) available in the front-line inspectorate offices to which citizens file complaints of criminal action.
- Public education campaigns spread lessons of tolerance and respect for the rights of others. Community leaders were trained in peaceful dispute settlement; children were encouraged to join a "Friends of Peace" program; humorous TV commercials aimed to reeducate citizens to follow the rules of everyday life (obeying traffic signals, waiting in line to board a bus).
- Public services were directed at reducing inequities. Primary and secondary schools were expanded in depressed areas of the city; water, light, and sewage services were introduced into squatter areas; and youth centers and enterprise development programs worked to bring teenage gang members back into the mainstream of society.
- Key catalysts of violent crime were directly confronted. Bans were placed on carrying handguns on "high-risk" weekends and sales of alcohol were restricted late at night and during holidays.

In 1995, after seven consecutive years of increase (to a peak of over 120 murders per 100,000 people), the murder rate finally began to decline.

More complex institutional underpinnings

3.9 Containing lawlessness is necessary to underpin property rights, but it need not be sufficient. Information and coordination problems can also impede development by undermining markets, a problem often found in low-income countries.

3.10 Information problems occur because people and firms are inevitably limited in information and understanding. They lack knowledge of the probity of potential business partners, as well as knowledge of some potentially profitable economic opportunities. The costs of seeking out this information decline as markets thicken and their supporting institutions develop, making economies more information-intensive. In developing countries, though, the costs of learning can be high.

3.11 Coordination is difficult because self-interested people and firms behave strategically—they generally are willing to share information only when they do not lose by doing so. The risk of moral hazard—that other parties might opportunistically renege on agreements—makes it difficult for firms to take advantage of opportunities for mutual gain. As markets develop, institutional arrangements evolve to facilitate economically beneficial cooperation among firms. In developing countries, though, the requisite institutions are underdeveloped, so cooperation can be difficult to achieve.

3.12 *Complex transactions need strong institutions.* For transactions to proceed, market participants need to have confidence that their counterparts will follow through on their commitments. Depending on the nature of the transaction, each participant may require:

- Information on whether individuals and firms possess the property rights they assert over the goods and services (including labor services) they bring to the transaction. These property rights might include the right to use an asset, to permit or exclude its use by others, to collect the income generated by the asset, and to sell or otherwise dispose of the asset.

- Information on the trading history of potential business counterparts and on how important good reputation is to counterpart's future business dealings.

- Mechanisms for enforcing business agreements.

3.13 Spot markets can emerge even when information and enforcement mechanisms are weak because when exchange is simultaneous opportunities to cheat are limited. For other transactions the costs of providing adequate information and enforcement mechanisms to enable business to proceed can be formidable.

3.14 Well-functioning institutions can reduce these transactions costs. Consider the example of mining investments in the nineteenth century in western Nevada in the U.S. "Wild West." Increasingly ambitious (and expensive) mining investments required increasingly precise specifications of property rights—which in turn led to the progressive strengthening of mining operations:

- In the 1850s a few hundred miners worked a forty-square mile area of seemingly marginal value. Only loosely tied to the U.S. polity, they operated under entirely unwritten and informal ownership agreements.

- The discovery of the gold—and silver-bearing Comstock lode in 1859 precipitated a flood of prospectors. Within five months the new miners had established a formal mining camp government, which enacted written rules on private holdings and enforced them through a permanent claim recorder and an ad hoc miners court.

- By 1861 the surface ore was exhausted, forcing mining deep beneath the ground, a substantially more expensive, capital-intensive undertaking. With more at stake financially and with increasingly complex disputes over underground mining rights, the miners pressured for the creation of a formal territorial government with a more extensive judiciary—a process subsidized in part by the U.S. Congress.

- By 1864, with mining production expanding, the territorial judicial system was overwhelmed by a massive case load, which could have taken up to four years to clear. At the end of that year, Nevada formally became a state within the United States and within a year,

some key judicial rulings resolved disputes over subsurface rights, property rights stabilized, and legal uncertainty ended.

3.15 The progress of land titling in Thailand is a more contemporary illustration of the way in which the formal specification of property rights can unleash "locked up" assets, and thereby accelerate private sector-led development (Box 3.3).

Box 3.3 Land titling in Thailand

Thailand has issued more than 4 million title deeds since 1985 in two land titling projects. A third project to title another 3.4 million parcels is being implemented. Land is an ideal form of collateral, so possession of a secure title has facilitated access to formal credit. Three years after titles were issued, Thai farmers who received titles had increased their borrowing from the formal sector by 27 percent. And titles to land by enhancing tenure security, can boost investment in land improvements (irrigation, fencing, de-stumping). Newly titled Thai farmers increased their use of inputs 10 to 30 percent, their rate of capital formation 30 to 67 percent, and their investments in land improvements 37 to 100 percent. Even after adjusting for other factors, productivity on titled land was between 12 and 27 percent higher than on untitled land.

Some key background conditions contributed to Thailand's success. First, formal credit markets were already well developed, and lack of formal title (and hence collateral) was the only reason why many farmers could not get loans. By contrast, in a number of African countries with weak credit markets no measurable impact of titling on borrowing and investment could be discerned. Second, the Thai titling projects took place against a backdrop of land disputes that threatened tenure security but could no longer be adequately resolved through traditional mechanisms. Sometimes, though, where land is cultivated individually but communally owned, traditional tenure systems can provide a considerable degree of tenure security. Generally strengthening such community-based systems of land administration can increase security of tenure (though not collateral for loans) at a fraction of the cost of establishing individual titles. That is an especially attractive option where communities can choose to switch to individual titles once the efficiency gains from allowing sales to outsiders outweigh the benefits associated with communal tenure.

3.16 *Some complex transactions can proceed even with simple judiciary systems.* A well-functioning judiciary is an important asset, which developing countries would do well to build up. As Chapter 6 details, creating a workable formal judicial system from scratch can be a slow and difficult process. But even less than perfect judicial systems that are cumbersome and costly can help underpin credibility (Box 3.4). What is key is not so much that judicial decisionmaking be fast but that it be fair and predictable. And for that to happen judges must be reasonably competent, the judicial system must keep individual judges from behaving arbitrarily and legislatures and executives need to respect the independence and enforcement capability of judiciaries.

3.17 But when a country's judicial system is still underdeveloped, firms and citizens can find other ways of monitoring contracts and enforcing disputes that enable quite complex private transactions to move forward. One option is social enforcement. Social enforcement, based on establishing long-term personal relationships, prevents cheating through the "long shadow of the future"—both parties are prepared to sacrifice short-term benefits for the expectation of a future stream of mutually beneficial exchanges.

3.18 The extended family is an important focus for doing business in many Latin American countries. Family members are bound together in intimate long-term relationships that reduce incentives for cheating on transactions and offer easy monitoring of each other's behavior. Though family size limits the number and variety of possible transactions, families find ways to expand their membership—marriage among business families, "adoption" of trading partners as godfathers, uncles, and aunts.

3.19 Another example of successful social enforcement is by Chinese clans which have formed extended business networks, sometimes with a global reach. These networks have been very successful in generating wealth for their members. Indonesia's Chinese (*nonpribumi*) business community used its extended Southeast Asian network of connections to kickstart exports of garments and furniture. A World Bank survey showed that over 90 percent of the initial export marketing contacts of nonpribumi firms were made through private business connections. Indonesia's non-Chinese exporters relied much more on initial support from public agencies.

3.20 In a recent study the most frequent explanation Chinese merchants gave for their success in business affairs was a characteristic referred to in Cantonese as *Sun Yung*, a form of reputational asset. Its value depends on a person's character and trading history, but even more on investments in social relations and on the amount of social pressure operating on that person. Sun Yung operates like a credit rating, and its monetary value translates directly into access to credit within the trading network.

3.21 Even when parties cannot rely on social enforcement, mechanisms of information-sharing can allow quite complex transactions to take place. Well-developed credit information systems that enable firms to learn about the payment records of new customers and can deter businesses from behaving opportunistically and earning a black credit mark (Box 3.4).

Box 3.4 Contracting and the judicial system in Brazil

The Brazilian judicial system is widely recognized as exceedingly cumbersome. Formal law is extraordinarily specific and is approved without specific reference to its consistency with existing law. Thus, from a firm's perspective, a complex maze of laws may apply to an otherwise simple business transaction. In 1981 for example 1,470 separate legal actions with thirteen government ministries and fifty agencies were required for an export license. The Brazilian legal process is also exceedingly slow, primarily because of a complex appeals procedure. Yet, surprisingly, when asked to evaluate the relative importance of a diverse array of constraints on doing business, private firms assigned a low ranking to problems associated with the legal system.

One reason is that, though cumbersome, the judicial system nonetheless seems to provide a secure backdrop of judicial recourse for business transactions. Most firms report that Brazil's judiciary is reasonably fair and predictable, and they do on occasion turn to it: two-thirds of a sample of Brazilian firms have disagreed with a government official and attempted to have a ruling changed; 60 percent have taken the government to court, and over 80 percent would do so again. Similarly, 1 in every 1,000 transactions among producers and buyers of garments finds its way into court—only 1 in every 2,600 does so in Chile, and 1 in every 20,000 in Peru.

A second reason that firms shrug off the slowness of the judicial system is that (as in all private market economies) institutional arrangements have been developed that restrain opportunism in business

dealings while bypassing cumbersome court proceedings. To cite three examples: Brazilian firms readily provide short-term credit even to new customers with whom they have had no prior dealings; they base their confidence on a well-developed credit information system (backstopped by a juridically sanctioned mechanism for publicizing information on people who fail to pay their debts). Second, though it is difficult to claim pledged property in the event of nonpayment of loans, under Brazilian law leased property can be reclaimed much more readily—so Brazilians make liberal use of leasing arrangements. Third, for some simple financial transactions, special judicial mechanisms have been put in place as a way of bypassing the more cumbersome ordinary judicial proceedings.

3.22 The revival of long-distance trade in Europe during the early middle ages shows how an effective, information-based mechanism for monitoring and enforcing contracts can emerge without any active state participation. Medieval merchants devised their own legal code *(lex mercatoria)* to govern commercial transactions. The code was administered by private judges drawn from the ranks of commerce. In the absence of state enforcement, the code would work only if it was in merchants' private interests to submit to its jurisdiction and abide by the decisions of private judges—even if doing so resulted in additional direct business costs. The code worked because judges were paid to supply information on a potential business counterpart's track record, as well as to resolve disputes, giving them an incentive to invest in learning about the track record of merchants. This system provided a way for honest merchants to signal their reputation to one another, to agree in advance on a basis for resolving disputes, and to know when they might be doing business with someone with a less than spotless record.

Focus on the foundations

3.23 Taken together, the evidence presented here offers both hope and challenge. There is reason for hope in the recognition that quite simple collective institutions and legal underpinnings can do much to facilitate market-based economic development. The challenge is to put in place a basic foundation of lawfulness—protection of life and property from criminal acts, a judicial system that is fair and predictable in the many countries that lack it.

3.24 Overcoming the lawlessness syndrome will take actions along many fronts to strengthen the effectiveness of the state, regain credibility for state institutions, and address poverty and inequality. Without successful responses to these challenges of social development and reinvigoration of state institutions, even the most far-reaching reforms to unleash markets and the private sector are unlikely to lead to sustained investment and economic growth.

3.25 Once a foundation of lawfulness is in sight, more attention can be given to the ways in which specific parts of the legal system can buttress property rights. The legal terrain is vast—ranging from land titling and the collateralization of movable property to laws governing securities markets, the protection of intellectual property, and anti-monopoly legislation to promote domestic competition. However, these more detailed reforms—especially the more sophisticated ones—will yield fruit only where institutional capabilities are strong. In many countries, more basic challenges remain to be met first.

Sustaining a benign policy environment

3.26 Property rights are the foundation for market-led growth and poverty reduction. But much more is needed. Firms need an environment that induces them to allocate resources efficiently, to improve productivity, and to innovate. And, unless firms are confident that policies will remain reasonably stable over time, they will fail to invest and growth will lag.

3.27 This section reviews evidence on international experience with some key policies which support development. It highlights some institutional and political reasons why countries find it so difficult to put good policies into place. And, on the assumption that political windows of opportunity for reform are open, it explores examples of ways in which countries with different institutional capabilities can "lock-in" good policies.

Good policies promote growth

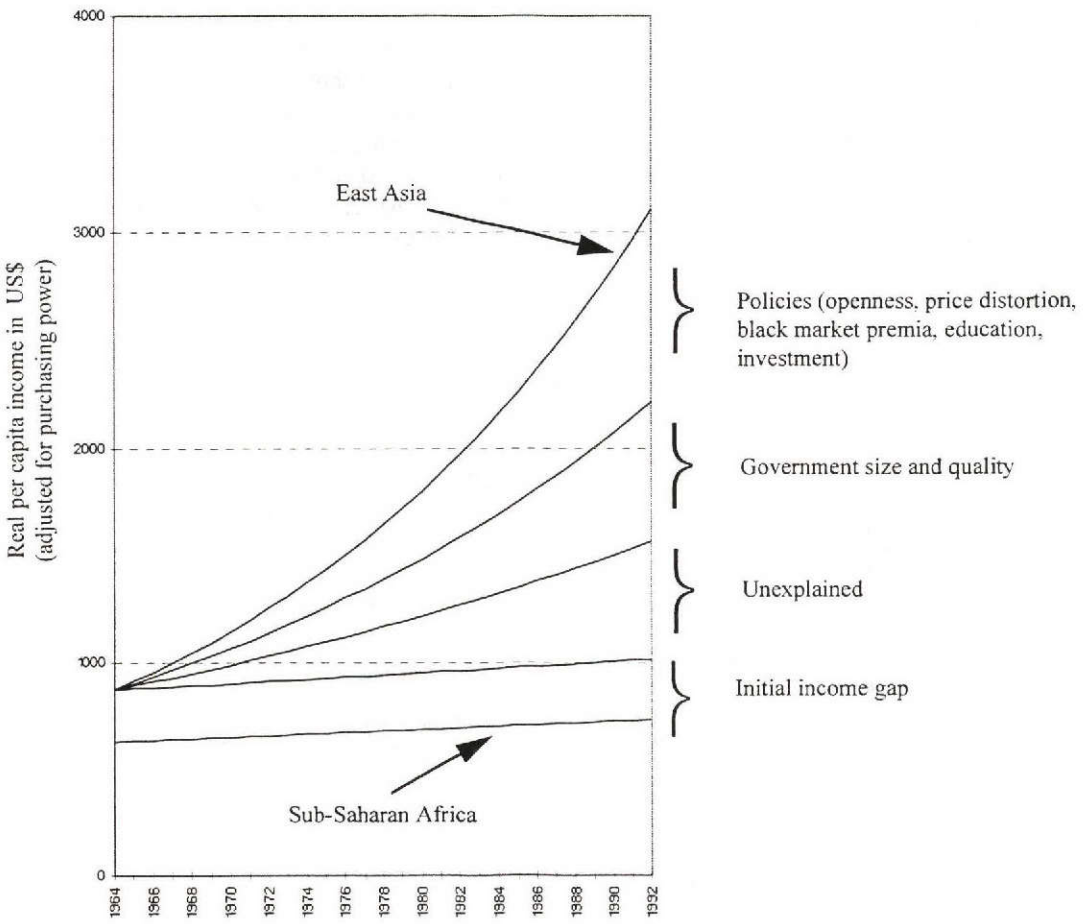
3.28 The past few decades have yielded a rich crop of lessons about the kinds of economic policies that support development. The *East Asian Miracle* has shown how government and the private sector can cooperate to achieve high growth and shared development. The recent recovery of Latin American economies, which have managed to break out of a long history of inflation and into renewed growth, have confirmed the power of a reliance on markets, budgetary restraint, and credibility-enhancing institutions. Although the African continent, especially south of the Sahara, seems not to have joined this movement, a few countries—Botswana, Côte d'Ivoire since the devaluation of the CFA franc, Mauritius, Uganda—have recently found promising paths to development.

3.29 Analyses of these and other successes and failures consistently find a core set of policies that appear to be essential for growth:

- Providing macroeconomic stability
- Liberalizing trade and investment
- Avoiding price distortions.

3.30 These policies help to position an economy to benefit from competitive market forces, which provide the appropriate signals and incentives for economic agents to accumulate resources, use them efficiently, and innovate technologically. In the early 1960s East Asia's per capita income was less than twice that of Sub-Saharan Africa. Thirty years later, it was six times greater. The graph depicts the results of statistical analysis which showed that differences in fundamental policies account for about one-third of that divergence, and differences in the size and quality of government account for another third (Figure 3.3).

Figure 3.3 Explaining growth differentials for East Asia and Sub-Saharan Africa



Source: Commander, Davoodi and Lee (1996)

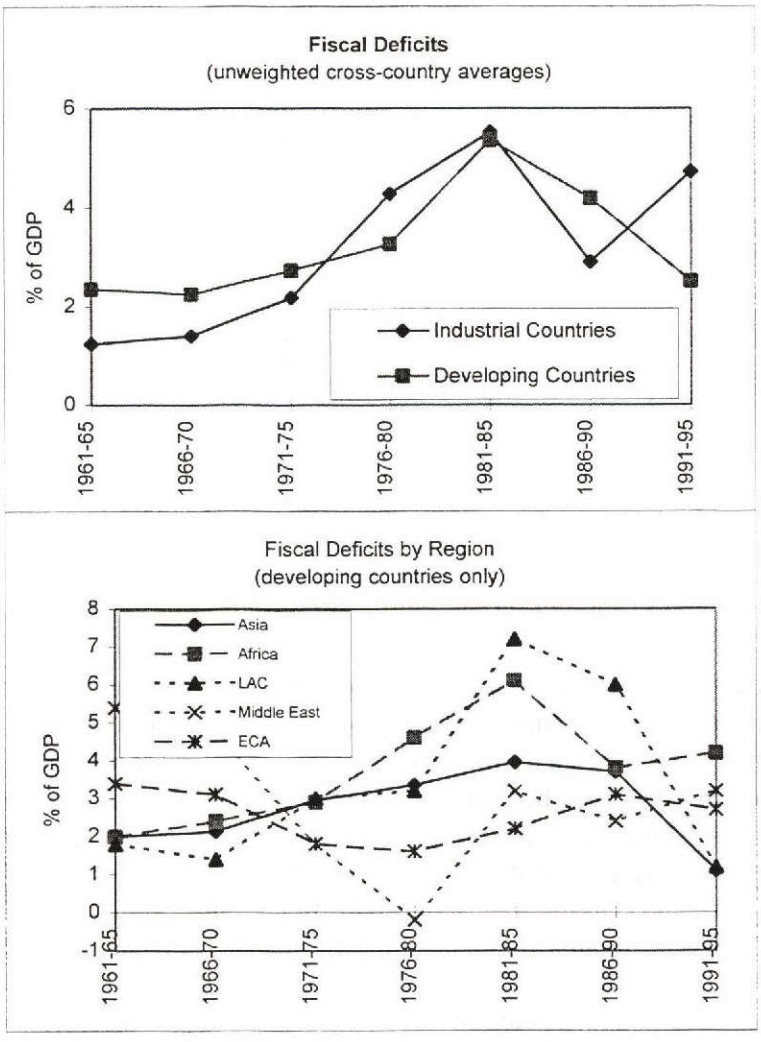
3.31 The relationship between growth and *macroeconomic stability* is well known. Empirical work has established a clear negative association between growth and high rates of inflation. In particular, countries with inflation above single-digit rates tend to show lower growth rates than those with lower inflation. High inflation creates uncertainty about the return on saving and investment, thus creating a disincentive for capital accumulation. And, high inflation makes it difficult to maintain a stable exchange rate at a competitive level, thereby making it hard for a country to benefit from integration in the world economy.

3.32 Ensuring stability takes strong fiscal and monetary discipline—difficult to achieve and maintain (Box 3.5). Yet, unless people believe that a country's fiscal and monetary discipline is sustainable, it may not elicit the confidence necessary to generate growth. As discussed below, appropriate institutional arrangements can help inspire such confidence.

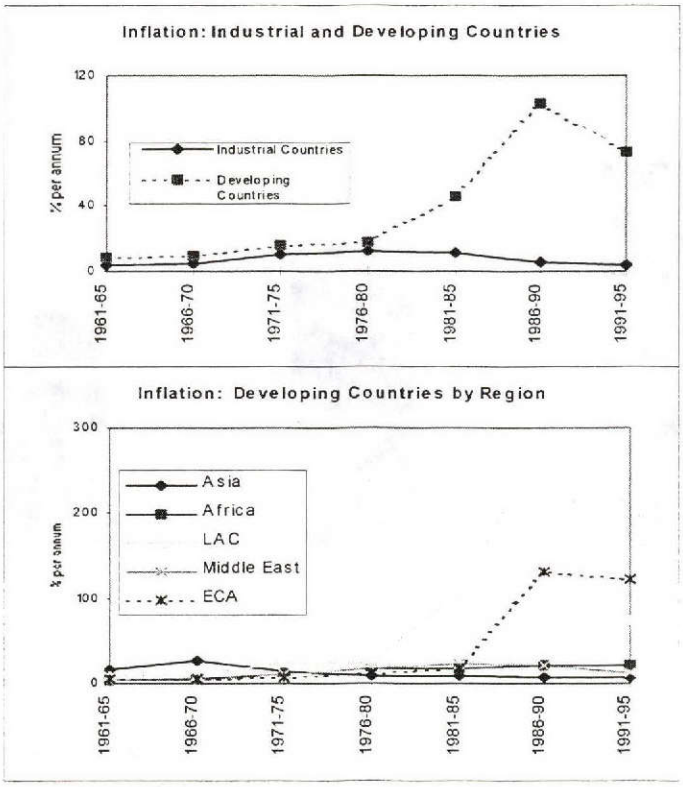
Box 3.5 International track records on fiscal deficits and inflation

As Box Figure 3.3.1 shows, fiscal deficits in industrial countries rose progressively for two decades starting in the early 1960s, stabilized briefly in the late 1980s, then began to grow again. The high persistent deficits have boosted public debt (not including unfunded pension liabilities) from about 40 percent of GDP in 1980 to 70 percent in 1995. Developing countries have shown considerable improvements in fiscal discipline, although there is substantial variation. Fiscal deficits started falling in the early 1980s, mainly because of expenditure cuts. However, this aggregate picture reflects mainly the success in fiscal consolidation in Asia and Latin America, where sustained and dramatic deficit reductions have been achieved. By contrast, in the first half of the 1990s neither African nor Middle Eastern countries have been able to follow through on deficit reductions achieved in the latter 1980s.

Box figure Fiscal deficits



Box figure Inflation



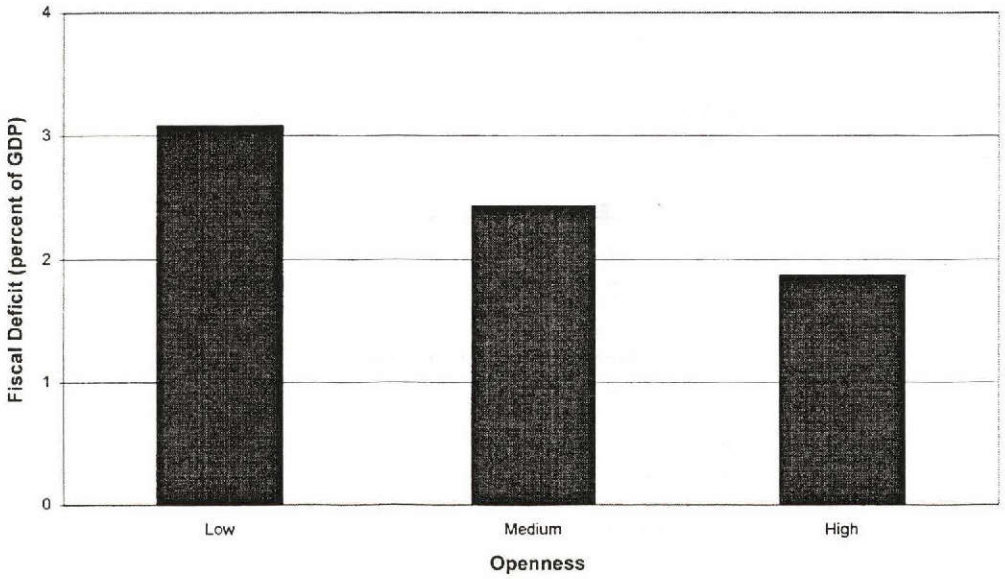
Source: International Monetary Fund (selected years)

Diversity in inflation rates across regions has been even greater than that of fiscal deficits. The inflationary episode of the 1970s and early 1980s spread quickly around the world. The cooling of inflation that started in industrial countries in the early 1980s has begun to take hold, but with a lag. In developing countries inflation began to moderate in the early 1990s, but not everywhere. In some developing regions, inflation rates are showing signs of convergence toward those of industrial countries.

3.33 Maintaining *liberal trade, capital market and investment regimes* is also essential for promoting growth and, as Chapter 8 details, many countries have moved in the direction of increased openness. Open markets offer opportunities for citizens and businesses by increasing access to supplies, equipment, technology, and finance. Trade linkages with the world economy also help domestic prices adjust to global market conditions and thus to reflect the scarcity values of goods and services. Improved incentives and opportunities allow entrepreneurs to use resources more efficiently.

3.34 A liberal and open trade regime also disciplines government behavior. Open economies are more exposed to external risks, making it more costly for governments to pursue inconsistent policies. Consequently, countries with a relatively high share of external trade tend to have lower fiscal deficits than those with a relatively low share (Figure 3.4). Discipline also arises from the need of governments to comply with the rules and conventions established through international treaties.

Figure 3.4 Openness restrains fiscal profligacy



Source: see technical notes, 1990-1994 average data

3.35 *Limiting price distortions* is an essential element of good policies because price distortions impede growth. They can discourage necessary investments, direct efforts into unproductive activity, and encourage wasteful or inefficient use of resources. Price distortions take on different forms, shaped by their diverse historical origins. The principal distortions, however, involve discrimination against agriculture, unrealistic wages, and hidden taxes or subsidies on the use of capital.

3.36 African agriculture offers a vivid illustration of how price distortions undermine economic development. Agriculture accounts for about 35 percent of Africa's GDP, 40 percent of exports, and 70 percent of employment. Yet historically, African farmers have faced very high rates of both explicit and implicit agricultural taxation. Explicit taxes (notably on agricultural exports) were high because administrative weaknesses limited the option of raising adequate revenue from other sources. Implicit taxes were high because pro-urban, pro-industry, and high protection policies resulted in seriously overvalued real effective exchange rates and because, in some countries, single channel public sector monopolies set large differentials between farm-gate and border prices—and absorbed much of the difference with in-house expenditures. The combination of high explicit taxes and overvalued exchange rates contributed to alarming declines in Sub-Saharan Africa's average annual rate of agricultural growth—from 2.2 percent in 1965-73 to 1.0 percent in 1974-80 to 0.6 percent in 1981-85.

3.37 Since the mid-1980s many African countries have made major strides in reversing their anti-agricultural bias. By the early 1990s two-thirds of a sample of twenty-seven countries had already reduced their policy biases against agriculture

through some combination of lower explicit taxes and a correction in the overvaluation of the exchange rate. And the recent devaluation of the CFA franc (Box 3.6) significantly reduced the bias against agriculture among virtually all the franc zone countries that failed to reform earlier.

3.38 Price distortions are also common in labor and capital markets, although they may be more difficult to detect. Legal minimum wages, for instance, may be set too high, with the unintended effect of making it more difficult for unskilled and low-wage workers to find jobs in the formal economy. Similarly, the price of capital—the interest rate—is sometimes elevated as a result of heavy taxation of financial transactions or high reserve requirements. When the authorities respond to borrower complaints, clamping a lid on lending rates or by giving subsidies to investors, another layer of distortions is added to the price system.

3.39 *Bad policies have become more risky.* Global integration has made good policies even more important—and bad ones more dangerous. An economy without sound policies is unable to engage fully in international trade and investment. Being part of an integrating world economy also carries new risks. With more open markets for goods and capital, it is difficult for the state to suppress the consequences of monetary indiscipline. If too much money is created, the foreign exchange market will quickly expect higher inflation and thus depreciate the local currency. This market feedback causes domestic interest rates to rise and with them the government's financing costs. Good policies are needed to cope with the risks of capital flight, volatile arbitrage activity, and sharp movements in commodity prices. Box 3.5 summarizes some differences in the way countries have responded to the new global environment.

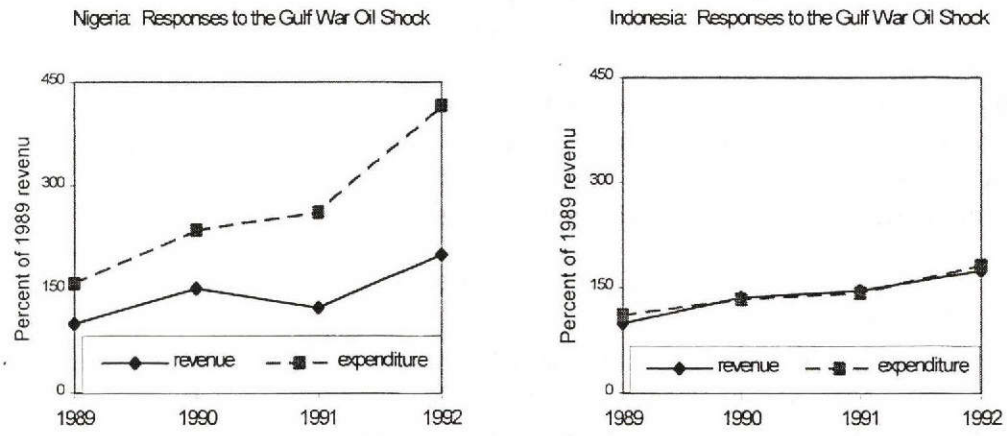
3.40 Capital inflows impose a discipline on domestic policymakers. They tend to appreciate the real exchange rate and can affect competitiveness and domestic savings. They can also be seriously destabilizing because of their quick responsiveness to short-run financial turbulence. Recent experience suggests that this turbulence can be contagious, spilling over to other countries or regions in ways that are not necessarily commensurate with the change in risk. Countries experiencing sizable capital inflows may need to run positive fiscal balances, using these precautionary savings as a hedge against the possibility of sudden capital outflows. Capital inflows also have major implications for exchange rate policy; fixed exchange rates, for example, are unlikely to be a workable option if a country is vulnerable in financial markets. In short, the quality of a government's management of the economy is critical.

3.41 The risk of capital flight and financial turmoil is vividly illustrated by Mexico's experience in 1994. An important reason for loss of confidence and the flight of capital was an overvalued exchange rate, maintained despite very large current account deficits. As foreign exchange reserves fell below the domestic monetary base late in 1994, the authorities failed to bring about the necessary monetary contraction. More consistent policies could have limited the loss of confidence.

3.42 An open economy is also exposed to price shocks arising from world markets. Energy and food prices are particularly volatile and can affect a country's external payments and fiscal positions. Exchange rates and interest rates are also volatile. Prudence calls for anticipating adverse shocks (a sharp price increase for importers, a price drop for exporters) by maintaining a debt buffer for new borrowing, and adequate foreign exchange reserves and, in the medium term, by establishing a more diversified economic base.

3.43 Favorable shocks can cause as much trouble as adverse ones. The prudent response to a favorable shock is to set aside part of the windfall for future use. When the 1990 Gulf War pushed up oil prices, Nigeria used its windfall oil revenue to expand spending (Figure 3.5). So in spite of the large increases in revenue, Nigeria's fiscal deficits rose during that year. When oil prices and revenue fell in 1991, spending remained at the new higher levels. By contrast, Indonesia (also an oil exporter) responded with fiscal discipline, explicitly budgeting a reserve fund to keep the increase in expenditure below the increase in revenue and maintain the budget balance.

Figure 3.5 Positive shocks require prudent management



Source: International Monetary Fund (1996)

Why are good policies so hard to achieve?

3.44 Though the recipe for good policies is well known, poor performance persists. This persistence often signals the presence of political and institutional incentives for "bad" policies.

3.45 First, bad policies from the perspective of development are often effective policies for redirecting benefits to politically influential groups. Many macroeconomic problems—inflation, exchange rate misalignment—are in fact covert ways of levying unexpected taxes on the private sector or of redistributing economic benefits. Similarly, a broad array of microeconomic restrictions on the operation of markets—restrictions on imports, local monopoly privileges, regulatory red-tape—serve to shelter powerful incumbent private firms or other favored segments of society.

3.46 Second, in some countries the political system has in-built tendencies toward chronic budget deficits. Legislators exchange favors, promising to vote for specific benefits to their constituents, without specifying how these benefits will be paid for. So fiscal deficits rise.

3.47 Third, when there is a revenue shortfall and a limited willingness to reduce spending, governments can chose to levy or raise taxes that are desirable from an efficiency standpoint or to impose taxes such as the inflation tax that are easy to implement. Increasing formal tax collection requires an efficient and honest tax administration. Achieving that may first require deep structural reform of fiscal administration. A change in the rate of a value added tax might require a vote of parliament, implying delays and political compromise. But an increase in the inflation tax could involve no more than a ministerial order for the central bank.

3.48 Fourth, even when intentions are good, governments can sometimes be forced to use easy-to-change taxes like the inflation tax. How does a government convince potential holders of its bonds that it will not inflate or default on them? How can it convince trade unions that it will not cut their real gains by raising the cost of living? If governments fail to be convincing, then these agents will protect themselves, by demanding a higher interest rate on government debt or a higher pay raise. Governments with low credibility might then be forced to bring about the inflation that private agents expect by loosening monetary policy and allowing real wages or interest rates to rise.

3.49 These perverse but powerful political and institutional incentives can make policy reform very difficult. And then, even if the reforms are initiated, the skepticism of businesses, workers, and citizens will often be self-fulfilling unless the government can communicate the seriousness of its intent.

Locking in good policies

3.50 Once reforms are announced, lasting success may depend on designing and implementing policies in ways that credibly signal that the government will not renege on its promises. In general, the logic of lock-in is similar whatever the precise example chosen: implementing agencies, officials, and politicians need to be subject to checks and balances that restrain any impulse to depart from announced commitments. If institutional capabilities are strong enough so that there can also be some flexibility to adapt rapidly in response to unexpected events, well and good. If not, experience suggests that long-run goals are better served by abiding by (and thereby strengthening the credibility of) self-imposed restraints and living with the rigidities they inflict. How this can be done is illustrated here through the examples of fiscal and monetary policy. (Chapter 4 will probe further using examples from regulation).

3.51 *Fiscal policy*. Many macroeconomic disturbances are set off by fiscal imbalances. The proximate causes of fiscal imbalances are the choices politicians make.

Additionally, recent research suggests that the political and institutional processes of budget-making can explain a significant part of the differences in fiscal performance.

3.52 An important characteristic is the transparency of budgeting. Politicians can gain from ambiguity—though society as a whole loses—by overstating benefits to some key constituents, by blurring the cost of favors to special interests, and by underestimating the long-run costs of short-term profligacy. When budgets are not transparent the use of tricks becomes easier, from "creative accounting," including off-budget expenditures, to overoptimistic revenue and growth projections, which make spending control more difficult.

3.53 How budgets are formulated and approved is also important, whether through a hierarchical or a collegial approach. A study of twenty Latin American countries probed the relation between fiscal performance (as measured by the primary deficit as a percentage of GDP) and a country's ranking along a collegial-nontransparent to a hierarchical-transparent dimension. Hierarchical approaches typically give strong powers to the finance ministry to set key budgetary parameters for the spending ministries. And, they often limit opportunities for legislators to amend the proposed budget; legislators must vote a simple yes or no. These approaches are thus hypothesized to foster fiscal discipline. Collegial approaches create more opportunities for line ministries and dissenting legislators to shape budgets in accord with their preferences—leaving space for negotiations over total spending, the composition of spending, and even the size of the deficit. Fiscal discipline is hypothesized to weaken.

3.54 The empirical results for Latin America support these hypotheses (Figure 3.6). Budget deficits tend to be higher among countries which use collegial and nontransparent approaches to budget preparation—and hence score low on the hierarchy-transparency index. Countries with the lowest index score averaged deficits of 1.8 percent of GDP. The middle third ran a budget surplus averaging 1.1 percent, while the top third had a budget surplus averaging 1.7 percent. These results should direct countries looking to improve their aggregate fiscal management to focus on the institutional processes that affect budgetary outcomes as well as on the content and levels of taxes and spending.

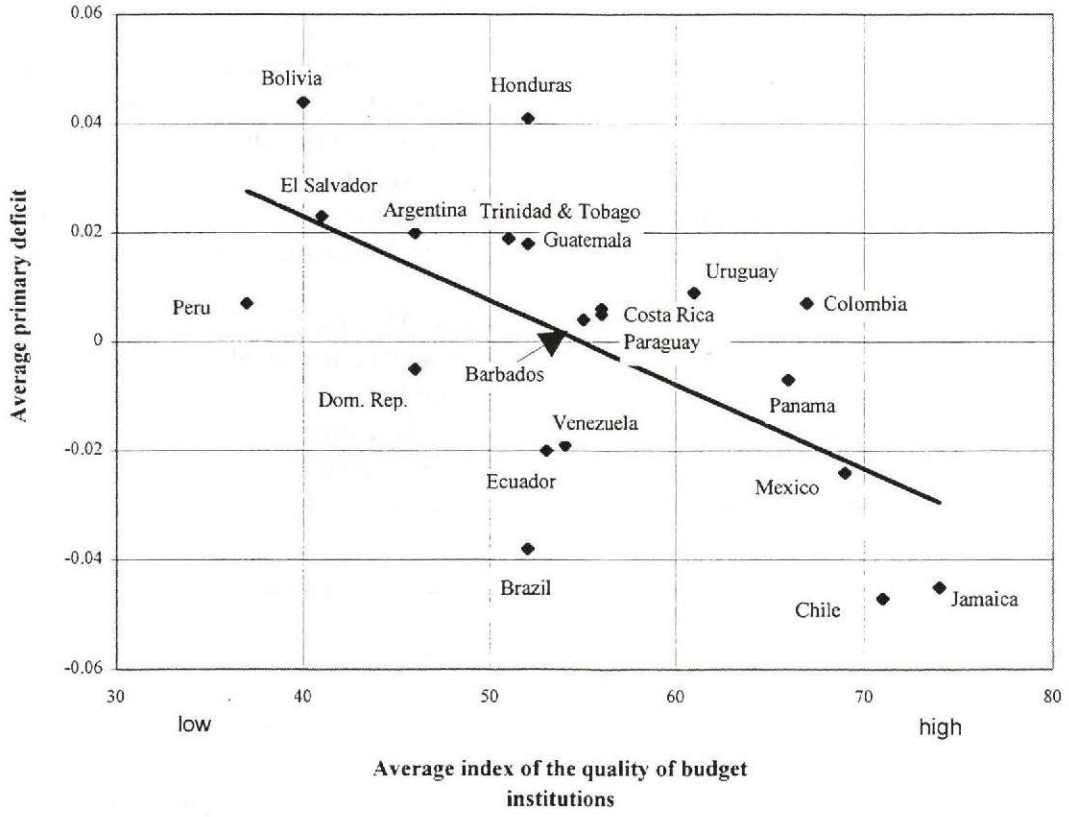
3.55 *Monetary policy.* A well-functioning, independent central bank can effectively reduce the threat of politically motivated monetary expansion while maintaining some flexibility to accommodate unavoidable exogenous shocks. And many countries seeking credibility for their monetary policy have chosen the model of an independent central bank.

3.56 In many cases this enthusiasm for an independent central bank sprang from evidence that OECD countries with independent central banks generally had lower rates of inflation than others—with no slowdown in growth. Recent evidence suggests, though, that independence is more complex than was first thought:

- Attempts to find a similar pattern to the OECD in developing countries yielded mixed results, with the results depending on how central bank independence was defined. This more complex story for developing countries suggests that central bank independence cannot simply be manufactured by fiat. It may require a prior foundation of checks and balances on arbitrary government action.

- In Russia, the governor of the independent central bank in the early 1990s was not persuaded that slowing growth of the money supply would ease some problems of transition. The result, not surprisingly, was that inflation remained at triple-digit levels.

Figure 3.6 Budget institutions and fiscal outcomes, 1980-92



Source: Alesina (1996)

3.57 Can developing countries reap the benefits of central bank independence while containing the risks? One way is to choose as central banker a conservative, whose preferences are biased against inflation compared with those of society at large. Another way is to assign only instrument independence to the central banker, leaving control over the goals of monetary policy to political authorities. A third option is a contract for the governor of the central bank that involves some penalty for deviating from an announced

inflation target—in short, a mechanism that mimics the anti-inflation bias of the conservative banker, without relying on some subjective characteristics of the person who holds the position.

3.58 The mixed success of independent central banks in restraining inflation raises the possibility that some developing countries may not be able to put in place mechanisms that credibly signal monetary restraint, while maintaining the capacity to respond flexibly to exogenous shocks. For them the choice may be between rigid mechanisms and no commitment whatsoever. A variety of inflexible approaches have been tried:

- Argentina, in breaking away from a long tradition of inflation, enacted a currency convertibility law in April 1991 that essentially amounts to turning the central bank into a currency board. The money stock must be fully backed by foreign exchange

- Many Latin American countries switched to a fixed nominal exchange rate to anchor prices and coordinate private sector expectations. A fixed rate precludes the use of devaluation to accommodate short-run external shocks. And as Mexico discovered to its peril in 1994, a fixed nominal exchange rate can become dangerously destabilizing if capital inflows or domestic policies pull the real exchange rate out of line.

- Most of the Francophone countries in Africa affiliated themselves with the CFA franc zone and its supranational central bank. Central bank advances to a member government are limited to 20 percent of the tax revenues collected the previous year. So countries are unable to substitute the inflation tax for conventional taxes (Box 3.6). This mechanism can provoke deflation however if the growth rate turns negative.

Box 3.6 Commitment or flexibility in the CFA zone

The CFA franc zone of west and central Africa is both a currency union and a monetary standard: the CFA franc is convertible to French francs at a fixed nominal exchange rate. France established the zone after World War II to oversee monetary and financial policies in its African colonies, and France continues to play a central role in its operations.

In exchange for France's guarantee of convertibility member countries necessarily surrender the right to print new currency. Policy changes require multilateral negotiations among the member states and France. Short of withdrawing completely from the zone, a single country cannot unilaterally renege on its commitment. Compared with similarly endowed neighbors, zone members experienced lower average inflation and higher growth throughout the 1970s and early 1980s.

By the second half of the 1980s, however, certain costs imposed by zone membership became apparent. The CFA zone was hit by a pair of shocks: real appreciation of the French franc against the dollar which led directly to a real appreciation of the CFA franc and a dramatic drop in the prices of major exports of some members. Using a nominal devaluation to adjust to these shocks was ruled out by the fixed exchange rate. Inflation remained very low in this period, but at the cost of stagnant growth rates. The very factors that had contributed to the credibility and stability of the CFA zone made it extremely

difficult to devalue the CFA franc. By the early 1990s, however, a consensus was finally reached that a devaluation was necessary.

A 50 percent devaluation was announced in January 1994. The dramatic size of the devaluation signaled that it was a once-and-for-all measure. Thus the economic benefits of the devaluation could be reaped without undermining the future credibility of the fixed exchange rate. Indications to date suggest that the devaluation has proved largely successful on both of these counts.

3.59 These hard-line approaches represent high stakes races against time. By raising the costs of reversing policy direction, such policies contribute to a belief that the government will hold fast to its monetary policy. But they should not be used rigidly—adjustments to exogenous shocks will still be necessary.

Investing in people and infrastructure

3.60 Well functioning markets are efficient providers of many goods and services. But markets undersupply both public goods and private goods for which positive spillovers are large. These are goods that generally have a significant impact on the quality of life—clean air and safe water, basic literacy and public health, low cost transportation and communications. They are also goods that often dramatically affect the welfare and life chances of the poorest members of society.

Public investments in health, education, and infrastructure yield high returns

3.61 In health, the control of infectious diseases and access to safe water constitute public goods and services with large externalities that will be underprovided or not provided at all by the private sector. Infectious diseases still account for a large fraction of deaths in developing countries, and the poor suffer the most. Nearly 1 billion people in the developing world lack access to clean water, and 1.7 billion people have no sanitation. Water-borne diseases like cholera, typhoid, and paratyphoid remain a pervasive threat to health in many developing countries, especially for the poor. Evidence from Malaysia shows that traditional public-health interventions—such as immunizations and safe water provision—can make a significant difference in rates of illness and death, especially in infant mortality.

3.62 In education, the returns are especially high at the primary level, because of large social externalities from basic literacy. Educating girls, for example, is linked to better health for women and their children and to lower rates of fertility. The economic success of East Asian countries has been attributed in part to their unwavering commitment to public funding for basic education as the cornerstone of human capital development.

3.63 As the *World Development Report 1994* on infrastructure highlighted, public investment in infrastructure gives a boost to private activity in developing and industrialized countries alike. A study of eighty-five districts in thirteen Indian states found that lower transport costs by making it easier for farmers to get their goods to

markets led to considerable agricultural expansion. More broadly, competing for new export markets requires high-quality infrastructure. Virtually all the improved practices designed to reduce the costs of logistics management (the combination of purchasing, production and marketing functions) are based on information technologies using telecommunications infrastructure. The faster and cheaper movements of freight over the past few decades has come largely from multimodal transport involving containerization, which requires intensive coordination by shippers across rail, port, air, and road freight modes.

Public resources often do not go to high return collective initiatives

3.64 The world over, too few resources are devoted to these vital basic services; Governments spend roughly $1 per capita on public health, against a minimum requirement of $4 per capita. About 130 million primary-school-age children—60 percent of them girls—were not enrolled in schools in 1990. Half the children in Africa do not go to school. Girls, the rural poor, and children from linguistic and ethnic minorities are less likely to be in school than others.

3.65 Part of the problem is in the way resources are prioritized across sectors—between defense, state enterprises, and social sectors, for example. In many developing countries, state enterprises produce goods that private markets could supply absorbing funds that could be better spent on public goods. Turkey's state-owned coal mining company lost $6.4 billion between 1986 and 1990. Tanzania's central government spent one and a half times what it spent on public health to subsidize state enterprises that were losing money. In low-income countries state enterprises' losses averaged 2.3 percent of GDP between 1978 and 1991.

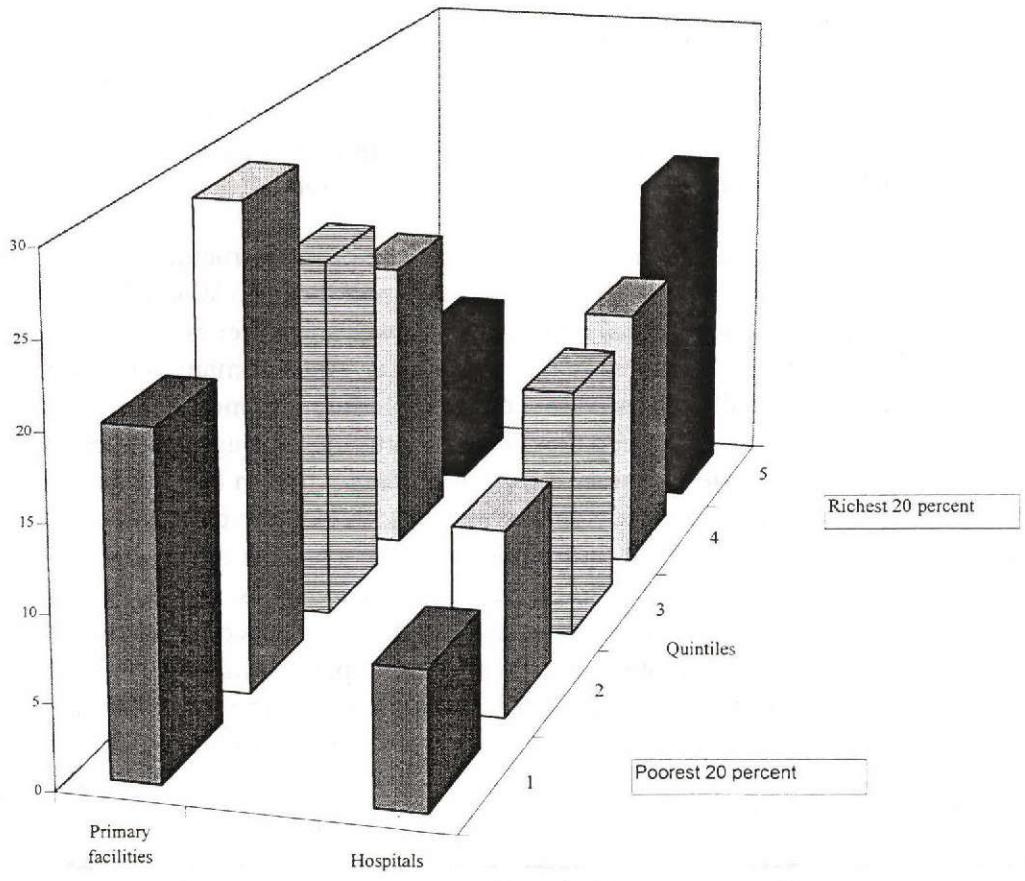
3.66 Another part of the problem is the way resources are prioritized within sectors. Spending on infrastructure and social sectors tends to be concentrated on areas where markets and private spending can meet most needs—urban hospitals, clinics, universities and transport—rather than on essential public goods. Expenditures in these areas often benefit the rich disproportionately, while the poor receive only a small fraction of the subsidies (Figure 3.7).

3.67 In health, for example, governments often try to finance the entire range of health care services. Yet public health interventions directed at improving the health status of large sections of the population, including the poor, warrant a higher priority. Most curative health care is a (nearly) pure private good—if government does not foot the bill, all but the poorest citizens will find ways to pay for care themselves. This may explain why the public provision of clinical care services had no effect on health status in Malaysia where citizens have the option of using private clinical services.

3.68 In education, although some governments are beginning to spend more on primary and secondary levels, higher education is still heavily subsidized. While Korea allocates 84 percent of its education budget to basic education, Venezuela allocates 31 percent. Thirty five percent of Bolivia's education budget—but only 11 percent of

Indonesia's—is allocated to higher education. The tilt towards higher education is most acute in Africa, where public spending per student is about 44 times greater student in higher education than in primary schools. At the extreme—in Tanzania—the ratio was238:1. In Brazil in the early 1990s, university spending exceeded $6000 per student (totaling close to $1 billion annually)—over 25 times spending per primary student, even though Brazil's basic education indicators (quantity and quality) were among the lowest in Latin America. This emphasis on clinical health services and higher education entrenches social inequities. Evidence from Vietnam confirms that the poor benefit more from primary health care, while wealthier groups benefit more from hospital care (Figure 3.7). Yet many countries continue to allocate more of their health budgets to curative care.

Figure 3.7 Vietnam: distribution of benefits from primary facilities vs. hospitals



Source: Demery (199x)

3.69 Government decisions about what services to supply are just part of the reason for such inequities. Differences in patterns of demand, notably gender-based differences also play a role. In Cote d'Ivoire, for instance, almost two-thirds of public

spending on education goes to boys. In Pakistan, boys benefit from about one-and-a-half times the amount of public spending in education as girls. In many cases the relative disadvantage of girls is even greater in poorer households—reflecting differences in demand in these households for education for girls and boys. Gender inequality within society is therefore a critical component in the overall inequality in the benefits derived from public spending.

Making better use of public resources

3.70 To focus public resources more efficiently on the provision of collective goods and services, countries will need to reallocate expenditures and improve the efficiency of resource use. In many countries, this will take both political and institutional changes. The vital first step in institutional change is a readiness to embrace a pluralistic approach to delivery—to permit private participation while focusing direct public involvement on genuinely collective goods and services (though, as the section below on protecting the vulnerable discusses, governments might also choose to subsidize consumption by the needy of goods whose returns are wholly private). Viewed against the common post-World War II presumption that the delivery of infrastructure and social services is the exclusive domain of public monopolies, pluralistic approaches might seem radical and untested. In fact, private and community participation in infrastructure and social services has a long historical pedigree.

3.71 The recent shift towards private provision of infrastructure, partly driven by technological change, has a back to the future ring to it: prior to World War I, infrastructure services (railways, canals, roads, gas, power and water systems) were privately owned, operated, and funded in most countries. And for many other services, including education and health, the private sector—including communities and for-profit and nonprofit organizations—had been the dominant provider throughout much of history (Box 3.7). Only in the twentieth century did governments—first in Europe and later in other regions—become important providers of services, in extreme cases excluding the private sector altogether. The transition from a limited to a substantial role for government evolved differently for different services and countries, so that today we find a very wide variation in the patterns of financing and delivery. In education, for example, the private share of total expenditure ranges from under 5 percent in South Africa and Malaysia to 70 percent or more in Korea and Peru. (Figure 3.8) The variations are also very wide in health. In Latin America, the private share ranges from one-third of total health expenditures in Ecuador, to 43 percent in Mexico and 57 percent in Brazil. Eighty percent of health expenditures in Thailand are private.

Box 3.7 The historical dominance of the private sector in providing social services

Only in the twentieth century did the state assume an important role in providing social services such as education and health care, once the domain of the private sector. The ability of the state to provide services has varied, however, resulting in different public-private mixes.

Today's modern education systems are founded on private—often religious—initiatives. From the Islamic schools in Indonesia and West Africa, to the Hindu gurus in India, the Christian churches in most

of Europe, and the village teachers of China, private religious schools have been teaching children for centuries. In general, though, education was a privilege of the elites. Mass public education is a nineteenth century invention originating in Europe and North America and spreading to former colonies after independence. Significant public investments led to expanding public sector enrollments, in several countries accompanied by a shrinking role for private schools. In Malawi, for example, private primary schools went from 77 percent of total primary enrollment in 1965 to 10 percent in 1979. Elsewhere, the inability of governments to keep up with demand or dissatisfaction with the quality of public schools led to an increase in enrollment in private schools.

Historically, medical services were for the most part privately provided by midwives, traditional healers, and neighborhood doctors. Not until the first antibiotic—penicillin—was mass-produced after World War II did western medicine begin to benefit large groups of people. In developing countries, increased urbanization and industrialization led to the formation of labor groups, that organized themselves to provide health insurance through "sickness funds" or pressed for publicly financed social insurance systems. By 1950, sixteen Latin American countries had enacted laws to provide health insurance to selected groups; however, only two African and four Asian nations had done so. The International Conference on Primary Health Care in Alma Ata in 1979 proclaimed health a "basic human right" and urged governments to take "responsibility for the health of their people." Several governments in developing countries created national health systems that purport to provide "free" medical care to the entire population. These efforts met with mixed success, and the private sector expanded to fill the void. In Malaysia, for example physicians in private practice rose from 43 percent of the total in 1975 to 90 percent in 1990. But large groups of the population still lack access to basic services, while others rely chiefly on private providers paid for out-of-pocket.

3.72 In many settings unbundling the delivery of infrastructure and social services can help achieve a better focus between roles and capabilities. In bundled systems of delivery a diverse array of activities—private and collective, subsidized and unsubsidized, competitive and monopolistic—are undertaken by a single public provider. Unbundling can be a powerful mechanism for making some key weaknesses of monopoly public delivery transparent and for creating the institutional space needed to experiment with alternative delivery options. When services are unbundled, it becomes possible:

- To distinguish between activities that could be financed and delivered entirely through private markets, and those that have important collective elements—and to begin to shed the former.

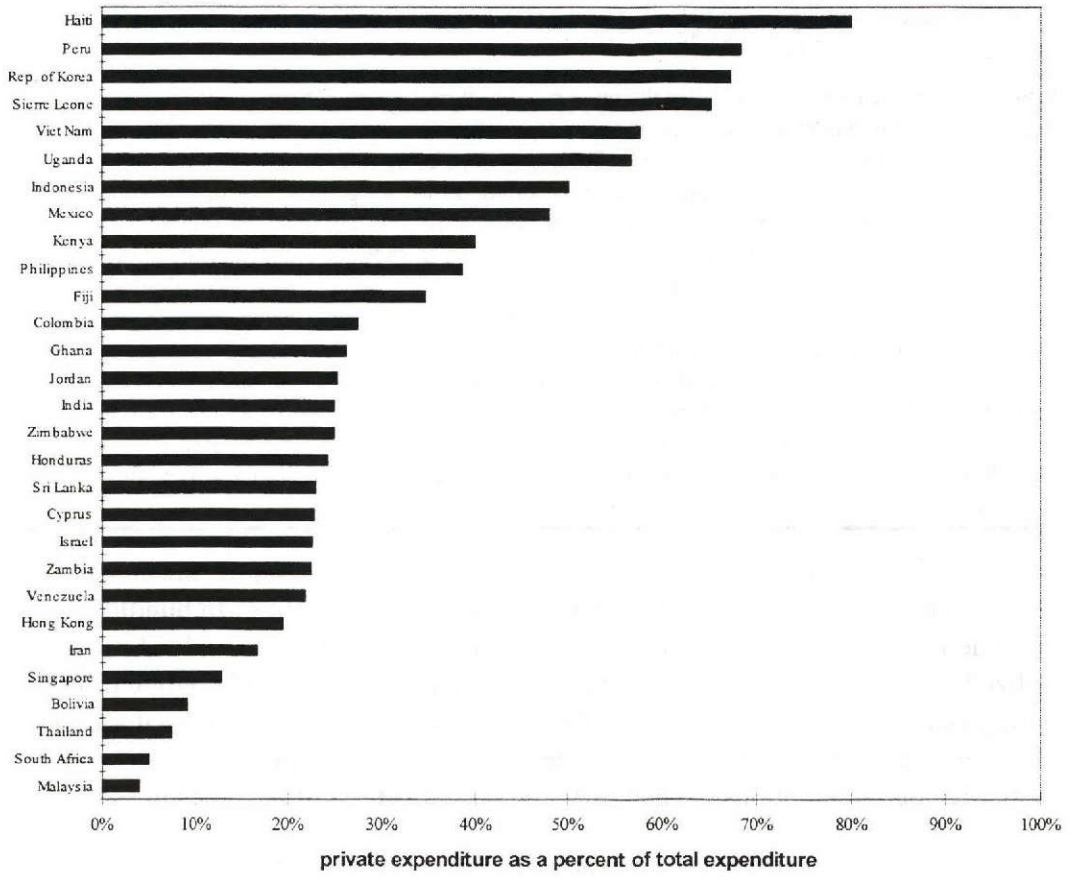
- To distinguish between collective activities whose delivery should remain in public hands and activities whose financing should be public and whose delivery private—with vouchers, contracting, and similar mechanisms providing the bridge between the public and private sectors. (Chapter 5 explores these options in more detail.)

- To take advantage of new opportunities for competition among the array of goods and services that can now be delivered privately. Sometimes, as examined in Chapter 4 for utilities, taking advantage of these new opportunities may require new regulatory arrangements.

- To increase the transparency of the uses to which public money is being put (which are much harder to see when many diverse activities are bundled together within a monopoly public provider.) As a result,

as explored further in the next section of this chapter, it may be possible to target subsidies more precisely for the vulnerable.

Figure 3.8 There are wide variations in financing and delivery of education



Source: Psacharopoulos

3.73 Yet organizational changes will not do it all. Perhaps the most important change in the incentive environment is to empower users themselves with "voice"—not only to work in partnership with providers where localized information is key to efficient delivery, but also to monitor performance by providers and to enforce through the political process a commitment to quality. How this can be achieved is the subject of Chapter 7.

Protecting the vulnerable

3.74 Over the long-term, the combination of rapid growth and investment in people will yield substantial reductions in poverty. Yet regardless of a country's income level, some of its citizens will be left behind despite aggregate economic gains, and others will suffer temporary hardships. This section examines how states the world over have wrestled with the challenge of protecting the vulnerable.

A wide variety of protective measures

3.75 Table 3.1 offers a glimpse of the rich variety of initiatives governments have tried to protect the vulnerable in transition and developing countries. All of these initiatives fall into one of two broad categories:

- Pension, unemployment, and other related social *insurance* programs aim to support people who—for reasons of age, the business cycle, or other circumstances—are outside the wage economy for some part of their lives.

- Programs of social *assistance* aim to help the poorest in society, those who barely are able to support themselves.

3.76 In industrial countries the universal welfare state—which has influenced welfare programs around the world—has blurred the distinction between these goals. Most of the main transfer programs—pensions, unemployment insurance, family assistance—began during the 1930s and 1940s in response to the effects of the Great Depression and World war II and following the realization that the elderly were especially vulnerable in industrial societies. These three programs, pensions especially, are absorbing a rapidly increasing share of national income (Figure 3.9) and rich countries around the world are revisiting some aspects of their welfare programs. Even Sweden, where citizens remain firmly committed to the welfare state, has made extensive reforms to better balance benefits and costs (Box 3.8).

3.77 In Eastern Europe and the former Soviet Union the state has traditionally provided a wide range of social services. Before transition these economies had very comprehensive benefits but they differed from those in rich market economies in four respects. First, because the system was based on the premise of full employment guaranteed by the state, there was no unemployment insurance. Second, social protection focused on individuals (such as the old and disabled) who could not work. Third, benefits were decentralized at the firm level. And fourth, in-kind subsidies (housing, energy) played an important role.

3.78 With an unprecedented economic contraction and tight budgets during transition, countries of Eastern European and the former Soviet Union are realizing that this system of universal coverage is no longer affordable and must be replaced by more targeted programs. Cash transfers as a percentage of GDP are high and increased significantly during the transition. In Poland transfers doubled from 9 percent in 1988 to 18 percent of GDP in 1993. Adapting the welfare system to the new conditions is proving politically difficult.

3.79 In contrast to the OECD, the vast majority of developing countries have created "oasis social insurance systems", which grant family benefits and pensions to formal sector workers and civil servants. The size of this oasis increases with per capita income. It covers 6 percent of the labor force in Sub-Saharan Africa, 23 percent in Asia

and 38 percent in Latin America. Formal unemployment insurance is rare, but the practice of using the public sector as employer of last resort is a form of disguised unemployment insurance.

Box 3.8 The benefits and costs of Sweden's welfare state model

Following World War II Sweden implemented a universal welfare system that included social insurance and a vast array of family assistance programs. This system is credited with unprecedented success in eradicating poverty.

During the first twenty-five years after World War II economic growth in Sweden was comparable to growth in other industrialized countries. In the early 1980s, however, the welfare system started showing signs of overload. First, the welfare system started to compromise fiscal balance, as social insurance expenditures (excluding unemployment insurance) rose from 7 percent of GDP in 1965 to 20 percent in 1996. To many observers, this increase highlights the system's bias toward higher expenditures and its vulnerability to economic shocks. Second, the financing of these expenditures led to high marginal effective taxes of around 50-60 percent. Together high marginal tax rates and generous social programs created many distortions—a conservative estimate puts deadweight loss at 40 percent. Third, there is evidence that increased tax wedges and associated distortions contributed to a significant slowdown in productivity and economic growth. Between the mid-1960s and the late 1970s, 75 percent of the 3 percent drop in the annual growth rate is estimated to have been attributable to rising taxes to finance the welfare state.

In December 1992 the Swedish government appointed a commission to study the crisis. The commission recommended fundamental changes in the design of welfare programs and deeper reforms in political institutions. On the welfare side it recommended an increase in co-insurance in the social insurance programs, a two-tiered pension system, and elimination of social insurance programs that are not inherently of an insurance type, such as parental-leave insurance. The commission also recommended strengthening the executive by introducing a constructive vote of no confidence, allowing the government to ask parliament to vote on a package rather than line by line, extending the elections from every three years to every four or five years, reducing the size of parliament by half, and eliminating county councils.

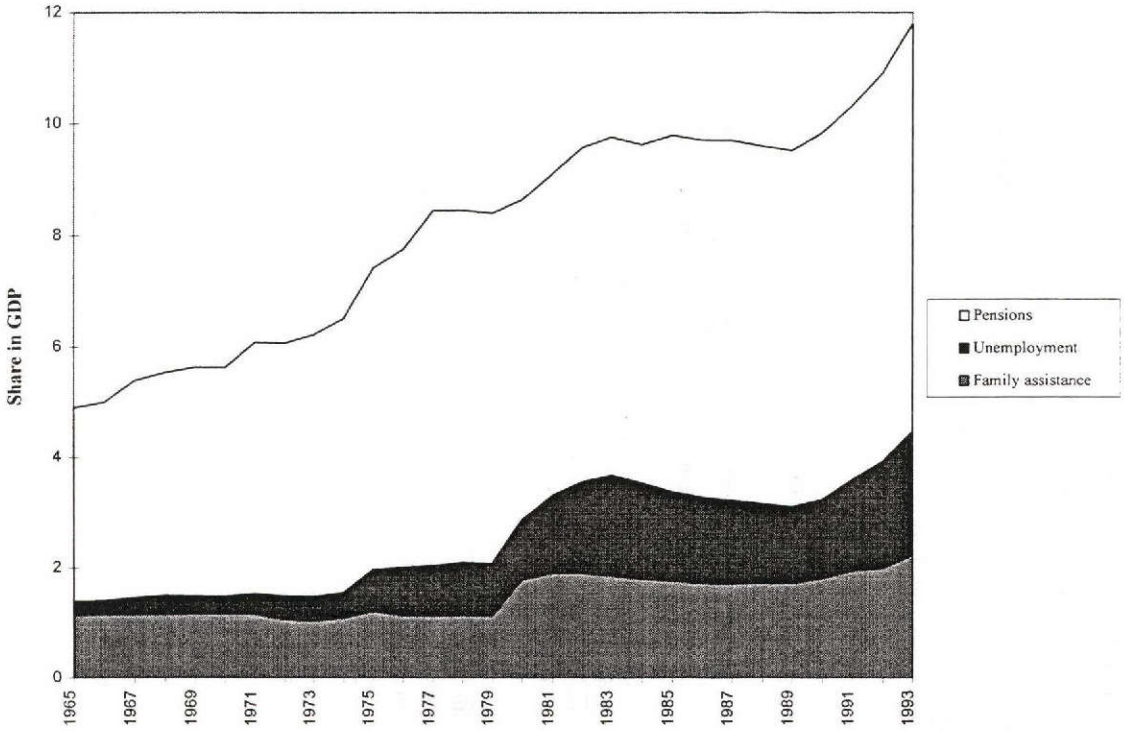
The new government that came to power in 1994 has adopted some changes to the welfare programs. For the first time in its history the child benefit was reduced in nominal terms (by 15 percent). The sickness insurance benefit was also reduced. Probably the most far-reaching reform was the adoption of a two-tiered pension system, with benefits under the public tier based on lifetime contributions and indexed on life expectancy at retirement. The Swedish experiment reveals that the welfare state can contribute to eradicating poverty but that the enormous visible and hidden economic costs cannot be ignored.

Table 3.1 Social insurance, social assistance, and poverty-targeted programs in developing countries: characteristics and lessons

Program	Coverage and Regional Patterns	Design-Issues and Lessons	Success stories
Pensions	Near universal coverage in transition countries, very low coverage in Sub-Saharan Africa, medium-high coverage in Latin America. Pay-as-you-go schemes dominate.	Actuarial imbalances, which prevail even in countries with young populations, threaten macro stability in transition countries, Uruguay, and Brazil. Transition countries need to increase pension age. Separating redistribution from insurance is desirable.	Innovative multipillar schemes in Argentina and Chile
Family assistance	Mid—to high-income countries include as part of social insurance. Universal at enterprise levels in transition economies	Family size and poverty correlation high in central Asian republics but does not hold in Eastern Europe and Former Soviet Union. Poverty incidence determines degree of progressivity. With low poverty incidence, means testing crucial to containing cost.	
Social assistance cash	Limited coverage in transition countries; rare in Asia; nonexistent in Latin America and Africa. Zakat in Pakistan and Jordan.	More suitable to countries with relatively low poverty incidence	Chile' s family subsidy and old-age social assistance pension
Food subsidy	General price subsidy dominates in Africa and the Middle East. Quantity rationing prevalent in South Asia. Food-for-work used in Latin America. Countries are shifting toward food stamp and targeted programs.	Open-ended price subsidies are fiscally unsustainable, distortionary, and regressive. Leakage's can be prevented by innovative targeting. Nutrition programs more cost effective than quantity rations or general subsidies. Programs with work requirement are more cost effective than food rations. Political economy often entails an urban bias.	Tunisia's food price subsidy, which reduced cost by 2 percent of GDP and increased targeting; Food for Education Program in Bangladesh 1993
Housing subsidies	Prevalent in transition economics, mostly on-budget. Less prevalent in other regions, mostly off-budget.	Often a very regressive program. Urban poor best protected by increasing and encouraging low cost housing production. NGOs have been more successful in targeting. Housing subsidy in Former Soviet Union has huge efficiency cost because it hinders labor mobility.	Chile's one-time subsidies for housing purchase on the private market.
Energy subsidies	Prevalent in transition countries and oil-producing countries, such as Venezuela.	Asia, Africa, and Latin America gasoline subsidies largely benefit non-poor. Some regressiveness also found in transition countries because of importance in consumption basket of non-poor. Elimination of subsidies would affect urban poor.	
Public works	Maharashtra Employment Guarantee and JRY in India, social funds in Africa and Latin America funded domestically and internationally	Serves both insurance and assistance objectives. Appropriate in areas where poverty is transient with scope for unskilled labor-intensive projects. Program wage should not be higher than ruling market wage rate. In-kind payment attract more women.	Maharashtra EGS India; South Korea's introduction and cancellation of work program
Credit-based programs	Prevalent everywhere, especially in Africa, South Asia, and Latin America.	Main problem is inability to borrow in the absence of collateral. Subsidize transaction cost but not interest rates, use local groups instead of direct targeting programs, organize beneficiaries into groups, and incorporate incentives to both borrowers and lenders to enforce repayment. Incorporate savings as a necessary component.	Grameen Bank in Bangladesh.

Source: Adapted from World Bank (1996) social assistance and poverty targeting

Figure 3.9 Pensions and other cash transfers have grown in the OECD



Source: see technical notes

3.80 Developing countries have also experimented with a variety of social assistance measures for meeting the basic needs of the poorest in society. These have ranged from programs that bundle assistance and insurance, to price subsidies (food, housing, energy), and labor-intensive public works (Table 3.1). The design of social assistance programs has often been heavily influenced by international assistance. The prevalence of food aid from the United States in the 1950s and 1960s, for example, led to the adoption of many food-for-work programs, particularly in South Asia. The emergence of social funds in the 1980s, especially in Latin America, reflects the shift to nonfood aid and greater cooperation with non governmental organizations and community-based groups in the delivery of targeted assistance. Labor-intensive public works programs have risen in popularity, particularly in South Asia and Africa.

3.81 In many countries, insurance and assistance programs have failed to achieve their objective of protecting the vulnerable. Often, they have resulted instead in transfers of resources to elite groups, sometimes with fiscally destabilizing consequences. New approaches are beginning to emerge for both insurance and assistance—and we examine each in turn.

Social insurance—options and hazards

3.82 Social insurance sometimes has been fiscally destabilizing. As Table 3.2 suggests, in many countries the liabilities to the state if all participants were granted their

Table 3.2 Implicit pension debt in developing countries (1990s)

Country	Implicit pension debt (as a % of GDP)
Uruguay	296
Hungary	213
Brazil	187
Ukraine	141
Turkey	72
China	63
Cameroon	44
Peru	37
Congo	30
Venezuela	30
Senegal	27
Mali	13
Ghana	9
Burkina-Faso	6

Source: Kane and Palacios (1996)
Note: The net present value of pension obligations is calculated using a 4 percent discount rate.

acquired pension rights far exceed fiscal capabilities. In part, demographic changes account for rapid expansions in pension liabilities. More than half of the expansion of pension and other welfare benefits in OECD countries over a thirty-year period can be accounted for by the aging of the population. Along similar lines, Ukraine and Hungary have older populations, which partly accounts for their very high implicit pension debt. The demographic pressures on pension programs are likely to accelerate especially rapidly in some developing countries. China's over-sixty population will double from 9 to 18 percent of the total in thirty years—a transition that took a hundred years in France and Britain.

3.83 But at root the problems go beyond demographics. Brazilian civil servants, for example, view their pensions as an entitlement, rather than a form of savings: they make no contributions to a retirement scheme, but receive a full salary as pension after thirty to thirty-five years of service. More generally, influential constituencies successfully lobby for transfers which they are unwilling to see scaled back even in the face of severe fiscal consequences. Or, as in some Francophone African countries (Box 3.9) public bureaucracies direct towards themselves resources intended for social insurance or for vulnerable groups.

3.84 Whatever the reasons for the current difficulties, unless social insurance can be put on a sounder financial footing, either the programs will collapse, or countries will be plunged into deep fiscal crises, or both. A key first step for reform is for governments to distinguish between between the goals of insurance and those of

assistance—especially in developing countries where the gap often is vast between the poorest citizens (generally the targets of assistance programs) and citizens who participate in the formal economy (generally the targets of insurance programs). Experience suggests that a failure to make this distinction is virtually certain to undermine both the fiscal viability of insurance programs (because the "insured" are able to lobby politically for unfunded benefits) and the poverty alleviation impact of assistance programs (because nontargeted groups are likely to capture resources intended for the poor).

Box 3.9 Social insurance and provident funds in Africa

Whereas Francophone Africa has generally followed the French model of social security, most Anglophone countries have instead set-up provident funds. Both types of schemes typically have a very narrow coverage, mainly the formal sector. And both have been plagued by fiscal imbalances and negative real returns. These are mainly the result of mismanagement, poor economic performance, and generous eligibility conditions.

Following the lead of France, virtually all Francophone developing countries have put in place family allowance programs in their formal sectors—even though the French program was triggered (in 1932) by worries about a slowdown in population growth, while the challenge in today's developing countries is to control rather than encourage population growth. Moreover, social insurance programs are financially shaky in many countries. In Chad arrears are estimated at about one-third of total assets. Congo's social insurance scheme went bankrupt altogether. Until a new management was brought in 1991 the Senegalese social insurance scheme (IPRES) was subject to considerable abuse, mainly from its own staff. Subsidized loans beyond repayment capacity were routinely granted and reached CFA950 million in 1991. These loans could not be recovered because 92 percent had no guarantee and some loan documents had simply disappeared. Bags of cash from contributions were also reported missing.

Provident funds in Anglophone African countries also have been subject to considerable abuse. The Kenyan provident fund ((NSSF) illustrates this situation. Between 1980 and 1995 the fund earned a return of -4 percent in real terms, compared with real returns of 14 percent earned by private pension funds (1991-95). In addition, for every dollar of contributions collected over 20 cents are absorbed by administrative expenses. This reflects questionable investments and related activities documented by various audit reports: purchase of real estate properties at overvalued prices, contract-awards without open tenders, excessive legal fees, subsidized housing and automobile loans to staffs, unreported receivables.

3.85 With insurance clearly distinguished from assistance, there exist a variety of ways to bring private participation and competition into insurance systems previously dominated by public monopolies:

- For pensions, unbundle the redistributive from saving components by creating a mandatory multipillar system, with the saving pillar fully funded, privately managed, and publicly regulated (as in Chile).
- Introduce mandatory savings accounts for unemployment insurance, as well as pensions (Box 3.10 describes a Chilean initiative along these lines).
- Allow companies and individuals to choose between public and private providers, as in Argentina, Japan, and the United Kingdom.

- Contract management of the assets of insurance programs to the private sector, as in Malaysia.

- Bring independent professionals instead of political appointees onto the boards of trustees of public programs.

3.86 To be sure, private pension (and other social insurance) schemes are only workable if financial markets are well-enough developed so that private intermediaries can readily match the (long-term) structure of their liabilities with long-term assets. Even so, the argument that thin capital markets in poor regions such as Sub-Saharan Africa are an impediment to private pension funds weakens under scrutiny. Given an appropriate—and enforceable—legal framework for financial sector development, countries could set up regional equity markets, a particularly attractive option for countries of the CFA zone, which have a common currency. Furthermore, some equity markets in Sub-Saharan Africa compare favorably—in terms of market capitalization—with those in Latin American countries that have recently privatized their pension systems (Peru).

Box 3.10 Chile's' new unemployment insurance scheme

After successfully privatizing its pension system, Chile is set to extend the principle to its unemployment insurance. Chile, which has had a severance pay scheme but no unemployment insurance, has drafted a law for an unemployment insurance scheme (PROTAC) that departs from OECD model countries and tries to circumvent the work disincentives often associated with unemployment insurance. Under the scheme workers who lose their jobs would first get severance pay equivalent to one month of salary per year of service, with a maximum of five years. During the first five months of unemployment, severance pay would be the only benefit. After that workers would draw on individual accounts, to which they and their employers would have jointly contributed 4 percent of the salary. These individual accounts would accumulate up to five months of the worker's salary. The state would step in only after the accounts were exhausted. Essentially, severance pay would become the first deductible paid by the employer; funds accumulated in individual accounts would be the second deductible, financed jointly by employer and employee. The individual accounts would be privately managed by institutions such as those that manage the private pension schemes. The state would regulate these unemployment insurance funds and guarantee a minimum unemployment benefit.

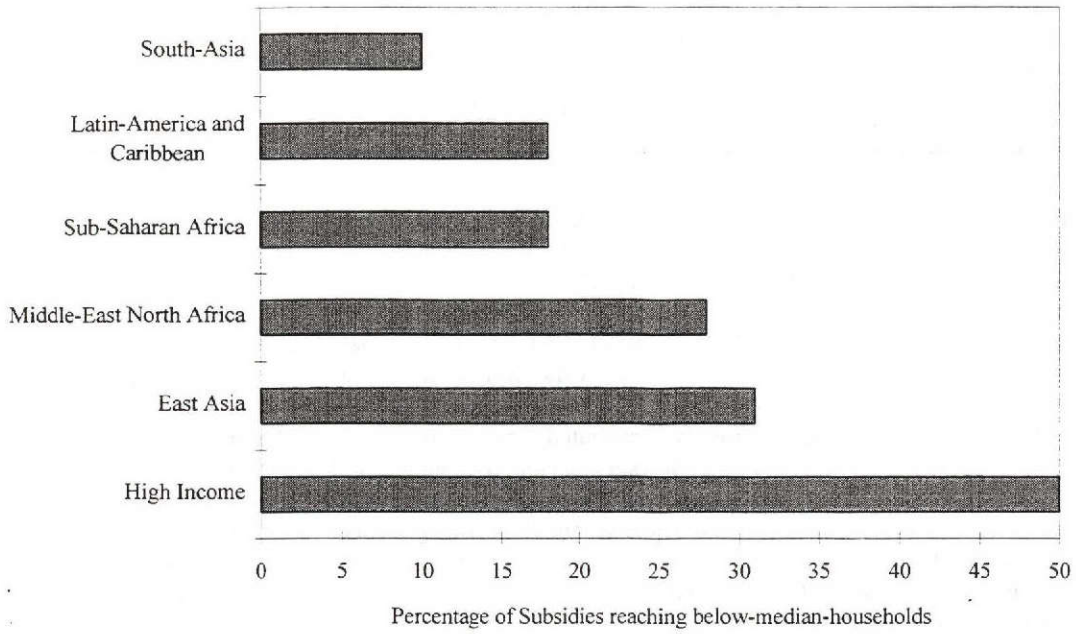
Sustainable approaches to social assistance

3.87 While social insurance can be self-financing, social assistance requires direct expenditures of public funds. Balancing poverty alleviation with fiscal prudence is thus vital. Table 3.1 summarizes the wide variety of approaches which have been tried. In the past, the primary debate was over the relative merits of broad-based subsidies versus means-tested programs. Today, the limitations of both approaches have become more apparent.

3.88 Means-tested programs are administratively-demanding, and hence are only likely to achieve their goal at reasonable cost in countries with strong institutional capability. Meanwhile, broad-based subsidies have lost their appeal on both poverty and fiscal grounds. Housing and infrastructure subsidies turn out to disproportionately benefit higher-income households. (Figure 3.10) Food subsidies can be more effective—if they are effectively targeted towards items consumed primarily by the poor. Tunisia

has effectively moved from a non-targeted to a targeted program by eliminating all subsidies on all goods consumed disproportionately by the nonpoor and, for food products which continued to be subsidized, differentiating product lines through the use of different types of packaging and generic ingredients. The result has been to reduce subsidy costs from 4 percent of GDP in the mid-1980s, to 2 percent by 1993—while still maintaining a food safety net for the poor. Jordan, however, exemplifies a more familiar, and less happy pattern. Prior to recent efforts at reform, not only did its bread subsidies absorb 17 percent of the state budget, up to 40 percent of the subsidies leaked to groups who did not formally qualify for them.

Figure 3.10 Little of housing subsidies reach low-income households



Source: World Bank 1996 Source Book

3.89 In the face of the problems of means-tested or broad-based assistance programs, there is a rise of interest in self-targeted approaches. One approach to self-targeting is to focus the delivery of benefits on urban and rural localities where the poor are disproportionately located. Another approach is to set the level of benefits low, and build in some kind of quid pro quo on the part of the program participants. Food-for-work programs incorporate these features. So, too, do lending programs for microenterprises in poor communities. Box 3.11 illustrates how Indonesia—which has made major strides in reducing poverty through broad-based growth—is initiating a variety of self-targeted programs in an effort to eliminate poverty entirely by the year 2005.

Box 3.11 Reducing poverty in Indonesia—how social assistance complements broad-based growth

Indonesia's rapid and broad-based pattern of growth has had a spectacular effect on poverty reduction. Between 1970 and 1990, the proportion of the population living below the official poverty line declined from 56 to 15 percent, with other indicators of welfare (e.g., infant mortality) also showing a similar improvement. The government of Indonesia has now set itself the ambitious target of eradicating absolute poverty completely within the next decade. This will be a challenging task, since the remaining poor are contained in pockets of poverty that are characterized by isolation, poor natural resource endowments, low population densities, and other socio-economic characteristics that make them difficult to reach.

To reach these groups, several targeted programs of intervention have been initiated in recent years, including:

- the Inpres Desa Tertinggal (IDT) program launched in 1994 and confined to villages that have been "left behind" in the development process. The program gives grants totaling US$200 million per year to selected 20,000 villages, constituting the poorest one-third of all Indonesian villages, to be used as seed capital for income-generating activities. The IDT program is combined with public works programs.
- the new Prosperous Family program launched in 1996 aims to improve the conditions of families living in non-IDT villages and whose living standards are below a certain level by providing them with small grants and subsidized credit;
- the Transmigration Program, under which about 750,000 families or over 3.6 million people, have been resettled at government expense from over-populated Java to the less-populated outer islands. The program aims to address landlessness as a cause of poverty and provides new settlers with agricultural land, along with other benefits; and

the Kampung Improvement Program (KIP), targeted at improving the provision of social services and infrastructure to the urban poor and confined to densely populated, low-income, urban neighborhoods.

3.90 The challenge of sustaining programs of social assistance is political as well as fiscal: since the marginal poor are politically weak almost everywhere, in times of fiscal belt-tightening even prudent programs risk losing political support. Self-targeted programs—especially those which impose some kind of reciprocal obligation on recipients—seem more politically resilient than those that are targeted more narrowly, but they too are vulnerable. At its root, then, the task—explored further in Chapter 7—is to find ways of giving voice to the concerns of the poor, and thereby enabling them to become more effective advocates of their own interests.

Doing better on the fundamentals: some strategic options

3.91 Though each of the four sets of economic and social fundamentals pose distinctive challenges, they have some challenges in common.

3.92 First, prioritization is vital. As this chapter shows, in all too many countries the state still does not provide the full complement of core collective goods and services—a foundation of lawfulness, the rudiments of public health, primary education, transport infrastructure, a minimal safety net. At the same time, it is overproviding a

wide variety of goods and services that private markets could provide. Especially in countries with weak institutional capabilities, there is thus an urgent need to focus the state's role on the fundamentals. In part, the failures of prioritization are political. Yet they also reflect organizational weaknesses in the strategic decisionmaking capability of states. Chapter 5 examines these weaknesses in more detail, and suggests ways in which they might be overcome.

3.93 Second, skillful use of private, competitive markets and voluntary activity can support development while sharply reducing the burden on states with weak institutional capabilities. Market-led growth in a supportive incentive environment is fundamental. Additionally, markets can provide a variety of private goods and services that in many countries have somehow wondered into the domain of public provision—tertiary education, curative health services, pensions and other forms of insurance. And in a range of other areas—using social funds for poverty alleviation, enhancing the quality of primary education, participation by nongovernmental organizations and broader communities can substantially improve service delivery. Countries with weak public institutions should assign high priority to finding ways to use markets and involve private and other nongovernmental providers in service delivery. More broadly, as Part C explores further, encouraging markets and civic activity can also shore up political will and prevent institutional and political backsliding.

3.94 Finally, states should seek ways to enhance the credibility of their actions. In the short run while weak domestic institutions are strengthened, stronger ties with external actors may be used to signal commitment. For monetary policy, regional arrangements (as in Francophone Africa) or stabilization programs (for example, with the International Monetary Fund) can serve this purpose; participation in regional and multilateral trade liberalization arrangements (Mercosur, NAFTA, the Marrakesh round of trade reform under the WTO) can help lock in open goods markets; a commitment to open capital markets is a strong signal of policy intent because of its difficulty to reverse; and multilaterally and bilaterally supported programs of public investment can help maintain the focus of efforts over time. In the long run, though, as Part C explores in depth, the vital challenge is to strengthen commitment mechanisms that are rooted in the domestic structure and operation of the state.

Chapter 4 Fostering Markets: Regulation and Industrial Policy

4.1 This chapter focuses on regulation and industrial policy—areas for which there is much less agreement about what states should do and how they should do it than for the economic and social fundamentals examined in Chapter 3. The chapter will suggest that, for both areas, attention to the relation between a state's role and its institutional capabilities helps reconcile some seemingly clashing prescriptions for state action. In countries where institutional capability remains weak, the scope for flexible initiatives is limited; the focus should be on winning credibility with firms and citizens that states will follow through on their stated commitments and will refrain from arbitrary and capricious action. Many countries with weak institutional capabilities are saddled for historical reasons with governments whose reach is overextended; for them, privatization and market liberalization is a key part of the policy agenda. As institutional capability develops, public organizations and officials will be able to take on more challenging collective initiatives to foster markets and to make increasing use of efficient—but difficult to manage—regulatory tools.

Better regulation

4.2 Regulation, if skillfully designed and implemented, can help societies to influence market outcomes for public purposes. Regulation can protect the environment by helping to reduce the pollution (and other negative externalities) that is a by-product of some private business. It can protect consumers and workers from some of the consequences of information asymmetries. It can foster competition and innovation and prevent the abuse of monopoly power. And, more broadly, it can help win social acceptance of the fairness and legitimacy of market outcomes.

4.3 If badly designed however, regulation can impose large costs on firms and society. As described in chapter 3, bad regulation can undermine property rights and fuel corruption. It can also inhibit market entry, encourage informality and can create whole new industries of its own. In Latin America, Brazil and Peru have well-developed markets for specialist services to navigate the regulatory maze is. Although their regulations seem much more cumbersome on paper than Chile's, the time and cost of formalizing a business are not much higher (Table 4.1). By contrast, in Ecuador and Uruguay, there seemed to be no easy way to avoid spending exorbitant amounts of time and money.

4.4 With economic liberalization many areas of regulation have been recognized as counterproductive and have wisely been abandoned. Yet, in some areas the basic externality and informational rationales for regulation remain. Moreover, the surge of liberalization and privatization has brought new regulatory issues to the fore. Thus—as this section will illustrate with the examples of utility, environmental and

banking regulation—the challenge is not to abandon regulation, but rather to find ways of proceeding which are more skillfully aligned with the diverse realities of state capabilities in different country settings.

Table 4.1 What does it take for firms to formalize in Latin America?

Country	Number of weeks	Cost ($)
Brazil	10	640
Chile	8	739
Ecuador	8-100	8000
Peru	15	975
Uruguay	30	2000

Source: Andrew Stone (1996)

Some new rationales for regulation

4.5 *Finance: from controls to prudential regulation.* There has been a tremendous change in the past decade in how financial sector development is viewed. The depth of a country's financial sector is now recognized as a powerful predictor and driver of development. The control-oriented approaches to financial intermediation adopted by many in the decades following World War II—directing subsidized credit to favored activities, limiting the sectoral and geographic diversification of financial intermediaries—have been identified as powerful inhibitors of financial deepening. The near-universal response has been to move away from controls over the structure of financial markets and their allocation of resources and to embark on a process of liberalization.

4.6 Financial liberalization is not identical to deregulation. On the contrary, the case for continuing regulation remains compelling. Its purpose, though, is no longer to channel credit in preferred directions but rather to safeguard the health of the financial system through prudential mechanisms.

4.7 For three reasons, in the absence of well-functioning prudential regulation it is much more difficult for an outside observer to judge the financial health of banks than of nonfinancial companies. First, outstanding loans are banks' primary assets. So long as banks receive interest on their loans, outside observers are likely to judge their asset portfolio to be healthy—even if (unknown to observers) borrowers lack the resources to repay the principal or (at the extreme) are bankrupt and have taken out new loans to make the interest payments. Second, unlike many nonfinancial companies, banks can be hopelessly insolvent without running into a liquidity crisis. So long as insolvent bankers can disguise their condition to outsiders, they can continue to attract

deposits (and aggressively pursue deposits by offering favorable interest rates). By throwing good deposits after bad, failing banks can engage in ever-more reckless gambles to salvage their position—driving up total losses before the inevitable crash. Third, banks balance sheets can be difficult to interpret—especially in countries where they increasingly are including in their portfolios options, derivatives, and other new types of financial instruments that are very hard to monitor.

4.8 This information asymmetry is destabilizing. Depositors, fearing for the safety of their funds, might rush to withdraw them when there are stories about troubled banks. Bank failures tend to be contagious. When troubled banks go under, nervous depositors can start runs on other banks. As liquidity drains out of the system even solvent banks may be forced to close their doors—with severe macroeconomic consequences if the bank run is systemwide. The combination of information problems and the negative spillover effects and distributional consequences of bank failures creates a rationale for regulation or other public actions of the kind discussed in subsequent sections.

4.9 *Utilities: regulation with competition.* For utilities, too, regulation has taken on renewed prominence—though here as a result of revolutionary technological changes and organizational innovations. In earlier years, the argument for utility regulation seemed straightforward. Utilities were considered natural monopolies. Consequently, unless they were regulated, private utility operators would set prices as monopolists—with harmful consequences for efficiency and income distribution. Today, though, technological and organizational innovations have created new scope for competition.

4.10 In telecommunications, dozens of countries throughout the Americas, Europe, and Asia (plus a few in Africa, including Ghana and South Africa) have introduced competition into long distance, cellular, and value-added (fax, data transmission, videoconferencing) services; a few countries (Chile, El Salvador) are exploring options for competition in local fixed-link networks. Power generation (though not transmission or distribution) is also now viewed as an arena for competition. In China, Indonesia, Malaysia, and the Philippines private investors are making major additions to generation capacity through independent power projects, alleviating acute shortages and enabling private finance to fill the gap resulting from shortfalls in public resources.

4.11 In this new world of utilities, the extent of natural monopoly has been drastically reduced (though perhaps not eliminated entirely). Yet for two reasons regulation remains central. First, regulation can facilitate competition. Consider the problem of interconnection. In competitive telecommunications and power markets, most services are not offered through exclusive, single-supplier networks. Telecommunications signals traverse multiple network segments owned by different operators. By failing for more than a decade to put in place workable rules to facilitate interconnection among networks, Chile's telecommunications regulators seriously

obstructed competition, leaving dominant incumbent firms with the power to control how the system evolved. After numerous court disputes a multicarrier system was introduced in 1994 that allows customers to choose their long distance provider. Within months, six new providers had entered the market and the price of long distance services dropped by half. Problems of interconnection also affect the electricity industry companies where generators supply customers through common-carrier transmission lines. Argentina dealt with these issues by combining aggressive promotion of competition with regulation as needed (Box 4.1).

Box 4.1 Competition plus regulation in Argentinean electricity

Argentina privatized much of its electricity industry in 1992. Its strategy was to promote competition where possible and, where it was not, to protect consumers and market participants from monopoly abuse:

- Power generation, transmission, and distribution were unbundled as entirely distinct markets, and vertical cross-ownership was prohibited.
- Pricing and entry are unregulated for electricity generation; generators are free to sell directly to large power users or to a power pool operator (owned in equal parts by generation, transmission, and distribution firms), which purchases on a spot basis from the lowest price source.
- Transmission continues to be considered a natural monopoly and the exclusive private concessionaire is closely regulated.
- Each of the twenty two distribution companies across Argentina (many of them privatized, including the largest ones) enjoy local natural monopolies and are closely regulated. Direct contracts between generators and large power users provide a competitive benchmark for the prices distributors charge to their customers.

Since the reforms, the number of generators has increased from ten to more than thirty, over 1,000 megawatts of new generating capacity are coming on line, the performance of established companies has improved (one large generator outside Buenos Aires has increased power availability from 30 percent of rated capacity to 75 percent). Early indications suggest that prices are declining for virtually all consumer groups.

4.12 A second reason for continuing regulation is that competition may not be sufficient to shield private investors from the risk of expropriation through creeping administrative decisions. Most utilities' assets are specific and nonredeployable in other uses, implying that utilities will be willing to operate as long as they can recover their working costs (even if they cannot recover their sunk investments). That makes them especially vulnerable to administrative expropriation (for example from regulations that set prices below long-run average costs). Although the prevalence of competing players is likely to reduce political pressure, as long as utility operators are large and their assets are nonredeployable, they remain vulnerable to punitive price and other regulations. Consequently, countries without a track record of respecting property rights may find it difficult to attract private investors into utilities, regardless of any commitment to competition in utility markets. As the next sections show, a well-designed mechanism that commits the regulator to a clearly defined course of action can offer the reassurance which potential investors need.

Where capabilities are strong, regulation can buttress both credibility and efficiency

4.13 We begin this examination of how states can match their regulatory role to their capabilities by laying out some regulatory options for utilities, for the environment and for banking that only work well if institutional capability is strong. As Table 4.2 previews, institution-intensive approaches combine three central elements:

- Using administrative capability to manage complex technical problems
- Delegating substantial flexibility to regulatory agencies to devise and adapt regulations in response to changing circumstances
- Embedding specialized regulatory agencies in an array of checks and balances that help to restrain arbitrariness and win legitimacy for regulatory decisionmaking.

4.14 *Utility price caps.* The example of price caps in utility regulation illustrates both the scope of authority of an independent regulator and the role of institutional checks on arbitrary action. Price-cap regulation gives the utility an incentive to be efficient and can encourage innovation, but it delegates substantial discretionary power to the regulator. In the United Kingdom (which pioneered price-cap regulation) telecommunications and electricity regulators impose an overall ceiling on utility prices, based on the annual rate of price inflation (RPI) minus an adjustment factor (X). The regulators decide on the level of the adjustment factor, and they can change it at will.

Table 4.2 The variety of regulatory experience

	Utility regulation	Environmental regulation	Financial regulation
Institution-intensive options	Price-cap regulation, with the regulator setting the price adjustment factor (X). Regulation by independent commission, with public hearings	Precise rules established by the regulatory agency or legislature (command and control or—preferably—incentive based)	Detailed regulations monitored by competent, impartial supervisory authorities (possibly including some deposit insurance)
Institution-light options	Regulation based on simple rules, embodied in transaction-specific legal agreements (enforceable domestically or through an international mechanism)	Bottom-up regulatory approaches:–public information plus citizen voice–initiatives by local authorities	Incentives structured so that bankers and depositors have a substantial stake in continuing bank solvency

The UK's regulator is constrained by systemic checks and balances: any decisions that the utility opposes must be cleared by both the country's Monopolies and Mergers Commission and the Secretary of State for Trade and Industry.

4.15 These checks on regulatory arbitrariness have proven strong enough to permit experimentation with highly flexible regulatory approaches while still attracting substantial private investment. Gross fixed capital formation in British Telecom, which had been stagnant before privatization in 1984, increased over the next six years at a real annual average rate of 16 percent. By the turn of the decade real annual investment was more than double its level before privatization. If countries with weaker checks and balances sought to adopt this type of regulation, private investors might reasonably expect the X factor to increase dramatically at the first renewal of the pricecap. Consequently, investors either would not invest or they would demand very high rates of return that ensured a quick payback.

4.16 *Banking supervision.* The financial sector provides an example of institution-intensive regulation. Though new ideas are emerging (and will be discussed in the next section) as to how to maintain bank solvency in the face of supervisory shortcomings, in many countries supervision remains a vital bulwark The idea behind bank supervision is that well-designed regulations, monitored and enforced by competent, impartial supervisory authorities, can help to overcome the problems of information asymmetry in the banking business and detect—and contain the impact of—potentially ruinous banking crises (Box 4.2). Key elements of such regulatory systems include:

- *Capital adequacy and entry criteria.* Minimum capital requirements impose discipline on banks by ensuring that owners have something to lose in the event of a bank failure. The minimum standard as recommended by the Basle Committee for industrial countries, is capital equivalent to at least 8 percent of risk weighted assets. When deciding whether to grant a license, supervisory authorities must also consider the qualifications and history of the proposed owners and managers.

- *Restraints on insider lending.* These restraints can inhibit fraudulent loans. Relatedly, limits on a bank's exposure (a common norm is to limit outstanding loans to a single client to 15-25 percent of capital) can guard against a circumstance in which a single client becomes too big to fail, inducing the bank to make unsound loans to keep the client afloat.

- *Rules governing asset classification.* Requiring banks to classify the quality and risks of their loan portfolio according to specific criteria and to define and identify nonperforming loans can provide early warning signals of potential problems.

- *Audit requirements.* Requiring banks to meet minimum auditing standards and disclosure requirements can provide reliable and timely information to bank depositors, investors, and creditors.

4.17 The administrative and political prerequisites of a robust system of prudential regulation and supervision are substantial. A first requirement is to have reasonably reliable accounting and auditing information on the financial health of a bank's borrowers. A second requirement is for a sufficient number of supervisors, of sufficient skill. A third requirement is that supervisors be free of political influence.

Box 4.2 How government supervision averted financial disaster in Malaysia

In 1985, a sudden fall in world commodity prices reversed Malaysia's decade long boom. The Malaysian stock price index, which had surged from 100 in 1977 to 427 in early 1984 fell to below 200 by early 1986; the value of prime commercial property in Kuala Lumpur fell from M$450 per square foot in 1983 to M$180 per square foot by 1986. Banks (which had moved heavily into real estate lending in the boom years) faced the specter of rising nonperforming loans and doubtful debts.

Because Malaysia had maintained a fairly high degree of supervision over the banking system, provisioning for nonperforming loans rose rapidly—from 3.5 percent of total lending in 1984 to 14.5 percent by 1988. Even so, supervisory inspections in 1985 identified three commercial banks whose solvency was threatened by problem portfolios (but whose management was reluctant to acknowledge the full scope of the problem). Additionally, twenty-four non-bank deposit-taking cooperatives—with over 522,000 depositors and about $1.5 billion in assets, but subject to much less supervision than the commercial banks—were in severe distress.

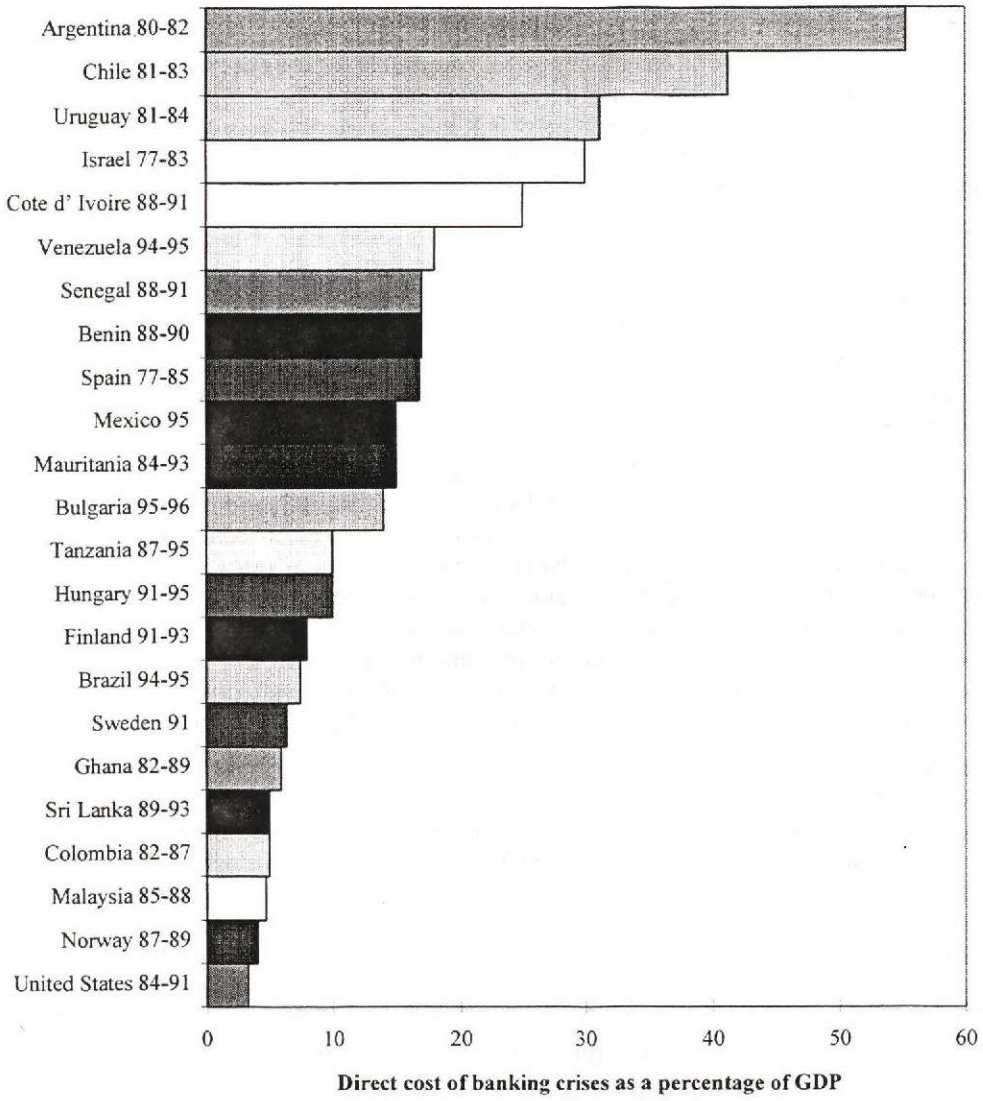
Bank supervisors in Bank Negara, Malaysia's central bank, devised rescue packages for the three ailing commercial banks and the twenty-four non-bank deposit taking institutions. To meet the M$1.2 billion losses of the commercial banks, Bank Negara injected close to M$700 million in new equity, shareholders provided M$160 million, and the balance was in the form of subordinated loans. To meet the almost M$700 million in losses of the deposit-taking corporations, the Action Committee on Cooperatives (chaired by Bank Negara) devised a complex package that included the conversion of a substantial portion of Cooperatives' deposits into equity, the takeover of some small cooperatives by larger financial institutions, the merger of others, and the provision of M$720 million in soft loans by Bank Negara. Total losses as a result of the banking crisis amounted to 4.7 percent of Malaysia's 1986 GNP.

Malaysia's experience underscores the value of well-functioning supervision. First, total losses in the tightly supervised banking sector amounted to 2.4 percent of total deposits—far less than the losses equivalent to 40 percent of deposits in the lightly supervised non-bank deposit-taking sector. Second, macroeconomic disaster was averted. The economy recovered in 1987, and stock and property prices and bank balance sheets recovered with it. Prompt action had made it possible to identify and address problems early, at a time when disciplined rescue was still affordable. Taken together, the skillful rescue package and economic recovery enabled the *Asian Wall Street Journal* to report in 1989 that the "Malaysian banking sector has regained health, and concern that the system would collapse has faded."

4.18 Many countries have relied exclusively on prudential regulation and supervision to undergird their banking sectors, without having these prerequisites in place. The consequences often have been disastrous. A recent World Bank study identified over one hundred major episodes of bank insolvency in ninety developing and transition economies from the late 1970s to 1994. In twenty-three of the thirty countries for which data were available, the direct losses sustained by governments as a result of these episodes exceeded 3 percent of GDP (Figure 4.1). In absolute terms losses were largest in industrial countries—official estimates put nonperforming loans in Japan in 1995 at about $400 billion; the cost of cleaning up the 1980s U.S. savings and loans debacle came to $180 billion. In relative terms the largest losses were in Latin America—Argentina's losses in the early 1980s amounted to more than 50 percent of its

GDP, and Chile's exceeded 40 percent. Subsequent sections examine some options for reducing the risks of bank failure which are not as dependent on supervision.

Figure 4.1 Banking crises are both common and costly to governments



Source: Caprio (1996)

4.19 *The environment: balancing science, economics, and citizen pressure.* Environmental regulation poses especially formidable challenges, both technical and political, even to countries with strong institutional capabilities. While the consequences of noxious fumes, poisoned water, and earsplitting noise are immediate and unmistakable, the costs of many forms of environmental damage are diffuse and may be invisible even to people adjacent to the pollution source who may suffer especially harmful consequences over time. Moreover, pollution emissions can be hard to measure,

and their environmental consequences can vary with the human settlement and ecological characteristics of a region.

4.20 A further complication is that the political incentives of key community, private sector, and political stakeholders can foster ambiguity and negotiated outcomes rather than predictable and consistent implementation. Poor communities daily confront the bleak need to balance immediate survival against the long-term environmental consequences of their actions. Private firms weigh the predictable but often quite costly certainty of well-defined environmental regulations against the prospect of keeping costs down by avoiding regulation altogether. Consequently, politicians may often conclude that environmental inaction (perhaps veiled behind the appearance of activism) is the politically expedient course. In such a climate a purely technocratic approach to environmental regulation has little hope of success (Box 4.3).

Box 4.3: "Top-down" regulation can often be ineffective

Many developing countries responded to the surge of interest in environmental issues by establishing new regulatory agencies, only to learn about the limitations of "top-down" approaches. Poland's regulatory agency, though technically competent, found its leverage in negotiations with plant managers limited in communities which were dependent on a few large enterprises which funded many community services. Chile's highly regarded environmental agency has (after four years of trying) so far been unable to implement a tradeable permit system for industrial emissions because of the difficulties of establishing baseline emissions, and measuring ongoing emissions. Prior to recent reforms described later, scarcities of skills in both the public and private sectors hindered implementation of Indonesia's systems of environmental management.

The dynamics of enforcement of environmental regulation—and the potential gains of shifting gears to "bottom-up" approaches—are well illustrated by the experience in Rio de Janeiro, Brazil. Once highly regarded, the Brazilian state of Rio de Janeiro's environmental agency, FEEMA, has become progressively bogged down administratively and politically. Repeated efforts have been made to transform the agency from a slow-moving issuer of licenses to one that more proactively pursues sound environmental management. However, these efforts have made little headway in the face of very tight fiscal constraints throughout the state, and urgent (and expensive) competing claims on public resources for security, health, and education programs:

- By 1996 the average real salaries of FEEMA's 1,000 employees had fallen to one-third of what they were in the 1970s and 1980s. The best people had left, it was impossible to hire competent new staff, and staff morale was low. Yet tight overall budget constraints meant that no additional salary resources were available.
- FEEMA was unable to enforce environmental regulations against the opposition of private industry. Industrial discharge tariffs were promulgated in 1986, but without a credible enforcement mechanism. Five years after the tariffs were set, a proposal for a noncompliance fee reached the legislature; after five more years in committee it has not yet been voted on by the legislature.

By mid-1997, environmental reformers in and outside state government had concluded that top-down initiatives to environmental regulation were unlikely to yield sustained results. Instead, they turned their attention to participative mechanisms (for example, the creation of the Rio Paraiba do Sul water basin management committee, which includes regulators, water users and polluters) which involve citizens more directly in the formulation and implementation of environmental policy.

4.21 A central challenge for environmental regulators has thus been to find ways of harmonizing technical excellence with the political legitimacy and policy credibility that comes from participation. In industrialized countries, strong institutions have been key to striking this balance—though the specific mechanisms have varied from country to country. In France, Germany, and the United Kingdom, elected legislators delegate the task of spelling out the details of policy to environmental authorities—which (though not formally required to do so) routinely consult with affected parties and respond to direct political pressure. Under the U.S. Administrative Procedures Act rules promulgated by executive agencies (such as the Environmental Protection Agency) are legally binding only if public notice of the rules is given in advance, all interested parties have an opportunity to comment (typically through public hearings), and a "reasoned opinion" accompanies agency decisions. The Dutch government provides more than half the funding of thirty to forty environmental NGOs and routinely consults with them and other affected parties when preparing environmental legislation.

4.22 Viewed through the narrow lens of economic efficiency, even these mechanisms have produced imperfect outcomes. Consider the examples of Germany and the United States, two leaders in environmental policy since the late 1960s. Both have been strikingly successful in reducing emissions of some major pollutants. Yet, in part because of the need to be seen as responsive to citizen concerns, both countries continue to rely overwhelmingly on command and control approaches to environmental regulation, even where market- and incentive-based regulation can achieve similar gains at substantially lower cost.

The regulatory "fit" when institutions are weak

4.23 In countries where institutions are weaker—administrative capability is more limited, and mechanisms do not yet exist to effectively balance flexibility and restraint—the risk is high that institution-intensive regulatory approaches could degenerate into arbitrary, unpredictable, and inconsistent action by regulators. For utilities, countries with weak institutions face the difficult challenge of credibly signaling to potential private investors that they will refrain from arbitrary action and administrative expropriation. In financial and environmental regulation the challenge is to restrain socially costly opportunistic behavior—banking fraud or pollution—by private players in settings where the authority of regulatory agencies cannot be relied on. Table 4.2 summarizes some of the options available to countries with weak institutions. Each of these is examined in turn.

4.24 *Commitment mechanisms help attract private utility investors.* The Jamaican telecommunications industry illustrates vividly the impact on private investment of the interplay between institutional capabilities and regulatory roles. Jamaica, because of its institutional structures, has been able to put in place regulatory commitment mechanisms capable of attracting sustained private investment, but only at the cost of limiting flexibility. Since independence the country's telecommunications industry has been on a regulatory roller-coaster, thriving when the country was willing to

forego flexibility, but lagging when the country tilted its system in favor of flexibility at the expense of commitment (Box 4.4).

Box 4.4 Telecommunications regulation in Jamaica

During much of the colonial period and in the years immediately following independence, the terms under which Jamaica's largest telecommunications utility operated were specified in a legally binding, precisely specified forty-year license contract. Then as now the ultimate court of appeal for Jamaica's independent judiciary was the Privy Council in the United Kingdom. This system was adequate to ensure steady growth of telecommunications services, and the number of subscribers trebled between 1950 and 1962. Yet newly independent Jamaica chafed under the apparent restrictiveness of a concession arrangement that afforded virtually no opportunity for democratic participation. Consequently, in 1966 the country established the Jamaica Public Utility Commission. Modeled on the U.S. system, the utility commission held regular public hearings and was afforded broad scope to base its regulatory decisions on inputs from a wide variety of stakeholders.

However, Jamaica lacked the other institutions needed to make a regulatory system based on a utility commission workable. In the U.S. there is a variety of constraints on regulatory discretion (including well-developed rules of administrative process and constitutional protections on property). Jamaica had virtually no checks and balances on commission decisions. The result was that price controls became progressively more punitive—to the point that in 1975 Jamaica's largest private telecommunications operator was relieved to sell its assets to the government. In 1987, after a decade of underinvestment, Jamaica reprivatized its telecommunications utility, this time using a precisely specified legally binding license contract, similar to those used prior to 1965. In the three subsequent years, average annual investment was more than three times what it had been over the previous fifteen years.

Private investment came at a cost, however. To maintain long-standing—and politically difficult to eliminate—cross subsidies between local and long-distance services, upon privatization Jamaica awarded a single telecommunications provider a twenty-five year concession to operate the entire system. Revenues from the (highly profitable) long distance network were used to extend the (unprofitable) local fixed-link network. There is continuing debate on whether even within the confines of its political constraints, Jamaica could have retained room for competition in some value added services, thereby preserving at least a modicum of pressure for innovation and productivity improvements in an era of rapid global technological change in telecommunications.

4.25 Unlike Jamaica, until recently the Philippines has been unable to put in a regulatory commitment mechanism capable of convincing private investors that the rules of the game would endure beyond the term of the president in office. Consequently, from the late 1950s until the early 1990s the country's private telecommunications utility was on a political investment cycle. Investment was high immediately following the inauguration of a government aligned with the group controlling the utility, but tailed off in the later years of the regime and stagnated in periods when relations with the group in power were more distant.

4.26 In electric power utilities, the Philippines resolved the problem of commitment by agreeing on very rigid legal agreements with private investors, sometimes enforceable offshore. Their contracts with independent power providers had some highly restrictive take-or-pay provisions that locked the countries into paying prespecified prices and procuring fixed quantities of power, regardless of aggregate demand or the price at which power was available from other sources. Another option is to use third-party guarantees—such as those offered by the World Bank Group—to

protect private investors and lenders against noncommercial risks, including the risk of administrative expropriation.

4.27 *Fostering incentives for prudent banking.* If aligned to be compatible with prudent banking, the incentives and interests of bank owners, managers, and depositors can be a vital complement to bank supervision. Historically the arena of banking has given rise to some unusually sophisticated self-enforcing arrangements for winning credibility, as Box 4.5 illustrates for Scotland. More recently, the World Bank and the European Bank for Reconstruction and Development collaborated on a project in Russia to onlend funds through participating banks, which voluntarily agreed to submit to annual audits by international accounting firms and to adhere to prudential norms.

Box 4.5 Free banking in Scotland

Between the early eighteenth and mid-nineteenth centuries, per capita income in Scotland rose from well under half that in England to approximate equality. This strong performance took place in an era of substantial uncertainty about the content and enforceability of the rules governing the financial system. Indeed, the financial system—including the issuance of bank notes—was virtually unregulated. The only effective restraint was the imposition of unlimited liability for losses on all but the three biggest banks.

Banks issued their own bank notes (redeemable for gold specie), which served as Scotland's currency. Intensive competition restrained imprudent practices. To win market share, banks commonly pointed out the hazards of their competitors, financial practices. Sometimes they tested their rivals' liquidity by collecting their banknotes and demanding immediate redemption; this threat ensured that all banks maintained reasonable reserves to back their loans.

In time, the Scottish banks devised a note exchange and clearing system through which they accepted and redeemed their rivals' bank notes. Since banks would only accept the notes of banks with the specie to back up their obligations, inclusion in the exchange and clearing system (which was entirely at the discretion of existing participants) served as a signal to depositors of a bank's soundness.

During the 150 years in which Scotland's system of "free banking" was in place, just one major bank (not one of the three largest) collapsed. As of 1845 (the year Scotland's system was formally brought under the control of the Bank of England), Scotland had twice the number of bank offices—and twice the value of banking assets— per 10,000 inhabitants as did its English neighbor, despite starting from a much lower point.

4.28 Using regulation to increase what bankers have at stake is another way to protect the health of the banking system. This approach is light in its supervisory requirements, though it implies more supervision than laissez-faire options. The following three regulatory tools can be used to raise the costs of bank failures to bankers:

- Regulators can impose strict capital requirements on banks—not the modest 8 percent of the Bank Convention but 20 percent of deposits or even higher.

- Regulators can restrict entry into banking, partly as a by-product of strict capital requirements, and partly as an intentional way of increasing the franchise value of a banking license for incumbents and thereby increasing their incentive to stay in business.

- Regulators can impose financial restraint by setting ceilings on the interest rates payable to depositors. While similar in impact in some ways to direct restrictions on entry, financial restraint results in rent opportunities that create powerful incentives for banks to extend their branch networks, which can boost overall savings deposits and accelerate financial deepening.

4.29 Another option that builds on incentives for prudence is to impose punitive contingent liability on bank owners, directors, and managers in the event of bank failure. Prior to the mid-1930s, U.S. authorities routinely imposed double liabilities on bank shareholders. Perhaps in part as a consequence, there were close to 4,500 voluntary bank closures between 1863 and 1928 but only 650 bank liquidations. And today, New Zealand imposes very stringent requirements on banks for transparent reporting, coupled with stringent sanctions on bank managers who violate them.

4.30 *Community pressure helps protect the environment.* For environmental regulation, meeting the challenge of sharing the monitoring and enforcing function is similarly crucial, though here the relevant counterpart is civil society more broadly. In settings where regulatory agencies are weak, community pressures can provide a powerful springboard for progressively strengthening of the credibility and efficacy of environmental regulation.

4.31 Two recent experiments in Indonesia illustrate how transparent, information-intensive initiatives may help moderate industrial pollution even when there are no enforceable formal rules:

- Compliance with the country's Clean River program, launched in 1989, is largely voluntary. Even so, by 1994 the total discharges of the one hundred participating plants had fallen by more than a third. Though most of the gains came from a small number of plants, participants had reduced their pollution intensity.

- The Program for Pollution Control, Evaluation, and Rating, announced in mid-1995, rates factories on a five-grade scale according to their environmental performance and makes the results public. In the pilot phase, 187 factories were rated. Within months 10 of the 121 factories that rated poorly had significantly improved their performance.

In both programs, the key to success was the reputation effect of making public to business peers, communities, and consumers the extent to which individual firms were good environmental citizens. Chapter 7 explores more broadly the ways in which information and voice can be used to further social goals.

4.32 Environmental programs built entirely around public information have obvious limits. Nearly half the firms participating in the Clean Rivers program did not reduce the intensity of their polluting activities. While information-driven programs help

signal where the most severe problems are to be found, it often will be necessary to introduce additional measures to induce heavily-polluting firms to clean up. Clearly, as countries develop, they will need to move toward more institutionalized approaches that integrate community pressures with more formalized mechanisms for enforcing compliance

4.33 In a pattern seen throughout the world, initiatives from the bottom up can set the stage for action at the national level. In the two decades after World War II Japan rushed headlong into industrialization, with little initial concern for the environmental impact. At a national level this period of neglect ended in 1967 with the landmark Basic Law for Environmental Pollution Control. But well before then grass-roots initiatives in many localities had set in motion sustained environmental reform (Box 4.6).

Box 4.6 Environmental activism in Yokohama City

In 1960 local medical associations began to petition against oil refinery emissions and the health damages they caused. Shortly thereafter, the municipal government, which had been foot-dragging on environmental issues, was ousted in elections by a reformist mayor who pledged to implement pollution prevention policies. A flurry of activity followed, punctuated by the establishment of a new unit within city government (the Bureau of Pollution Control, which by the end of 1964 had a staff of ten people), a residents organization (the Council on Conservation of Environmental Sanitation), and a joint community, academic, and business expert advisory group (the Council on Environmental Pollution Control Measures).

Although the city had no legal authority to impose controls on pollution, by December 1964 it entered into a formal voluntary agreement with a new coal-fired power plant to drastically reduce emissions. This agreement offered a precedent for a subsequent voluntary agreements with other new and existing large factories, which reduced emissions to just 20 percent of their earlier projected levels. Over the next two decades Yokohama City progressively increased the stringency of these voluntary agreements—and consistently maintained higher environmental control standards than did Japan's national government (which itself was continually raising its standards for environmental control).

Clarifying regulatory options

4.34 The reality of imperfect markets brings regulation onto the development policy agenda. The reality of imperfect government cautions against hasty enactment of institution-intensive regulatory systems in settings where institutional capabilities are weak. The key to success is to focus the regulatory agenda and the regulatory tools to fit a country's institutional capabilities. Three questions can help guide countries in the search for better regulation:

4.35 Are formal rules necessary to correct the market imperfections? The mixed record of regulation suggests that the use of formal rules to regulate markets is better viewed as a complement to other measures (or even as a last resort) than as an automatic response to problems. Moreover, country experiences with utility, environmental, and financial regulation show how competition, voice, and self-regulation can workably achieve social objectives that were once thought to require rule-based solutions.

4.36 Does a country have the institutional and political underpinnings necessary for formal rules to serve as a basis for credible commitments in the relevant regulatory domain? On the political front, the relevant question is whether countries have the political will to follow through on what they enact formally. On the institutional front, a key issue is whether a country has an independent judiciary, with a reputation for impartiality, whose decisions are enforced. If not, other commitment mechanisms (sometimes extraterritorial) may be needed. A second key institutional issue concerns ways to ensure that formal rules, once enacted, cannot be amended too readily. In countries where political coalitions capable of amending rules are difficult to stitch together, legislation may suffice; in other countries it may be desirable to embed formal rules in binding legal agreements with individual firms.

4.37 If formal rules are called for, which rules are both workably efficient and (for a given country) fit well with the country's background institutions? In an ideal world flexible rules are preferable to rigid ones. However, in countries that lack appropriate checks and balances flexibility can degenerate into arbitrary and unpredictable enforcement. What superficially appears less than efficient, may thus be the best a country can do in its specific circumstances.

Can state activism enhance market development?

4.38 In cases where externalities, a lack of competition, and other market imperfections drive a wedge between private and social goals, there is general acceptance at least in principle that states can enhance welfare by regulating markets. There is much more controversy about whether states should also try to accelerate market development through an activist industrial policy. The theoretical case for industrial policy rests on the proposition that the information and coordination problems highlighted earlier can be especially pervasive in developing and transition economies—and can go beyond those addressed by well-functioning institutions to protect property rights. The main problem is that in severely underdeveloped markets, the small number of participants makes the costs of learning especially high. Consequently, information that is freely available in industrialize countries can become a source of power that is tightly held. Coordination becomes especially difficult.

4.39 When that is the case governments can, in theory, act as brokers of information and facilitators of mutual learning and collaboration, and thereby play a market-enhancing role in support of industrial development. In practice, the extent to governments can play this role depends on their institutional capabilities. Most proponents recognize that activist government measures can enhance markets only if three key background conditions are in place.

4.40 First, substantial institutional capability is needed in one or more of the following areas:

- Governments will need enough administrative capacity to persuade firms of the merits of probing for possible gains from learning and coordination, and to follow through on implementation.

- Commitments made by private participants in collaborative endeavors will also need to be credible, else individual firms, wary of bearing the costs of nonperformance by others, will fail to follow through on their side of the bargain, and the entire initiative will unravel.

- Within the confines of mutually agreed objectives and standards of compliance, implementation will need to be capable of adapting as circumstances evolve. Ordinarily, this will require a commitment by government to implement policy jointly with the private sector.

4.41 Second, initiatives to promote industrial development must be kept honest through competitive market pressures. These pressures can take the form of competition among domestic firms, competition from imports, or competition in export markets. Unless firms are systematically challenged by one or more of these forms of competition, they will have little incentive to use resources efficiently or to innovate, productivity will not improve, and industrial expansion will not be sustained.

4.42 Third, a country's strategies for industrial development should be guided by its evolving comparative advantage—by its relative abundance of natural resources, unskilled labor, skilled labor, and capital for investment. Some proponents of activist measures might support efforts to nurture a country's dynamic comparative advantage by encouraging firms to take risks beyond the margin of where they might spontaneously be willing to invest on the basis of static comparative advantage. But very few would support attempts at leapfrogging, say, by low income countries subsidizing investments in technology-intensive activities. And there is broad agreement that high levels of protection to promote infant industries without countervailing pressures to perform are deadly for sustainable industrial development.

Industrial policy in practice

4.43 Though there are many approaches to an activist industrial policy, they can be organized into three groups—investment coordination, network-thickening, and picking winners. In the last of these approaches, governments aim to supersede markets; in the first two the aim of government is to enhance market signals and private activity—although the institutional demands of investment coordination are much greater than those of network-thickening initiatives.

4.44 *Investment coordination initiatives.* In the classic big-push rationale for government activism, substantial benefits are posited from coordinating investments that are mutually beneficial to firms but that are unlikely to be undertaken singly. Postwar Japan's development of steel, coal, machinery, and shipbuilding industries illustrates this

rationale for intervention, as well as the stringent institutional requisites for success (Box 4.7).

- A domestic private sector capable of efficiently managing complex, large-scale projects.
- A private sector willing to cooperate with government in pursuit of the shared goal of competitive industrial development.
- Strong technical capabilities in public agencies for evaluating private analyses of investment options and, on occasion, generating independent industrial analyses.
- Sufficient mutual credibility to enable each party to base its investment decisions on others' commitments and to adapt its actions in response to changing circumstances without undermining the overall commitment to collaborate.

Box 4.7 Japan's post-war big push in metal industries

A coordinated restructuring of the machinery, steel, shipping, and coal industries made a major contribution to Japan's economic recovery after World War II. Machinery companies identified the high cost of steel as a major impediment to penetrating export markets. Steel companies identified the high cost of coal as a major reason for high steel prices. High coal prices were a consequence of continued mining from expensive Japanese mines and the high costs of shipping imported coal to Japan.

Building on institutional arrangements nurtured during wartime, Japan's Ministry of International Trade and Industry (MITI) put in place in 1949 a joint public-private deliberative structure, the Council for Industrial Rationalization. Composed of representatives of industrial associations, leading enterprises from each industry, and public officials, the council included twenty-nine sectoral branches and two central branches. Three branches of the council—iron and steel, coal, and coordination—worked closely together and agreed on the following commitments:

- The steel and coordination branches identified the price of coal that would make it possible to produce export competitive steel.
- The coal industry committed to invest Y40 billion to rationalize production from domestic mines, as long as steel firms agreed to purchase coal from them afterwards at the new prices—18 percent below prevailing levels.
- The steel and coal industries agreed on an overall target purchase price for coal by steel firms—achievable by mixing domestic purchases and imports.
- The steel industry committed to invest Y42 billion to upgrade its facilities. With this investment, and lower coal prices, it would be able to sell steel at export competitive prices.
- In return for commitments of lower steel prices, the machinery and shipbuilding industries were in a position to embark on major, export-oriented investment programs. These commitments provided the domestic market underpinning the steel industry needed to embark on its investment program, and confidence that the shipping costs of imported coal would decline.

Once the Japan Development Bank (after careful technical analysis, and in consultation with both MITI and the Bank of Japan) agreed to participate in these projects (at only moderately subsidized interest rates), Japan's main bank system took the lead in mobilizing the investment funds.

4.45 Pursuing this style of investment coordination presupposes levels of public and private institutional capability that are beyond the reach of most developing

countries. Philippine experience in the 1970s and 1980s shows what can happen when large ambitions are not matched by institutional strengths, and industrial policies are pursued in settings where government is swayed by powerful private interests.

4.46 During the 1970s Philippine industrial policy had become increasingly interventionist, with growing recourse to protective barriers and targeted incentives. Though growth was initially rapid, it began to slow by the end of the decade, as the country's industrial structure became increasingly capital intensive and created few jobs. Total factor productivity was declining.

4.47 Driven in part by the desire to create new business opportunities for domestic private allies, the Philippine government announced in late 1979 a new $5 billion program of "major industrial projects"—all in capital-intensive, heavy industries. Under pressure from critics, the government agreed within a year of the announcement to subject the projects to another round of economic and financial scrutiny. Soon thereafter, the political and financial turmoil surrounding the fall of the regime of President Marcos intervened. By late 1987 five of the eleven initial projects, accounting for almost $4 billion of the initial $5 billion, had been shelved as infeasible. A sixth project was initiated, but abandoned as its lack of economic potential became apparent. A fertilizer plant, completed at a cost of $550 million, was making losses that were being shouldered by government. Only four projects, accounting for just $800 million, were operating profitably.

4.48 *Network-thickening initiatives.* Activist initiatives need not be large scale—with commensurably large demands on the institutional capabilities of the public and private sectors, and with large risks—or directed only to increasing investment. They can also aim to strengthen the private-to-private networks that flourish in mature market systems. Domestic, regional, and international networks create numerous sources of learning and opportunity for firms: specialized buyers open up new market niches and offer information on product standards, equipment providers transfer technological know-how, input suppliers help with product and process innovations, and competitors are a rich source of new ideas. Often, clusters of firms, buyers, equipment suppliers, input and service providers, industry associations, design centers, and other specialized cooperative organizations come together in the same geographic region.

4.49 Countries whose markets are underdeveloped may need some catalyst (public or private) to set in motion this cumulative process of market thickening and network development. A variety of approaches has been used.

4.50 Support for exports has been one (although World Trade Organization rules limit its relevance today). Participation in export markets brings firms into contact with international best practice and is a source of competitive pressure; it fosters learning and productivity growth. Export performance can also be invaluable as a simple indicator of the effectiveness (or otherwise) of promotional initiatives by governments. Many countries directed credit in favor of exporters and set up export promotion organizations.

With few exceptions (mostly in East Asia), the promotion organizations became expensive white elephants. Other export support measures also were tried, with mixed results.

4.51 A second approach, which can require substantial resources, aims to strengthen local infrastructure (physical, human, and institutional). The history of the Republic of Korea's once-lagging Cholla region illustrates the impact local infrastructure can have. The Cholla region had been bypassed by central government in the initial stages of Korea's surge of industrial growth. In 1978, Cholla accounted for less than 9 percent of the country's land area allocated for industrial use. In the mid-1970s the government and the World Bank began to work on a series of infrastructure projects in the region. In 1983 the region opened its first large-scale industrial estate. The success of this first estate set in motion a cumulative process of learning by local authorities about how to plan, finance, build, and operate large-scale industrial estates (three more followed). It also began a transformation of the business environment from one bogged down by red tape and other bureaucratic obstacles to one of close cooperation and coordination between the local government and the private sector. By 1991 Cholla accounted for 15 percent of industrial land in Korea, and the region's manufacturing output was growing at the rate higher than that of the country as a whole.

4.52 As more was learned about how relations among firms affect market operations, a third approach to fostering such relations came to the fore, based on public-private partnerships. Public partners are generally drawn from local or regional governments. Some successful examples of this approach:

- *Matching grants to individual firms, typically on a 50:50 cost-sharing basis, to support efforts to penetrate new markets and upgrade technologies*. India introduced a matching grant scheme as part of its effort to spur firms to enter export markets. The scheme encouraged companies to focus on improving production efficiency and better meeting the needs of overseas clients, rather than simply trying to export whatever they were producing for the local market. Easy to implement, with management delegated to private contractors, and demand-driven (participating firms must themselves foot half the bill of a supported initiative) matching grant programs are under way in countries as diverse as Argentina, Jamaica, Mauritius, Uganda, and Zimbabwe.

- *Initiatives directed to groups of firms*. Sometimes these can be highly focused events, such as joint participation of a group of firms in a trade fair. Sometimes, as in Denmark's ambitious network initiative, the goal can be more broadly to transform business culture toward support for increased cooperation among firms. Over the five-year life of the program 5,000 firms became involved in forming networks; three years into the program, 75 percent of participating enterprises reported

that networking was improving their ability to compete, and 90 percent expected to continue of networking even after subsidy support ended.

- *Use of public procurement to foster competitive private sector development.* In the state of Ceara, Brazil, an innovative cost- and quality-driven procurement program worked through associations of small producers to transform the economy of the town of Sao Joao do Arauru. Before the program the town had four sawmills with twelve employees. Five years later, there were forty-two sawmills and about three hundred and fifty workers; nearly 1,000 of the town's 9,000 inhabitants were directly or indirectly employed in the woodworking industry; 70 percent of output was going to the private sector.

4.53 *Superseding markets.* Sometimes information and coordination problems are so severe—markets so underdeveloped, and private agents so lacking in resources and experience—that market-enhancing initiatives are unlikely to yield any response. As a way of kick-starting industrial growth, states have been tempted to supersede market judgments, replacing them with information and judgments generated in the public sector. These efforts rarely work, though the success of some ventures by Korea's *chaebol* made at the initiative of government suggests that the quest to pick winners is not inevitably a fool's errand.

4.54 What distinguished Korea's success from others' failures was that these initiatives were channeled through the private sector, whereas most such efforts (including some in Korea) have been implemented by state-owned firms. When state firms are used as implementing agencies, the opportunities for venality—or fanciful romanticism—are virtually limitless. So, though there are some instances of success, it is hardly surprising that the landscape is littered with failed attempts to use state firms to pick "winners." To cite just two of many notorious examples:

- Zambia's state fertilizer and automobile assembly plants were built in the 1980s with bilateral support from Japan and Italy, over strenuous opposition of local and international advisers. The fertilizer plant never operated at more than 20 percent of rated capacity, and the automobile plant never assembled more than 100 vehicles a year. After close to a decade of losing money, both operations were liquidated in the early 1990s.

- In the late 1960s Indian authorities entrusted the task of expanding domestic fertilizer production to a state firm, which placed heavy emphasis on the development of indigenous technology. All eight plants in which the state firm played a major role in design and construction experienced delays in completion. Their rates of capacity utilization hovered around 50 percent—almost 30 percent below equivalent rates for plants built with private participation. Taken

together, the delays and reduced capacity utilization reduced the present value of these fertilizer investments by upward of $150 million per plant!

4.55 More broadly, a number of countries have subsidized loss making state enterprises to the severe detriment of fiscal performance. The generally sorry experience with investment in state enterprises has convincingly demonstrated that the production of tradable products is best left exclusively to private firms.

Walking the industrial policy tightrope

4.56 The experiences reviewed above highlight why the debate over industrial policy has been unusually heated: industrial policy is combustible. Economic theory and evidence suggest that there are no grounds for dismissing out of hand the possibility that activist industrial policy could yield substantial gains if implemented properly. Institutional theory and evidence suggest, however, that implemented badly, activist industrial policy can be a recipe for disaster. How, then, might countries proceed?

4.57 Taken together, the economic and institutional perspectives suggest that a key distinction is between initiatives that require only a light touch from government (for example, some network-thickening initiatives) and initiatives that require high-intensity government support (such as coordinating investment or picking winners). High-intensity initiatives should be approached cautiously, or not at all, unless countries have unusually strong institutional capabilities—strong administrative capability, commitment mechanisms that credibly restrain arbitrary government action, a capacity to respond flexibly to surprises, a competitive business environment, and a track record of public-private partnership.

4.58 By contrast, light-touch initiatives (inexpensive, supportive rather than restrictive or command-oriented, and oriented toward fostering the provision of intra-industry public goods) offer more flexibility. The key institutional attribute required for success is an unambiguous commitment by government to public-private partnership. When this commitment exists, when countries do not overreach their institutional capabilities, and when the overall business environment is reasonably supportive of private sector development, the benefits of experimentation with light-touch initiatives could be large, and the cost of failure low.

Privatizing and liberalizing markets in overextended states

4.59 While carefully crafted industrial policy and regulatory initiatives can foster markets and thereby enhance the ability of the private sector to support economic development, in all too many countries a complementary relation between states and markets remains far from the reality. Instead, markets and private initiative are held hostage to the historical baggage of ideologies of state domination and of antagonistic state-private relations. Rigid regulations inhibit private initiative. State-owned

enterprises—often buttressed by monopoly privileges—dominate economic terrain which could more fruitfully be the locus of competitive, market activity. At the extreme, the proliferation of inefficient SOEs can block private dynamism entirely, even as it imposes unmanageable fiscal and administrative burdens on the public sector more broadly. In many countries, then, the immediate challenge is to scale back the overextended state.

4.60 The gains from easing the ownership or regulatory grip of the state can be substantial:

- Diverting subsidies to loss-making to basic education would have increased central government education expenditures by 50 percent in Mexico, 74 percent in Tanzania, 160 percent in Tunisia and 550 percent in India.

- National welfare rose in eleven of twelve carefully studied cases of divestiture in Chile, Malaysia, Mexico and the United Kingdom, primarily as a result of improved productivity, increased investment, and better pricing.

- In the port sector, the liberalization of harbor terminals in Buenos Aires has led to an 80% reduction of the fees. The opening of stevedoring operations to multiple parties in the port of Montevideo, Uruguay, has increased productivity by 300%.

- In the United States, initiatives which began in the latter to eliminate entry and exit restrictions and to free prices to their market levels had, by 1990, yielded gains of US$40 billion 1970s in five hitherto tightly regulated sectors. (Table 4.3)

As China's experience since the latter 1970s (plus Poland and the Czech republic's recent economic performance) suggests, the gains can be very large indeed for formerly centrally planned economies that can successfully navigate the transition: their economies as a whole can move from stagnation to market-driven dynamism.

4.61 The challenges of scaling back the overextended state are at least as much political and institutional as they are technical—but they are different from those describe earlier in the chapter. While improving regulation and actively fostering markets calls primarily for institution-building, scaling back the overextended state depends not so much on building sustainable institutions as on the ability to proceed with reform even in the face of opposition from powerful incumbents who benefit from the status quo. Chapter 9 examines from an economy-wide perspective how reforms can most effectively be initiated and sustained. This section focuses more narrowly on programs of market liberalization and privatization, but perforce from a political as well as technical perspective.

Table 4.3 Welfare gains from deregulation in the United States, 1990 (billions of dollars).

Industry	Consumers	Producers	Total	Further potential gains
Airlines	8.8-14.8	4.9	13.7-19.7	4.9
Railways	7.2-9.7	3.2	10.4-12.9	0.4
Road freight	15.4	- 4.8	10.6	0.0
Telecommunications	0.7-1.6	-	0.7-1.6	11.8
Cable television	0.4-1.3	-	0.4-1.3	0.4-0.8
Stockbroking	0.1	- 0.1	0.0	0.0
Natural gas	-	-	-	4.1
Total	32.6-43	3.2	35.8-46.2	21.6-22.0

Source: Winston (1993)

4.62 Initiatives to foster market liberalization and privatization can be segmented into three overlapping phases—preparing for reform, putting in place an enabling business environment, and privatizing (or liquidating) state-owned business enterprises. Transparency is the vital ingredient as governments begin to prepare for reform. Ideally, transparent preparation includes:

- an explicit statement of the objectives of the reform program (to unleash a competitive, market economy, with fiscal and other objectives hopefully at most secondary in importance);
- clarification of the criteria which will be used to assess which regulations are useful and which should be discarded;
- preparation of financial statements and public budgets (including information on borrowing from banks) to assess which parastatals are lossmakers and what are the reasons for these losses; and
- specification of open and competitive mechanisms for divesting parastatals.

4.63 Even at this initial stage, it can quickly become apparent whether or not a country is indeed politically ready for reform—whether key political actors are desirous of reform and find it politically feasible to translate these desires into action. Without political readiness, effort will be wasted—and may even prove to be counterproductive, with the entire initiative ending up as just one more in an endless cycle of arbitrary actions, dysfunctional to the task of development. Guinea, for example, was initially regarded as an early success story of African privatization, with 158 SOEs sold or liquidated between 1985 and 1992. Yet initial shortcomings in preparation pointed to a lack of political readiness for reform. The efficiency and fiscal goals of the program were not well-specified, and transparent procedures for valuation and competitive bidding were lacking. As a result, the program was rife with "anomalies". A textile plant was sold for

GNF 6 million when two generators in the plant alone were worth GNF 30 million; sales and payment terms included very long grace periods and very low interest rates; little effort was made to find more than one bidder per transaction; and "sweeteners" such as domestic monopoly privileges, tax exemptions, and exemptions from import duties for cigarette and soft drink producers were commonly included in deals.

4.64 With the initial preparation done, the second phase of reform is to put in place a business environment supportive of competitive, private markets—including "rules of the game" which facilitate easy entry and free competition, a complementary institutional and legal framework which can underpin property rights and markets (notably including financial markets), and programs to protect the vulnerable. Earlier sections have described independently the economic merits of each of these elements of the business environment. Viewed from the perspective of scaling back the overextended state, they emerge as potentially part of a virtuous spiral.

4.65 In this virtuous spiral, each reform makes the next one easier to achieve. The stronger is the business environment, the greater is the range of opportunities and supports available to entrepreneurs, bureaucrats and workers—and thus the lower will be the political opposition to dismantling dysfunctional rules and agencies, and liquidating or privatizing SOEs that better belong in the private sector. The challenge is to find a way of setting this virtuous spiral into motion: at the outset those who gain from the dysfunctional system will have much to lose, but the gainers are unlikely to have reached the critical mass needed to lobby for their own interests. Box 4.8 describes how Mexico was able to overcome initial resistance to the rollback of regulatory controls.

Box 4.8 Mexico's experience with a "Deregulation Czar"

In 1988, the President of Mexico appointed a "czar of deregulation". Each month the "czar" reported directly to the President and his economic council of ministers responsible for economic management. When he received a complaint, his office was obliged to find out why a rule existed, how it interacted with other regulations and whether it should continue to exist. Every business no matter how large or small had equal access to his office to file a complaint. From the time of the complaint, his office was under a strict 45 day timetable for action—if he did not act within this time either to maintain, revise or abolish a rule, the rule would automatically be abolished. His functions were accompanied by a clear legal description of his power and sanctions to officials failing to abide by his rulings, which could be overruled by the President and his economic council.

The work of this deregulation chief over his first four years is widely credited with greatly accelerating the reform process. It provided struggling private businessman with an effective, responsive champion at the highest level of government. The reasons for success included the following:

- Presidential support was unequivocal, and signaled to both bureaucrats and citizens the need to complying with his decisions.
- Real power meant that decisions could be overruled only at the highest level of government.
- Real penalties for resistant officials who failed to implement the chiefs rulings ensured compliance in implementation.
- A time limit to act on complaints ensured quick and visible results;
- Skilled staff were vital because no one person can effectively carry out a government-wide program of deregulation. The chief's technical staff was skilled in the economic consequences of regulation, their interactions with other regulations and their administrative requirements.

- Credibility was won both within the government and with the public, through responding equally to complaints from the powerless and the influential, and through a consistent record of impartial performance.

4.66 Since it takes time for the business environment to become supportive—and since privatization becomes easier as the environment improves—the temptation to proceed with other reforms but delay privatization can be strong. This is precisely the approach which has been adopted by China and, in earlier years, by Korea and Taiwan (China) as well. As of the early 1960s, the SOE share of manufacturing production in both of the latter countries was close to 40 percent. By the mid-1980s it had fallen to about 10 percent—not as a result of privatization, but because of the very rapid expansion of the Korean and Taiwanese private sectors.

4.67 Though a strategy of "growing out" of state dominance appears to have worked in some East Asian nations, in other countries reformers would do well to keep privatization on the front burner of their programs on both economic and political grounds. Economically:

- In many countries, loss-making parastatals year after year drain substantial resources from public coffers (or from banks as "loans" which are unlikely ever to be payable from internally generated resources). Transparent information on the financial status of SOEs, prepared during the initial phase of reform, is key to assessing which are the problem parastatals. In Turkey, a state-owned coal mining company lost the equivalent of about US$6.4 billion between 1986 and 1990. Losses in 1992 alone amounted to about US$12,000 per worker, six times the national income. In some countries, unless losses can be contained, and hard budget constraints imposed on parastatals even prior to privatization, the resulting fiscal instability can undermine an entire reform program.

- The presence of poorly-performing parastatals can obstruct sectoral restructuring more broadly, not only in once state-dominated, centrally planned countries but also in mixed economies. In Zambia, for example, market liberalization created major opportunities for the expansion of cotton growing and exports by smallholder farmers. To be exported cotton must, however, be processed at least to the point of being "ginned"—yet for some years after liberalization, virtually all the country's ginneries were under the control of a monopoly parastatal, slowing the pace at which farmers and businesses could take advantage of the new opportunities.

- Anticipating privatization down the road, managers and workers in parastatals can be tempted to asset-strip, taking what they can while the going is good.

4.68 Politically the risk is that, without privatization, the momentum of reform could be lost. By the time the business environment has matured, the political window of opportunity might close—with the beneficiaries of the overextended state in place to support any reversal of reform. These political and economic risks have led countries with both mixed and transition countries—Argentina provides an example (discussed further in chapter 9) of the former, and the Czech Republic, Estonia and Russia examples of the latter— to put full-speed privatization at the center of their reform agendas, ahead of carefully designed programs of regulatory reform. As Box 4.9 summarizes, countries have used a variety of approaches to try and manage the risk of privatization.

Box 4.9 Six objections to privatization—and how to address them

"We can't throw public sector workers into the street. Its wrong—and they won't stand for it."

Winning the acquiescence of employees is key to successful privatization. Some countries have given shares to employees, or privatized via employee and management buy-outs. Others have offered generous severance pay. More broadly, privatization is easier as countries develops programs to protect the vulnerable of the kind described in chapter 3.

"Privatization is just another way for powerful politicians and businessmen to scratch each other's backs, and get rich at the expense of the people."

Process matters. Privatization must be based on competitive bidding, with the criteria of selection carefully specified in advance. And it all should be done in the open, in full view of the media and citizens.

"Our citizens won't accept our handing over precious national assets to foreign (or local) fat cats!"

Broad-based ownership can be help win popular support for privatization. One approach (adopted in the Czech Republic, Russia, and Mongolia) is to distribute privatization vouchers to citizens to use to accumulate shares. Another approach (adopted in Argentina, Chile and the United Kingdom) is to make an initial public offering of shares to citizens at attractive prices. Both approaches can be designed to also make room for a strong strategic partner with the incentive and expertise to effectively restructure the enterprise.

"Our local private sector is too weak. Without state enterprises, our economy will grind to a halt."

Certainly, privatization is easier if a well-functioning, private market economy (including financial markets) already is in place. So a key complement (and, if appropriate, antecedent) to privatization is market liberalization, perhaps accompanied by the activist initiatives to foster markets described earlier in this chapter. Even so, in most settings it is the heavy hand of the overextended state which is restraining private activity— the objection confuses cause with effect.

"All that privatization will do is replace a public monopoly with a private monopoly."

Regulatory reform is a key complement to privatization—deregulation to remove artificial monopoly privileges, and the development of a regulatory system which credibly restrains the abuse of economic power in noncompetitive markets.

"Why go through this trauma? Next time, lets just do the job of managing SOEs properly!"

Certainly, if governments are willing to put in place hard budget constraints, to embrace competition with SOEs from private firms, and to provide appropriate incentives for SOE managers, performance can improve. The sad reality is that, though some committed governments have reformed SOEs in the short-term, it is much more difficult to make these reforms stick over the long haul. The 1983 WDR highlighted a number of good SOE performers around the world; by 1993, a majority of these ten had sunk into decline.

4.69 Two broad conclusions emerge as to how countries with overextended states should proceed to scale them back. First, a commitment to competitive, private markets—and a concomitant willingness to eliminate regulatory and other obstacles to their operation—is a fundamental and necessary part of reform. Market liberalization enables new entrants to create jobs and wealth. It also eases politically—and increases the economic benefits of—privatization. Second, while the overextended state needs to scale back its role as owner—and while there is no good economic reason for state ownership to persist in tradable sectors— there can be no blanket endorsement of one approach to sequencing privatization over another. Rather, the decision depends on country-specific assessments of the likely economic and political dynamics of reform under different scenarios for privatization.

Focusing on the workable

4.70 In the realm of regulation, privatization and industrial policy (indeed in the full range of state actions probed in this report) there is no simple "one-size-fits-all" formula which can be applied indiscriminately. Privatization and market liberalization is the appropriate priority for countries whose governments have been overextended. For all countries, there is also an important agenda of institution-building, not just dismantling. This chapter has distinguished between "institution-intensive" and "institution-light" approaches to regulation and industrial policy, highlighting how the choice of approaches might appropriately vary with a country's institutional capabilities.

4.71 Successful institution-intensive approaches generally share two characteristics. They require strong administrative capabilities. And, they delegate substantial discretion for policy and implementation to a public agency—although the agency is embedded in a broader system of checks and balances that prevents discretion from degenerating into counterproductive arbitrariness. Examples of institution-intensive state actions considered in this chapter include:

- The activist industrial policy pursued by MITI in Japan in the decades after World War II, and by Korea's Economic Planning Board and industry ministry from the 1960s to the 1980s
- The use of price-caps for utility regulation in the United Kingdom
- The supervision and restructuring of ailing financial institutions by bank supervisors in Bank Negara, Malaysia's central bank
- The delegation of environmental regulation in the United States to the Environmental Protection Agency, subject to requirements for citizen participation embodied in the Administrative Procedures Act

4.72 If institutions are strong, these state actions can contribute to economic well-being. In the absence of strong institutional foundations, however, the chapter's

evidence and analysis also suggest that, state actions along these lines are likely to prove ineffective at best and, at worst, a recipe for capture by powerful private interests or predation by powerful and self-interested state actors.

4.73 How, then, should countries proceed if they lack the administrative capabilities and framework of checks and balances needed for institution-intensive approaches to work? A strategy for the long-run is to strengthen the requisite institutions. Part C explores how this can be achieved. A second strategy is to focus on the essentials and take on a lighter agenda for state action. A third strategy is to experiment with tools for state action that are better aligned with country capabilities. Though there is still much to be learned, this chapter has highlighted two sets of tools that appear to have substantial potential even where institutional capabilities are weak:

- Specify the content of policy in precise rules, and then lock in the rules using mechanisms that make it costly to reverse course. Take- or-pay contracts with independent power producers is an example from utility regulation. Regional common-currency arrangements such as the currency zone in Francophone Africa and Argentina's currency board are an example in the arena of monetary policy (examined in Chapter 3).

- Work in partnership with firms and citizens, and sometimes shift the burden of implementation entirely outside government. In industrial policy, foster private-to-private collaboration, rather than put together a state industrial bureaucracy. In financial regulation, give bankers an incentive to operate prudently, rather than just build up supervision capability. And for environmental regulation, use information to encourage citizen initiatives, rather than focus exclusively on the top-down promulgation of often unenforceable rules.

4.74 The policies that rely on these approaches may not be first-best policies in a textbook sense. But as state capability grows, it will become possible to switch to more flexible tools, capable of squeezing out further efficiency gains. Throughout, states must maintain the confidence of firms and citizens that flexibility will not be accompanied by arbitrariness—else the foundation for development will crumble, and nothing will be achieved.

DRAFT
(NOT FOR QUOTATION)
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WORLD DEVELOPMENT REPORT 1997
THE STATE IN A CHANGING WORLD

Part C Reinvigorating Institutional Capability

5. Building Institutions for an Effective Public Sector

6. Restraining Arbitrary State Action and Corruption

7. Bringing the State Closer to People

8. Facilitating Global Collective Action

This draft has been prepared by a team led by Ajay Chhibber and with principal authors Simon Commander, Alison Evans, Harald Fuhr, Cheikh Kane, Chad Leechor, Brian Levy, Sanjay Pradhan, and Beatrice Weder. The work was carried out under the direction of the late Michael Bruno, Lyn Squire, and Joseph Stiglitz.

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Part C: Reinvigorating Institutional Capability

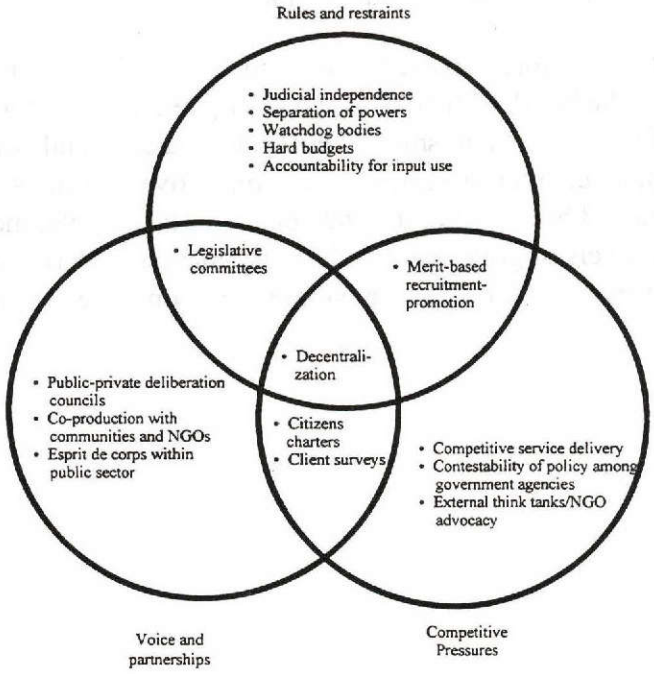
C.1 Parts A and B of the Report have underscored that the state plays an important role in facilitating economic development, but that this role needs to be matched by the state's institutional capability. This part of the report focuses on mechanisms to improve the capability of the state.

C.2 State capability refers to ability of the state to undertake collective actions at least cost to society. This notion of capability subsumes the administrative or technical capacity of state officials but is much broader than that. It encompasses more fundamentally institutional mechanisms that provide flexibility for state agencies and officials to intervene when appropriate, create incentives for them to act in the collective interest, and restrain arbitrary action.

C.3 Three interrelated sets of institutional mechanisms can provide an incentive environment to enhance state capability (Figure C.1). These consist of mechanisms that:

- enforce rules and restraints in society as well as within the state;
- facilitate voice and partnerships from outside and within the state; and
- promote competitive pressures from outside and within the state.

Figure C.1 Mechanisms to enhance state capability



C.4 Over the long term, sustainable institutions have been built upon formal checks and balances, anchored around core state institutions such as an independent judiciary and the separation of powers. These are essential for ensuring that neither state officials nor the rest of society is above the law. Rule-based governance is crucial for underpinning the credibility of a country's business environment and providing an incentive environment that promotes sustainable development. Within the executive as well, credibility of rules provides an enabling environment for promoting public sector performance. This includes hard budget constraints, implementation of policies (for example, budgets) as approved, predictability in the flow of resources, accountability for the use of financial resources and for the achievement of outputs where measurable, and restraints on political patronage in personnel policies.

C.5 But rule-based governance by itself is not enough. State capability can be enhanced by institutional arrangements that foster partnerships with and provide competitive pressures from actors outside and within the state. Partnerships with and participation in state activities by external stakeholders—businesses and civil society—can provide credibility, build consensus on a shared vision, and supplement state capacity to implement collective actions. Similarly, partnerships among state agencies and officials can foster esprit de corps, build commitment and loyalty, and reduce the transactions costs of achieving shared goals.

C.6 On the flip side of partnerships, competitive pressures—from markets and civil society and from agencies within the state—improve incentives for performance, and check the potential abuse of the state's monopoly in policymaking and service delivery. Similarly competitive or merit-based criteria in public service recruitment and promotion is crucial for building a capable bureaucracy.

C.7 The next two chapters examine mechanisms to reinvigorate state institutions, starting with the building blocks for an effective public sector, and followed by the broader issues of formal mechanisms of checks and balance and control over corruption. The subsequent chapter examines how competitive pressures, voice and partnerships can be enhanced by bringing the state closer to the people, including decentralization to local levels of government. The last chapter in Part C examines how partnerships and competitive pressures from beyond the nation-state can facilitate global collective action.

Chapter 5 Building Institutions for an Effective Public Sector

> *Sire, a vast majority of civil servants are ill paid.... The result is that skilled and talented men shun public service. The Government of Your Majesty is then forced to recruit mediocre personnel whose sole aim is to improve their weak pecuniary situation...intelligent, hardworking, competent, and motivated individuals should direct Your Empire's civil service.... It is Your Majesty's prerogative to introduce the indispensable principle of accountability, without which all progress is retarded and work inevitably destroyed.*
>
> — Excerpts from *The Political Testaments of Ali Pasha*, Grand Vizier to Ottoman Sultan Abdulaziz, *circa* 1871. (Source: Andic and Andic 1996)

5.1 The same problems that plagued Sultan Abdulaziz's bureaucracy haunt today's public bureaucracies. Leaders struggle to build institutions for an effective public sector. Yet in many countries the public sector is ineffective or, worse, corrupt. Why this persistence?

5.2 Part of the reason is politics. Depending on the nature of political dynamics, political preferences can translate into public sectors with very different degrees of effectiveness. In some instances politicians and their constituencies may have an incentive to maintain a status quo with a high degree of inefficiency and inequity. And those who lose out from such an arrangement may be unable to provide effective pressures for change. In some other instances the private interests of the political principals may run counter to those of their constituencies. But effective institutional mechanisms may not exist to restrain the arbitrary actions of politicians or hold them accountable for results.

5.3 Still, the problem is not entirely political. In many instances politicians have strong incentives and interest to improve public sector performance. But managing public bureaucracies is a complex business, one that does not lend itself to clear, unambiguous solutions. Building institutions for an effective public sector requires addressing a host of underlying behavioral problems that distort incentives and ultimately lead to poor outcomes.

5.4 Politicians face information and capacity constraints in formulating and implementing policies that meet the interests of their constituencies. Of necessity, they delegate some aspects of policy formulation and all of implementation to bureaucrats. At the same time politicians must ensure that bureaucrats act in accordance with the politicians' preferences. But the costs of monitoring what bureaucrats actually do are high. Politicians can structure and attempt to enforce appropriate contracts that set the parameters for bureaucrats' activities. But the outputs of public agencies are often difficult to measure and not subject to competitive pressures, making it costly or infeasible to enforce such contracts. These same problems get played out throughout the hierarchy of principals and agents in the public sector. Quite understandably then, many countries struggle with fashioning and developing an effective bureaucracy.

5.5 But countries that have done better at addressing Abdulaziz's problem have been rewarded with economic growth. Early reforms in industrial countries and in the more successful developing countries sought to restrain political patronage for private gain and to build professional meritocracies shaped by the rule of law. In Europe, for instance, the development of such bureaucracies took decades. Only in 1854 did England's civil servants begin receiving formal salaries, marking the decline of the widespread practice of distributing offices as spoils (Box 5.1). The Northcote-Trevelyan reforms of the civil service heralded the self-conscious construction of a professional meritocracy that was part of the foundation for a half-century of English dominance over international commerce.

Box 5.1 Laying bureaucratic foundations—the Northcote-Trevelyan reforms in England

During the nineteenth century most industrializing states underwent administrative modernization. Early leaders included France, Prussia, and England. Until the early nineteenth century the affairs of the state in England were administered by public officials who owed their positions to political patronage and influence. There was no common system of pay, bribes augmented official salaries, and office holders, who viewed their positions as property that could be sold, often engaged and paid their own staff. Although such a system did not rule out advance by individual ability, it was not the basis for sound administration. As the Victorian era advanced, however, England underwent a period of intense reform driven by social and economic change and the demands of an expanding and educated middle class. Universities, the armed forces, the judiciary, and central and local bureaucracies were all reformed.

The blueprint for civil service reform was the Northcote-Trevelyan Report of 1854, which proposed the creation of a modern bureaucracy based on a career civil service. Drawing on similar ideas advanced for the Indian civil service by Macaulay, Northcote and Trevelyan proposed dividing work into two classes—intellectual (policy and administration) and mechanical (clerical)—and creating a career civil service to carry out this work. New staff for intellectual work would be recruited from the newly reformed universities, securing the best talent through tough competitive examinations supervised by a board of civil service commissioners.

Opposition was strong. Although the civil service commission was established in 1855, many departments continued recruiting in their own way until 1870, when patronage was abolished and the two grades were made compulsory for all departments. The Northcote-Trevelyan reforms were followed by reforms in the armed forces, the judiciary, and, later, municipal government. There were also extensive changes in the machinery of government. By the end of the nineteenth century the foundations of modern government had been laid and the values of honesty, equity, economy, and political neutrality institutionalized.

Lessons to be drawn from England's reforms include the clarity of Northcote-Trevelyan's vision, the importance of political leadership (by Gladstone, first as chancellor and then as prime minister), and the role of social and economic forces in modernizating the state (boosted by the logistical fiasco of the Crimean War). Even so, the blueprint took several decades to be implemented.

5.6 More recently, the high-performing East Asian economies have instituted and nurtured the basic foundations of capable bureaucracies. These include meritocratic recruitment and promotion, adequate pay to attract capable staff and build an esprit de corps, strong central capacity for strategic policy formulation, and public-private partnerships through deliberation councils for sharing ideas and oversight.

5.7 But many low-income countries have been unable to institutionalize the basic underpinnings of a professional, rule-based bureaucracy. And there have been few effective institutionalized links to external stakeholders for feedback and accountability.

Though formal systems in many developing countries resemble those of the industrial countries that once colonized them, informality remains the norm. Merit-based personnel rules are circumvented in favor of recruitment, promotion, and transfers based on patronage and clientelistic ties. Budgets are unrealistic, and decisions are made in an ad hoc manner during budget implementation. These problems reflect poor enforceability of the rule of law within and beyond the public sector, few institutionalized mechanisms for listening to and forming partnerships with firms or civil society, and an absence of competitive pressures in policymaking, service delivery, and personnel practices.

5.8 Cross-country evidence helps corroborate that bureaucratic capability matters for economic performance and that governments can reap payoffs from an effective public sector. Figures 2.2 and 2.4 (Chapter 2) plot an index of bureaucratic capability (based on assessments by investors) against the part of economic growth as well as infant mortality that is unexplained by such variables as income and education. It shows a fairly high correlation between the index and the residuals. The implication is that more effective bureaucracies can contribute to growth over and above the effect of typical socioeconomic variables.

5.9 A well-functioning bureaucracy can promote growth and reduce poverty by providing sound policy inputs for state intervention and by delivering critical public goods and services at least cost. Experience suggests that building institutions for an effective public sector requires putting in place incentives that can generate well-informed and disciplined strategic policies, deliver public services efficiently and effectively, and attract and motivate capable staff to carry out these tasks. Each of these three building blocks is discussed in turn.

Strengthening Institutions for Policymaking

5.10 Politicians set goals and broad strategic directions to achieve their political objectives. Sound institutional arrangements can enhance the capacity of politicians to translate those goals into effective policy priorities. For instance, rules and norms can make transparent the costs and benefits of competing policies. To address information constraints, institutional arrangements can embed policymakers in processes that provide input and oversight from internal and external stakeholders. These processes can contribute to better informed decisions while enhancing the credibility and legitimacy of policymaking.

5.11 Institutional arrangements can also impose collective restraints and curb the influence of political pressures that can lead to poor decisionmaking and outcomes. The unrestrained pursuit of individual interests by politicians or bureaucrats may be collectively undesirable. For instance, the cumulative efforts of politicians in allocating funds to their constituencies can be macroeconomically destabilizing and unsustainable. Rules and norms can help discipline, coordinate, and contest competing policies. In some countries politicians have delegated macroeconomic and strategic policy coordination to capable, relatively autonomous central agencies, whose activities are embedded in

transparent consultative processes. In other instances politicians collectively restrain and contest each other in forums with shared decisionmaking. But many countries have no effective mechanisms for collective restraint and decisionmaking, an absence manifested in incoherent strategic policies and macroeconomic instability.

5.12 Although the precise institutional arrangements vary, effective public sectors the world over have generally been characterized by strong central capacity for macroeconomic and strategic policy formulation; mechanisms to delegate, discipline, and contest policies among government agencies; and transparent links to external stakeholders for feedback and accountability. In many developing and transition economies, however, policymaking capacity is weak and fragmented, and there are few institutionalized inputs or oversight from key stakeholders.

Policymaking mechanisms in industrial countries

5.13 Many OECD countries have built up well-functioning policymaking mechanisms over of time. At the heart of these systems are mechanisms for properly preparing policy proposals, estimating the costs of competing policies within a disciplined framework of aggregate expenditures, ensuring the contestability of policies through consultation and debate in a shared arena, and systematically recording decisions and monitoring implementation. A vital complement to these mechanisms is effective capacity at the center of government—the Secretariat-General du Gouvernement in France, the Cabinet Office in the United Kingdom, the Office of Management and Budget in the United States—to facilitate consultation and ensure extensive horizontal coordination before ministries submit policy proposals to cabinet.

5.14 Among industrial countries, Australia provides a good example of reforms designed explicitly to create a more transparent, competitive, and results-oriented policymaking process. Of particular relevance to other countries is the emphasis on publishing data on the medium-term costs of competing policies, facilitating debate and consultation on policy priorities within hard budgets in cabinet and among government agencies, and focusing attention on results through ex-post evaluations and reporting on outcomes (Box 5.2). By reorienting policy priorities these reforms helped turn the fiscal deficit into a surplus during the 1980s.

Box 5.2: Australia's mechanisms for transparent, competitive, and results-oriented policymaking

One of the main objectives of Australia's public sector reforms has been to institute a process to discipline, coordinate, and contest policies. Some of the challenges faced by the Labour government when it came to power in the early 1980s were similar to those confronting many developing countries today: fiscal crises and the unsustainable fiscal commitments of previous policies.

To discipline policy formulation and gain political support for strategic prioritization, the new administration decided to publish forward estimates of existing policies. In the early years these estimates projected sizable and unsustainable real growth in future spending requirements and so underscored the need to scale back the size and scope of government activities. Once the government had published the estimates, however, it was obliged to continue to do so to show continuing declines in future commitments—the so-called "falling man" (Box Figure 5.2a). Open financial markets served as an additional disciplining device on the publication of these data. The reforms also required the government to

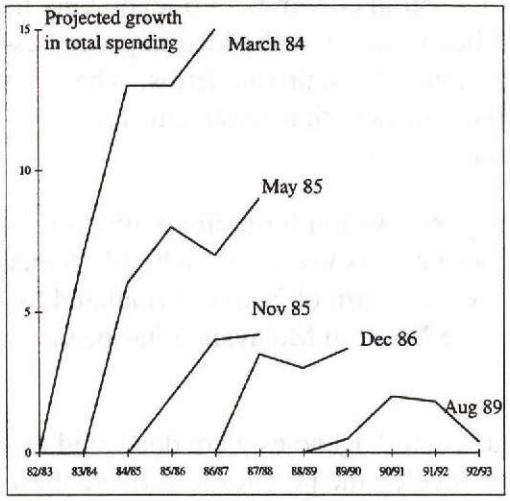
publish a reconciliation table showing the deviation between the forward estimates of existing policies and those of new policies. These measures helped make transparent changes in the government's strategic priorities, as well as the medium-term costs of new commitments. Additionaly, forward estimates provided predictability in resource flows to line ministries, since forward estimates were automatically rolled over into the budget if there were no changes in policy. This approach helped improve decisionmaking and the operational efficiency of line agencies.

The reforms also required that any new policy or changes in existing policy proposed by line ministries be accompanied by offsetting savings to stay within the resource envelope agreed in the cabinet. The cabinet focused on changes in strategic priorities to meet targets for net spending or savings. Policy proposals were contested in the cabinet as well as by the requirement that all ministries and agencies affected by the policy submit written comments on the soundness of the proposals. This approach helped legitimize and build consensus on policy priorities. The reforms also devolved program decisions to line ministries under hard budget constraints and strategic priorities articulated by the Cabinet, and provided managerial flexibility in the use of administrative expenses. Finally, the reforms focused attention on policy results through mandated periodic evaluation of new and existing policies and through reporting on performance and outcomes.

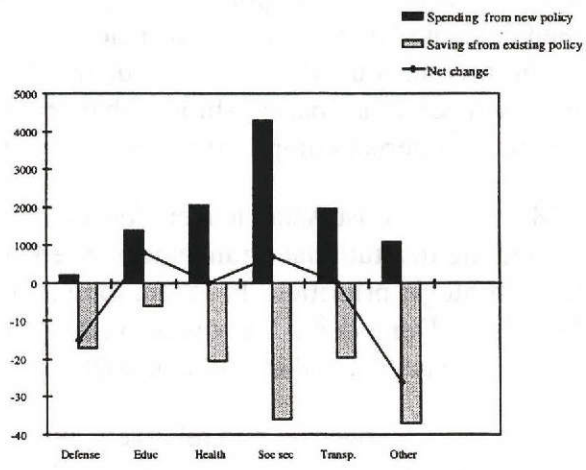
The results? The deficit, 4 percent of GDP in 1983, became a surplus by the end of the decade. Moreover, there were significant changes in the composition of public expenditures, reflecting both the strategic shifts in intersectoral priorities identified by the Cabinet and changes in intraministerial priorities, often identified by line agencies themselves (Box Figure 5.2b).

Box Figures 5.2a and 5.2b

Australia: Declining Medium-Term Costs of Policies



Australia: Changes in Expenditure Composition, 1983-94



5.15 Some OECD countries have recently introduced explicit measures to separate policymaking from implementation. These mechanisms are designed to ensure that contestable policy options are generated and to guard against capture of the public sector by provider interests that would unduly influence its policy proposals. Examples of formal separation of purchasers and providers abound in all areas of the public sector in New Zealand and the United Kingdom. Such formal separation is not without its risks, however, policymakers are delinked from operations that provide information and feedback for decisionmaking.

5.16 The United States and continental Europe have instituted other mechanisms for consultation and oversight in policymaking. Like the cabinet in a parliamentary system congressional committees in the U.S. presidential system are the principal arena for contesting and trading policies. U.S. executive agencies, for their part, are governed by the Administrative Procedures Act of 1946, which provides flexibility on the substance of policies while imposing procedural requirements—such as public announcement of new policy and mandatory participation of interested parties in decisionmaking—that are enforceable in courts. This procedures-oriented approach to policy formulation allows legislators to shift substantive policymaking to specialist agencies and other interested parties closer to the problem. This decentralized mechanism relies on citizen voice and the judiciary for ensuring accountability, albeit with the inevitable consequence of slowing the pace of decisionmaking. Many continental European countries—Belgium, France, Germany, Italy, Spain—rely on administrative law and specialized courts for judicial review of administrative actions. Citizens can challenge administrative decisions on legal grounds or for errors of facts. The European Union has adopted this system to allow the European Court of Justice to oversee decisions made by European institutions.

Elite central agencies in East Asia

5.17 The successful East Asian economies adopted an approach that shares some key aspects of the policymaking systems of industrial countries. Policymaking has been delegated to elite central agencies whose deliberations are embedded in processes—public-private councils—that provide input and oversight from private firms. The approach combines partnerships with external stakeholders with mechanisms for enhancing internal competitive pressures in decisionmaking.

5.18 East Asian leaders formulated a long-term vision for their country and created the institutional arrangements needed to translate this vision into a highly focused set of strategic priorities. In Japan, for example, the long-term objective formulated by the Liberal Democratic Party was to catch up with the West; in Malaysia it has been Prime Minister Mahathir's Vision 2020.

5.19 Powerful and relatively autonomous central agencies were delegated the authority to maintain macroeconomic stability and develop the policies to achieve these long-term objectives. The Ministry of International Trade and Industry (MITI) in Japan and the Economic Planning Board (EPB) in the Republic of Korea are considered the primary movers behind their countries' industrial policies and use of administrative guidance. In Thailand the Ministry of Finance, the Budget Bureau, the Central Bank, and the National Economic and Social Development Board—the so-called gang of four—act in unison to cap spending and control inflation. In Indonesia the Ministry of Finance and the planning agency Bapennas have been the guardians of the purse and the brains of the civil service. These central agencies are staffed by professional and capable employees, recruited on the basis of merit often through highly competitive examinations.

5.20 As in East Asia, the delegation of macroeconomic policy to competent and reputable technocrats has been a common feature in several Latin American countries including Argentina, Colombia, Mexico, and Peru. This policymaking arrangement, combined with hierarchy and transparency in budgetary decisionmaking (Chapter 3), has been an important contributing factor in reducing inflation during the late 1980s and early 1990s. India has also followed this route since 1991, and even the recently elected leftist government appointed a fiscal conservative as minister of finance with the express mandate of maintaining macroeconomic discipline and signaling the government's credibility to investors.

5.21 But the East Asian policymaking apparatus has had additional features that fostered partnerships and competitive pressures. Both in Indonesia's technocracy and Japan's MITI senior officials were bound by an esprit de corps—a common understanding of shared objectives, manifested in both formal and informal norms and resulting in a high degree of internal coherence and partnership. Chile shares several features with East Asia's high performers. Most striking is the affinity of its group of high-level advisers—the Chicago Boys—with Indonesia's Berkeley mafia and Thailand's gang of four.

5.22 The central agencies in East Asia (and Chile) had considerable flexibility in policymaking, but they were also embedded in a larger network of deliberation councils and external think-tanks. In Japan and the Republic of Korea information about the costs of industrial policies was distributed through public-private deliberation councils. Working in tightly organized consultative committees, private firms and ministerial bureaucrats regularly exchanged information about the potential and actual effects of policies, an approach that exposed costly programs to rigorous review. Other examples of successful deliberation councils include Singapore's National Wages Council, composed of government, employer, and labor representatives; Thailand's National Joint Public and Private Consultative Committee; and the Malaysian Business Council.

5.23 These transparent and institutionalized mechanisms of consultation circumscribed opportunities for clientelism and rent seeking. They also gave a veto and restraining power to nongovernment actors while providing flexibility for policymakers to adapt policy to changing circumstances. Competitive pressures among ministries within overall fiscal and macroeconomic constraints—for example, the so-called bureau-pluralism among bureaucracies representing different sectoral constituencies in Japan—also created restraints on policy capture and provided internal discipline.

5.24 While deliberation councils have been successful in East Asia, they have not proven effective in many African countries. Botswana is a notable exception. Policy consultation through Botswana's planning commission is extensive and involves all levels of government as well as private firms, NGOs, and community organizations. But elsewhere in Africa, including francophone countries with their Economic and Social Councils, the experience has not been satisfactory. To succeed deliberation councils require substantial technical capability to prepare coherent policies and to incorporate

information from private participants. A more fundamental difficulty is that these councils typically exclude broader segments of society from deliberations. If the private sector is too small, the councils could all too easily degenerate into well-oiled mechanisms for unproductive rent extraction. If public-private deliberation councils are to support sustainable development they will need to be complemented by other approaches to winning legitimacy from society more broadly, as they were in East Asia.

Weak capacity and fragmented policymaking in developing countries

5.25 Many developing countries especially in Africa, Central America, and the Caribbean lack the critical mass of effective capacity and internal coherence required to formulate and coordinate macroeconomic and strategic policies. Central capacity is weak and stretched thinly among a handful of senior officials who must attend to numerous tasks. Contributing to the weakness are political patronage, overstaffing at lower levels, wage compression and poor pay at senior levels, and an absence of meritocratic recruitment and promotion. Moreover, this limited central capacity is not buttressed by a larger network of external think tanks, which could provide input and contest policies.

5.26 Weak central capacity also results in an inability to make budgetary forecasts based on sound and realistic assumptions. This undermines transparency and predictability in decisionmaking. For instance, published budgets are often not followed because policies are remade during budget implementation. In recent years the variation between budgeted and actual recurrent expenditures has averaged more than 50 percent in Tanzania and more than 30 percent in Uganda. Transparency and coherence of decisionmaking are also undermined by the use of extrabudgetary funds (for instance, more than 50 percent of federal expenditures in Nigeria). Lags in the production of financial accounts and audits are common and impede informed decisionmaking. More significantly, budgeting and policymaking in many countries are preoccupied almost exclusively with the allocation of inputs rather than with the results they are intended to achieve. And information on the costs or outcomes of policies is rarely available.

5.27 In aid-dependent countries, donors both alleviate and exacerbate the problem of weak central capacity. To the extent that donors provide policy advice that supplements weak capacity at the center, the short-term problem is mitigated. But advice does nothing to build long-term capacity if politicans fail to recognize the need for local experts.

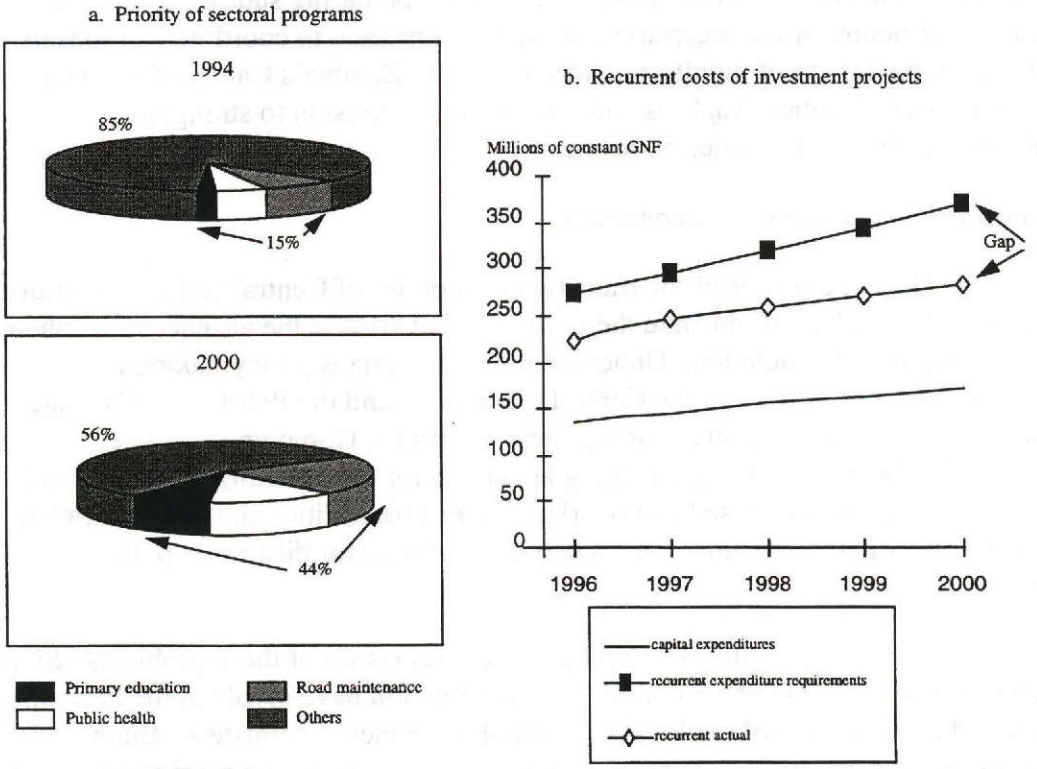
5.28 Donors also fragment central capacity for policy formulation through the fragmentation in decisionmaking introduced by individual projects. Ministries and donors enter into bilateral deals on projects even though the cumulative effects of these projects may not be collectively sustainable or mutually consistent. In many countries public investment programs have become passive repositories of donor-driven projects that contribute to an expansionary fiscal bias through the future recurrent costs of the projects. Lack of coordination between the ministry of planning and the ministry of finance sometimes further impedes the integration of capital and current expenditures.

Together these factors weaken institutional mechanisms to coordinate, contest, and discipline decisionmaking.

5.29 The problems that typically result are illustrated in the case of Guinea. The government's stated priorities are primary education, public health, and road maintenance, but allocations have occurred to other programs. Further, there is no system of costing or of contesting policies. An exercise to cost out policies to meet stated priorities revealed that the share of priority programs in overall spending would need to triple over the next four years, implying drastic cuts in other expenditures (Figure 5.1a). Moreover, the recurrent costs of donor-led investment projects are unsustainable (Figure 5.1b). Similar problems in many developing countries result in newly constructed roads falling into disrepair, schools without textbooks, and health centers without drugs.

Guinea must restructure its spending to achieve its policy objectives

Figure 5.1 Costs of sector programs and investment projects in Guinea, 1994-2000



Source: World Bank 1996.

5.30 Several initiatives have been launched to address these problems, although all are still in their early stages. The Africa Capacity Building Foundation established by donors and African governments seeks to strengthen African capacity in economic policy and management. However, its focus is not on reforming the incentive framework that governs decisionmaking in the public sector. Governments and donors have also launched sectoral investment programs to coordinate donor assistance. The Agricultural Sector Investment Program in Zambia replaces 180 individual donor projects. But while

they consolidate fragmented policies in a shared arena, such efforts can create coordination problems of their own as long as capacity remains weak.

5.31 Countries like Malawi and Uganda are moving to the next level, developing a systematic process for strategic prioritization across sectors and within aggregate spending constraints. Uganda is replacing a disfunctional system of protracted and repetitive haggling with line ministries over detailed input allocations for unclear or unspecified purposes with an outcome-oriented budgetary process that focuses on the results that expenditures are expected to achieve. In Malawi four pilot ministries—education, health, public works, and agriculture—are costing out policies within a hard budget constraint and for the first time are focusing on what competing policies are designed to achieve and how much they cost. Colombia and some other countries are undertaking comprehensive efforts to institute an ex post evaluation system to assess whether policies and programs are achieving their intended outcomes.

5.32 Changes in the way policy is formulated are also under way in a number of countries. These changes are evident in procedures for preparing submissions to the cabinet, in the structure of the secretariat, in mechanisms used to coordinate proposals, and in the implementation of monitoring arrangements. Zambia's Cabinet Office has recently established a Policy Analysis and Coordination Division to strengthen coordination capacity at the center of government.

Policy coordination in transition economies

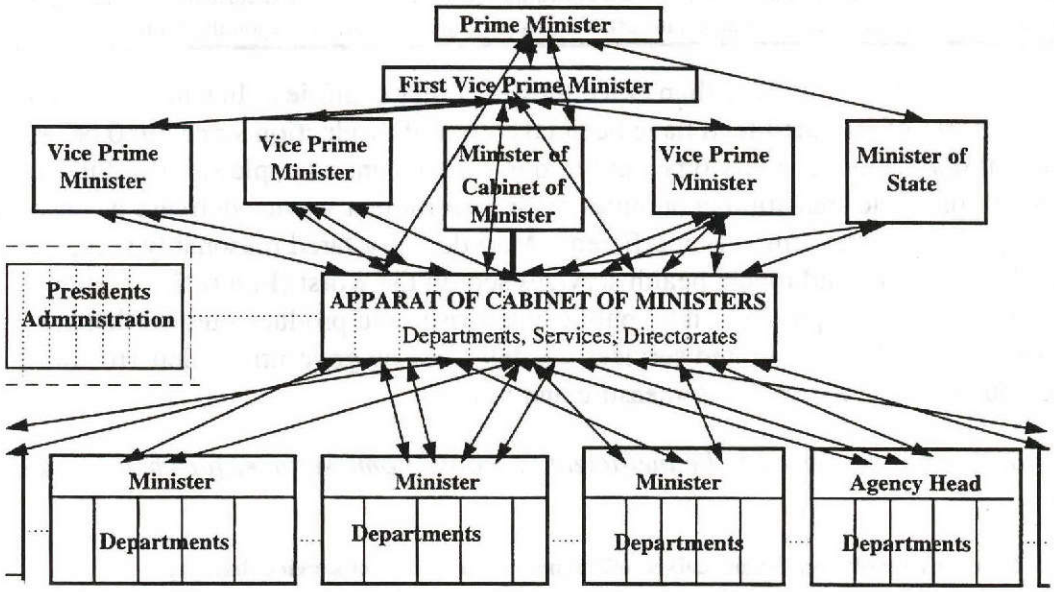
5.33 The experiences of the transition economies of Central and Eastern Europe and the former Soviet Union illustrate the problems that arise in the absence of a coherent mechanism for policy formulation. Under Communist regimes policymaking and coordination were the function of the Central Committee and the Politburo. The state administration simply implemented party policy. When the Communist regimes collapsed, so did the central decisionmaking apparatus for coordinating ministries and departments. As a result confused and overlapping responsibilities and multiple rather than collective accountability emerged—a sure-fire formula for disastrous policy formulation.

5.34 Ukraine exemplifies a particularly egregious set of these problems. Since independence in 1991, policy formulation and coordination have involved the Parliament (Supreme Rada), the Office of the President, and the Cabinet of Ministers. But because there has not been an unambiguous separation of powers between the president and the Rada, there are often conflicts between the two. The 1995 Constitutional Agreement rests responsibility for policy formulation with the president and responsibility for policy coordination with the Cabinet of Ministers. In practice, however, the president and the cabinet engage in both activities, and agencies are accountable to multiple principals with conflicting responsibilities (Figure 5.2).

5.35 Some Central and Eastern European countries with similar though perhaps less severe problems have initiated promising reforms of their central decisionmaking

mechanisms. In Poland the reforms of 1996 have streamlined multiple and conflicting responsibilities. To reduce dissension and conflict between the Council of Ministers and the government, ministers are required to endorse joint cabinet decisions. Hungary relies on a dual-meeting mechanism, whereby administrative secretaries meet first to vet initial policy proposals. When the cabinet meets, only the best-prepared, highest priority issues make it to the agenda, reducing transactions costs and speeding decisionmaking. In Georgia streamling has removed overlapping and conflicting positions and draft laws are now debated and agreed on in the presence of all ministers of the President's Economic Councils before they are submitted to Parliament. These reforms have facilitated consultation and coordination in central government decisionmaking.

Figure 5.2 Central decisionmaking and information flows are overly complex in Ukraine



Source: Wood 1996.

Reforming Institutions for Delivery

5.36 Even when policies are well-designed, major implementation problems can arise. Poor quality, high cost, waste, fraud, and corruption have marred the delivery of services in many developing countries. Some of the challenges to public delivery systems are a consequence of the state's expansion into new areas of service provision over the past few decades. As discussed in previous chapters, governments in developing countries embarked on strategies that accorded the state a dominant role in economic transformation. Governments viewed themselves as the dominant—if not sole—provider of many services.

5.37 In many countries this expansion of the state's role has provided opportunities for politicians to exploit their positions for political gain (Box 5.3). And governments have overextended themselves with deleterious results. Examples abound of services not being delivered or being delivered badly. Power system losses in

Box 5.3 Bangladesh—The mushrooming of government

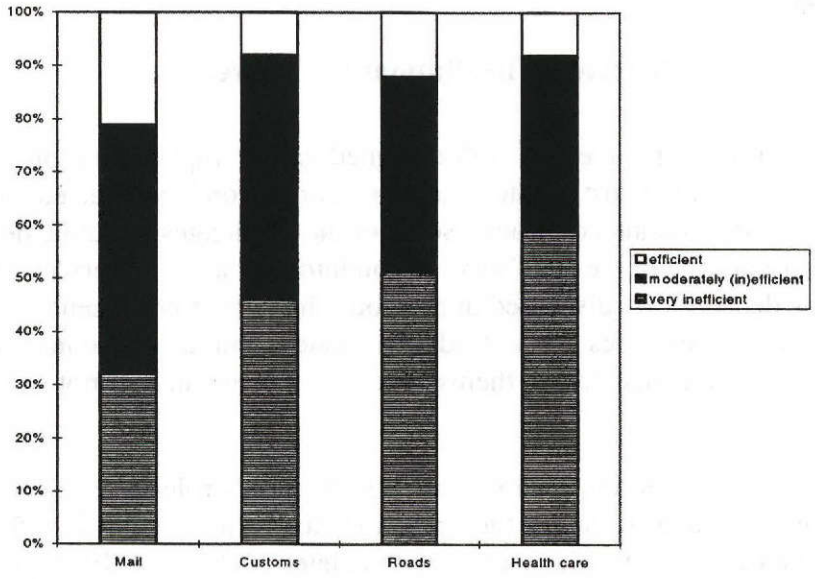
Since independence in 1971 the Government of Bangladesh has basically doubled. The number of ministries increased from twenty-one to thirty-five over the past two decades, and between 1990 and 1994 the number of departments and directorates went from 109 to 221. Public sector employment increased from 450,000 in 1971 to almost one million in 1992—a compounded rate of 3.6 percent a year compared with population growth of 2.5 percent during the same period. Civil service pay has fallen considerably, especially for those at the top. The basic pay of a permanent secretary has declined by 87 percent (in real terms) since 1971.

New ministries, divisions, and departments were created in part to meet emerging needs such as environmental concerns and women's issues. But the state has also spread its wings into commercial economic activities. Moreover, growth has often been stimulated by political considerations. The increase in ministries accommodated more intraparty groups and offered more ministerial positions—and, of course, created more jobs to be dispensed by political leaders. Aside from its budgetary effects, this expansion has stretched implementation capacity, compounded coordination problems, and exacerbated regulatory intrusiveness. It also has created vested interests that have blocked efforts at rationalization and reform.

low-income countries are more than twice those in other countries. In China nearly 1 million hectares of irrigated land have been taken out of production since 1980 because of insufficient maintenance. Only 6 percent of domestic businesspeople surveyed in fifty-eight developing and transition economies rated government service delivery as efficient while 36 percent rated them very inefficient. Mail delivery fared reasonably well, followed by customs and roads; health services scored the worst (Figure 5.3). The higher-rated services typically run by public enterprises and produce outputs that are easier to monitor; the lower-rated services are delivered by government departments and produce outputs that are harder to measure and monitor.

Service delivery is perceived to be inefficient, although some services fare better than others.

Figure 5.3 Survey results on the perceived efficiency of government service delivery



Source: Questionnaire for private sector survey.

5.38 What is needed is better management of the principal-agent relationships inherent in delivery. In many countries service delivery suffers because neither principals (politicians) nor agents (bureaucrats) live up to their side of the implicit bargain. Politicians interfere in the day-to-day operations of public agencies. And services are delivered through government departments whose managers have little operational flexibility and whose resource flows are unpredictable. Even where managers have been able to circumvent these rules, they have had few incentives to achieve better results. In the many countries where the public sector has assumed a monopoly role in delivery, external pressures for better performance are eliminated. And few countries have had credible restraints in the form of accountability for the use of inputs or for achievement of measurable outputs or outcomes.

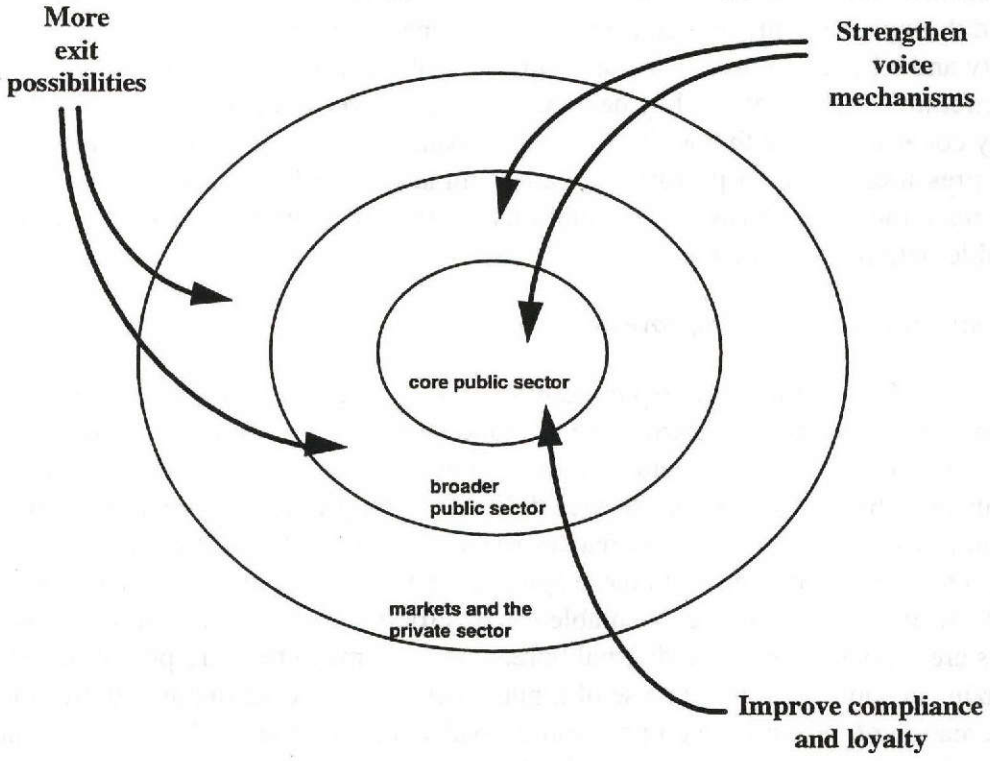
Institutional mechanisms to improve delivery

5.39 Governments are experimenting with a range of institutional mechanisms to improve service delivery. Greater use of markets is creating competitive pressures and more options for users seeking better quality or lower cost. These exit options are also being enhanced by contracting out service delivery to the private sector and to NGOs. Some countries are setting up performance-based agencies in the public sector and entering into formal contracts with these agencies, providing them greater managerial flexibility while holding them accountable for specified outputs or outcomes. Many countries are relying on more traditional bureaucratic forms in the core public sector, emphasizing accountability in the use of inputs, meritocratic recruitment and promotion, and the creation of an esprit de corps to build loyalty for effective performance. Finally, user participation, client surveys, and published benchmarks and other voice mechanisms are providing external pressures for improving delivery.

5.40 These initiatives can be classified into three broad categories—strengthening exit, voice, and compliance, and loyalty—that apply in varying degrees in different incentive environments through which services can be delivered (Figure 5.4). Markets and contracts with the private sector offer primarily exit options for better performance. The broader public sector—including corporatized public enterprises and performance-based agencies—offer fewer exit options, but voice begins to become influential. For activities that are difficult to specify and not contestable, the core civil service provides no realistic exit options and has considerably less flexibility in financial and personnel management. As exit completely disappears as an option, incentives switch to voice and improved rule-based compliance and loyalty of the civil service.

Different incentive environments offer different options for improving delivery

Figure 5.4 Incentive environments and service delivery



5.41 Recently, public management reforms in industrial countries have sought to move delivery away from the core public sector (the center of the circle in Figure 5.4), primarily by using market-type mechanisms and formal contracting. New Zealand provides the most dramatic example. Commercial and contestable activities were hived off, corporatized, and often privatized. All remaining large, multipurpose ministries were split up into focused business units headed by chief executive officers on fixed-term, output-based contracts with considerable managerial autonomy (including the right to hire and fire). These reforms helped turn a 9 percent budget deficit into a surplus during the 1980s and cut the unit costs of delivery more than 20 percent in some agencies.

5.42 The new public management reforms are being emulated in several developing countries. But what is feasible in New Zealand may be unworkable in many developing countries. It takes considerable capacity and commitment to write and enforce contracts, especially for outputs in the social sectors which are difficult to specify. The appropriate mechanism for improving performance depends on both the characteristics of the service and the capability of the state to enforce internal and external contracts (Table 5.1).

Table 5.1 Mechanisms to improve delivery

	Service characteristics and state capability		
	Contestable	**Easy to specify and enforce**	**Difficult to specify and enforce**
Markets and the private sector	♦ Strengthen markets: credible regulation ♦ Create markets: vouchers	♦ Contract out to for-profit or nonprofit agencies	
Broader public sector	♦ Enhance internal competition ♦ Create hard budgets and divest state firms	♦ Set up performance-based agencies ♦ Corporatize and establish enforceable performance contracts ♦ Strengthen voice mechanisms	
Core public sector			♦ Ensure clarity of purpose and task ♦ Improve rule compliance ♦ Increase loyalty ♦ Strengthen voice mechanisms

5.43 For instance, for services that are contestable—such as commercial products and, more recently, telecommunications and power generation—market mechanisms can generate powerful competitive pressures for improved delivery. For services whose outputs the state can specify and enforce at low transactions costs, contracting out to private firms and NGOs is an attractive option. Countries with strong capacity and commitment are setting up performance-based agencies and formal contracts even for complex activities within the core public sector (defense, education, health care). But countries with scarce capacity to enforce complex contracts and weak bureaucratic controls to restrain arbitrariness under more flexible management regimes need to proceed with caution.

Using competitive markets to improve delivery

5.44 Given overstretched state capacity and fiscal constraints, governments are relying more on market mechanisms to improve delivery of contestable services. As discussed in Chapter 3, governments are providing a range of services (baking cookies, making watches) for which market failure is not an issue. A recent study found that

better-performing countries have divested state-owned enterprises operating in competitive markets.

5.45 Changes in technology have also created new scope for competition. Unbundling activities within sectors provides opportunities for more competitive and efficient delivery of services that were previously provided by public monopolies. Deregulation of telecommunications and power generation has led to significantly lower unit costs and a rapid expansion in services provided. Dozens of countries throughout the Americas, Europe, and Asia have introduced competition in long-distance and cellular services. In China, Indonesia, Malaysia, and the Philippines investors are substantially increasing power generation capacity.

5.46 Other recent innovations such as vouchers and capitation grants have increased the scope for competition in the provision of some social services. Experience with these mechanisms is still limited, however, and confined largely to education. Chile's capitation grant system allows students to enroll in any school (Box 5.4). Private enrollments have increased, but the program's effects on school performance are not yet clear. Vouchers are promising but carry a risk of increasing polarization among users if not properly regulated.

Box 5.4 Vouchers and school choice

One partial solution to the problem of poor-quality schools is the school choice or voucher system. Under such a system students would be given vouchers funded by public tax dollars but redeemable in either private or public schools. Schools would then have to compete for students.

Opponents of the voucher system claim that it would lead to a mass exodus of public school students—especially the better ones—and so gut the public system. Yet in a 1993 pilot school choice program in Puerto Rico, the 18 percent of students who did transfer to private schools was largely offset by the 15 percent who transferred from private to public schools—hardly a mass exodus. Puerto Rico's experiment was so successful that in its second year the number of applicants jumped from 1,600 to 15,500.

Public funding for private schools is nothing new. In the Netherlands two-thirds of students attend publicly funded private schools. When Chile reformed its education system in 1980, the Ministry of Education began providing per student payments for both public and private schools. Because the payment was based on the average cost of education in the public sector and expenditures per student were 70 percent less in the private sector, private schools eagerly vied for students. By 1986 primary enrollment in private schools had more than doubled, going from 14 to 29 percent, and enrollment in private secondary schools had increased almost fourfold. However, the effects on school performance are not yet clear.

Vouchers also present potential risks. The most commonly cited one is increased stratification among services and polarization among users. For instance, some analysts have criticized the unfettered rush toward school choice in the formerly Soviet republics, arguing that it will exacerbate social tensions in polarized societies. The underlying concern is that in the absence of national controls, school curriculums will be divisive and parochial, and an essential role of the state—social cohesion—will be undermined.

5.47 Indeed, greater use of market mechanisms must be accompanied by effective regulatory capacity. As discussed in Chapter 4, this is not always easy to achieve. The difficulties of regulation are even more daunting in the social sectors than in infrastructure. For instance, the private delivery of health care services is unregulated in many developing countries because regulating a large number of small-scale providers is beyond the capacity of most of these countries (Brazil is a notable exception).

Contracting out to the private sector and NGOs

5.48 Sometimes competition in the market may not be feasible, but contracting out of services to the private sector through competitive bidding may be an option. Contracting has become a prominent feature in many industrial countries. Victoria State in Australia provides a particularly dramatic example—each local council is required to contract at least half of its annual budget through competitive tender, including complex community care services. In the United Kingdom contracting between 1992 and 1996 subjected $6 billion in services to market testing—resulting in annual savings of $900 million and a reduction in the civil service of 20,000 people.

5.49 There are fewer options for contracting out in developing countries, where both markets and state capacities are weak. Still, where outputs are easily specified and direct competition is not possible, competition managed through such contractual arrangements as service contracts, management contracts, leases, and long-term concessions can yield efficiency gains. In Brazil, for instance, contracting out road maintenance to private contractors led to savings of 25 percent over the use of government employees or force accounts. Leases have increased the technical efficiency of water supply in Guinea and the operation of Port Kelang in Malaysia. Indonesia contracted a Swiss firm to handle specified tasks for its customs services, such as pre-inspection and valuation of imports and collection of import duties. Customs clearance times improved dramatically and import duty collections jumped; anecdotal evidence also suggests a significant reduction in bribes.

5.50 Governments are also contracting out the delivery of social services, especially to NGOs. Even though outputs are difficult to specify, governments have used NGOs where they have been perceived to be committed to high quality or where they can serve certain groups better because of their religious or ideological orientation (for example, schools in the Netherlands). NGOs and the private sector have also been used where they offer opportunities for partnerships to improve delivery, especially where state capacity is weak. In Bolivia contracting schooling to a local church is producing promising results (Box 5.5). In Uganda the government is entering into partnerships with NGOs to deliver preventive health care which is normally within the public domain as well as curative health services.

Box 5.5 Contracting NGOs for better schooling in Bolivia

In an experimental program in Bolivia, the government contracted the church-based Fe y Alegria to manage a certain number of mostly secondary public schools. Before agreeing to do so, Fe y Alegria demanded (and received) the right to appoint principals and teachers and to allow teachers to work both the morning and afternoon shifts—rather than the 3.5 hours allotted for instruction in public schools.

In all other ways Fe y Alegria schools are identical to other Bolivian public schools. Although hand-picked, teachers receive little special training and are paid the same salary as other public school teachers. Fe y Alegria schools receive no additional money for books or supplies, and their curriculums and teaching methods are the same as those used in other public schools.

The only comparative advantage Fe y Alegria schools have is an exceptional esprit de corps among students, parents, and staff. Teachers and students flock to Fe y Alegria schools, with many families paying extra school fees for their children to attend them. On the rare occasions when innovative teaching methods

have been tried (such as a math course transmitted over a public radio station), they have also proved popular, both in the schools and throughout the community. This public-private partnership between government and a religious NGO appears to be so successful that the government is studying it as a possible model for national education reform.

5.51 But like regulatory contracts and vouchers, contracting out is not a panacea. In general, contracting is best suited to services whose outputs are easy to specify and where markets are strong so that the effectiveness of alternative suppliers can be readily judged. For activities that are complex or nonroutinized contracting out will inevitably incur higher transactions costs. Further, contracting is prone to corruption and mismanagement, much as are internal contracts within the public sector. The Inspector General of Uganda, to take but one example, reported several instances of fraud in contracts with the private sector, including payments for roads that were never built or maintained.

Improving delivery through the broader public sector

5.52 A large number of services will continue to be delivered through the public sector. For these the challenge is to create an enabling environment that provides incentives for better performance by public sector organizations.

5.53 *Internal competition.* Some industrial countries are experimenting with competitions within the public sector to improve services for which external market competition or contracting out is not feasible. To boost efficiency and quality, several countries are creating internal markets and allowing people to purchase services from alternative public or private providers. In the United Kingdom an internal market has been created within the national health service by transforming local health authorities and general practitioner groups into purchasers of hospital services on behalf of their patients. This arrangement has created competition among hospitals as a decentralized mechanism for reallocating resources.

5.54 Decentralization of delivery to lower levels of government provides another potentially powerful mechanism for introducing internal competitive pressures, particularly for services that provide local public goods with few interjurisdictional spillovers or economies of scale. Local governments are allowed the flexibility to match supply to specific local preferences or demands, while local accountability and interjurisdictional competition in supply provide potential restraints. But as discussed in Chapter 7, appropriate institutional preconditions need to be in place if decentralization is to improve performance.

5.55 *Performance-based agencies.* Called the new public management, some reforms in industrial countries have sought to break up the core public sector into a series of distinct businesses groups or special-purpose agencies. In general, these agencies have clarity of purpose and task, greater managerial flexibility in the allocation of financial and human resources, and greater accountability for results. Sweden and other Nordic countries have long separated cabinet ministries from agencies with specific purposes. In France many state services have recently been established as special-purpose agencies, or

centres de responsabilité. The United Kingdom has moved nearly two-thirds of its civil service into executive agencies charged with specific delivery functions. New Zealand has broken conglomerate ministries into focused business units and separated policy from operations, purchaser from provider, and regulator from operator.

5.56 These changes have been accompanied by substantial devolution of managerial authority and accountability for results. In Australia, Denmark, Ireland, and Sweden detailed and itemized administrative costs have been consolidated into a single-line budget item, making it possible for managers to reallocate resources in accordance with changing priorities and needs. Managers are also being given greater authority over human resources management; in New Zealand and Sweden managers have the right to hire, fire, and set pay within overall bounds. Along with devolution of resources has come more stringent performance requirements. New Zealand has replaced permanent secretaries with chief executives on fixed-term performance contracts linked to the cost-effective production of outputs.

5.57 Among developing countries, Singapore had a headstart in creating focused business units. As early as the 1970s the Singaporean civil service was organized around the concept of statutory boards. Elsewhere, Jamaica has selected eleven pilot agencies for conversion into executive agencies.

5.58 But countries with inadequate controls over inputs and weak capacity need to proceed with caution. The industrial countries that have now relaxed detailed control over inputs developed credible restraints on arbitrary behavior over a long period of time. For the many countries that have not succeeded in instituting credible controls over the use of inputs, providing greater managerial flexibility will only increase arbitrariness and corruption without commensurate improvements in performance. Further, writing and enforcing contracts, particularly for complex outputs, requires specialized skills that are scarce in many developing countries.

5.59 A recent study of public enterprises found the overall record of performance contracts in developing countries to be disappointing. In particular, there were few credible rewards or sanctions for performance. Managers operated under government-imposed constraints and political interference that seriously limited their autonomy. Governments not only controlled the prices of factors and products and decisions about wages and layoffs, they also strongly influenced whether an enterprise was paid by its customers.

5.60 While performance contracts have not been successful, developing countries have sought to create performance-based agencies for easily specified and high-priority tasks such as road maintenance or tax collection. These agencies are typically set up as enclaves within the civil service, with greater managerial flexibility, better pay and greater accountability for results. In Sub-Saharan Africa, for instance, performance-based agencies have been created to achieve tax collection targets in Ghana, Uganda, and Zambia. Other countries appear ready to follow suit. Enclaving tax collection has been viewed as a prerequisite for improving a government's capacity to raise revenues

(Chapter 3) and improve incentives for the rest of the civil service. Results have been impressive, but the enclaves are not without problems (Box 5.6). While tax revenues have increased, the rest of the civil service has bristled at the benefits provided to the tax collectors.

Box 5.6 A performance-based agency for tax and customs management in Ghana

A performance-based agency approach to tax and customs administration was first used in Sub-Saharan Africa in 1984, when Ghana established of the National Revenue Secretariat. The secretariat was established because tax revenues had dropped drastically, partly because a progressive depression of salaries had drained out high-caliber staff. Staff who remained lacked motivation and performed their tasks in a perfunctory manner. Incentive systems were poor, corruption and absenteeism were common, and the Public Service Commission's hold on recruitment and dismissal often constrained management.

The first step in reforming tax and customs administration involved the creation of two new services: the Internal Revenue Service, responsible for direct taxes, and the Customs, Excise, and Preventive Service, responsible for most indirect taxes. Both agencies are headed by commissioners appointed by the cabinet, with governing boards consisting of a chairman and six cabinet appointees. The controller and accountant-general sits on both boards. The boards are responsible for the collection of all taxes, policy-related management, and all appointments, promotions, and disciplinary action. They draw up service schemes that prescribe the terms and conditions of service and guidelines for remuneration.

A number of measures were adopted to sustain a performance-based culture. Most important, the revenue services were instructed to set targets (agreed with the Ministry of Finance), the attainment or nonattainment of which govern incentive packages. In line with the general belief that low pay feeds corruption and undercollection, the basic salary levels of all staff were raised to levels comparable to those in the private and banking sectors. Professional staff at the Ministry of Finance—alone in the civil service—now get an additional inducement allowance of 12 percent. Revenue officers in the National Revenue Secretariat get an additional 22 percent. In addition workers that achieve agreed targets get a 15 percent bonus on their basic salaries. The National Revenue Secretariat meets its operational expenses by retaining a small percentage (on average 3 percent) of revenues collected, and has been able to improve working conditions for its staff. At the same time more than 250 corrupt officials have been dismissed, while others were retired.

This approach appears to have paid off—but not without problems. Between 1984 and 1988 tax and customs revenues increased from 6.6 to 12.3 percent of GDP, mainly because of beter collection. But the rest of the civil service chafed at the special treatment afforded tax collectors, and the Ministry of Finance objected to its loss of authority. The program could not have gone forward without strong support from the top.

5.61 In aid-dependent countries donors have set up project enclaves with their own systems of remuneration and accountability. Often, these enclaves have not been based on any systematic consideration of the nature of the services provided or of the optimal sequencing of institutional reforms. Such enclaves have often created disparities.

5.62 As discussed in Chapter 9, enclaves have often been designed as quick fixes. Though they have sometimes accomplished short-term goals, they can create obstacles to deeper institutional reform. Enclaves can be useful as an experimental stage of reforms to be progressively extended, and as a demonstration that reforms can be effective. Even then, it is important to ensure that systematic criteria are applied in hiving off agencies, such as the ease with which outputs can be monitored in exchange for greater managerial flexibility. Hiving off agencies that produce easily specified outputs (such as tax collection) can be a useful starting point in a sequence of long-term

institutional reforms. But it is no substitute for the longer-term reform needed to create a motivated, capable civil service.

Improving delivery through the core public sector

5.63 Contracting out, setting up performance-based agencies, and ensuring formal accountability for results are not viable options for many services in countries with weak capacities. The challenge is particularly acute for street-level bureaucracies whose operators (police constables, irrigation patrollers, health workers, teachers, extension workers) interact daily with citizen-clients, are geographically dispersed, have substantial discretion, and produce outputs that are difficult to monitor and are not subject to competitive pressures.

5.64 Countries have adopted a variety of approaches to improve delivery of such services. Some have emphasized more clarity of purpose and task and greater predictability in the flow of resources, along with systems of monitoring compliance with rules or procedures (including accountability for the use of financial resources). To lower the costs of monitoring and enforcement, some systems have emphasized building loyalty and esprit de corps to achieve a better congruence between individual and organizational goals. In others, pressure from clients and beneficiaries has been seen as a cost-effective monitoring device for ensuring performance.

5.65 Experience suggests that a combination of mechanisms can be set up to improve incentives for performance. A study comparing irrigation agencies in India and Korea revealed that the Indian organization provided few incentives for people to work conscientiously, while the Korean organization was full of them. Korean irrigation patrollers had greater clarity of purpose and task and were subject to random monitoring from three separate agencies. Supervision techniques in India sought to discover grounds for punishment; in Korea they sought to solve problems. With staff from all parts of the organization traveling frequently up and down the canals in Korea, there was more external pressures from farmers and stronger partnerships for better performance. The successful training and visit system in agricultural extension operates on a similar principle.

5.66 *Performance-orientation and predictability in resource flows.* Even where formal performance contracts are infeasible or have proved unsuccessful, it is possible to introduce greater performance orientation in public sector organizations. An important starting point is greater clarity of purpose and task. Colombia, Mexico and Uganda are introducing performance measurement to orient managers to achieving desired results. While some countries (New Zealand is one) have emphasized goods and services produced (outputs) as performance measures, others (Australia, Colombia, Uganda) are emphasizing the impact of outputs on beneficiaries (outcomes) and ex post evaluation.

5.67 But even with greater clarity of purpose and task, public sector managers will be unable to perform effectively if they face too much uncertainty about the flow of budgeted resources. In many developing countries the budget as approved bears little

resemblance to the budget as implemented. The problem starts in a policymaking process in which there is a mismatch between the resource requirements and availability. This leads to problems downstream, when overextended government departments and services are starved of necessary operations and maintenance funds. A credible medium-term expenditure framework—such as in Australia (see Box 5.2)—provides greater consistency between policies and resources and therefore more predictability in the flow of resources. Malawi and Uganda are in the initial stages of instituting such a framework.

5.68 Several Latin American countries are planning or undertaking measures to leverage enhanced predictability during budget execution for improved performance. On a pilot basis Ecuador plans to guarantee greater reliability in resource flows. In return, managers will report on performance with the understanding that these incentives can be withdrawn if results are not forthcoming. Bolivia and Nicaragua are undertaking similar reforms.

5.69 *Financial and management controls*. Since public sector outputs are often difficult to measure and monitor, financial control and accountability are needed to ensure probity, prevent the poor use or abuse of public resources, and improve service delivery. An expenditure tracking exercise in Uganda revealed that a significant portion of funds allocated for basic social services never reach health clinics or schools, particularly in rural areas. In many countries financial accounts and audits are outdated and inadequate and therefore do not provide credible restraints. Furthermore, too many detailed controls can stifle managerial flexibility and tempt managers to circumvent controls and use nontransparent mechanisms, prompting the imposition of new centralized controls.

5.70 Sound financial control and accountability start with transparency in the use of public resources. Examples of mechanisms that enhance transparency are accounting systems that meet specified functional and performance standards, audit trails to identify individuals using resources, competitive procurement of inputs, periodic reporting and auditing in accordance with specified requirements, and formal review by independent bodies such as an auditor-general and parlimentary committees.

5.71 To improve the transparency and quality of their financial accounting and auditing systems, countries are modernizing their financial information systems to reduce lags and improve the reliability of financial accounts and audits. Some countries are setting into law the principles of accounting practices, backed by strong professional associations inside government and the private sector.

- Argentina has modernized its financial information system and is posting quarterly financial reports on the Internet to demonstrate its commitment to transparency.

- In China new national accounting and auditing standards are being developed based on internationally accepted standards.

- Standards and laws are being complemented by professional associations of accountants and auditors in Kazakstan and Moldova, which have active Accountants and Auditors Associations.

- In Indonesia the quality of university faculties in accounting is being strengthened through advanced degree programs abroad as well as in-country training.

- Several countries in Latin America are adopting integrated financial management systems that improve the quality of financial management information by integrating information from budgeting, accounting, cash and debt management, and internal and external audits. Bolivia has established a fully integrated national system of accounting. A review found government audits to be of better quality than those of several private firms.

5.72 Although systematic evidence about the effects of these reforms is not available, some useful policy lessons can nevertheless be gleaned. Modern, computer-based information systems can improve both transparency and strengthen aggregate controls while reducing the need for transaction-specific controls. Experience from some Latin American countries suggests that automating data entry and retrieval can enhance timeliness and reliability, facilitate consolidation of accounts and public dissemination, and ease the task of generating reliable audit trails by building appropriate checks and balances into the software itself. Input controls can be broadened sequentially as systems and trust are built up, moving away from detailed, ex ante line-item controls to broader budget categories, broader-band salary scales, and greater latitude in procurement and recruitment. The shift from ex ante to ex post transaction-specific input controls proceed carefully and only as controls over budgetary aggregates are improved, as executing agencies demonstrate that they can be trusted with greater autonomy, and as ex post controls build up through strengthened accounting and auditing capacities.

5.73 But experience also suggests that moving from a highly centralized, transaction-specific, control regime to a more decentralized one can encounter resistance. For instance in Ecuador a 1995 plan to devolve payment controls has yet to be implemented, largely because of central agencies' fears of fiscal indiscipline. Trust needs to be built up first by strengthening systems of performance measurement and ex post input controls. As the systems become more credible, there will be less resistance to the changeover and managers can be provided greater flexibility with stronger accountability for results.

5.74 *Loyalty, motivation, and competence.* Better systems of monitoring, accounting, and auditing alone may not improve the delivery of many services. Mechanisms for enhancing the loyalty, motivation, and competence of the civil service are also needed. Loyalty promotes staff identification with an organization's goals and a willingness to take a longer-term view of responsibilities. Loyalty is essential in the core public sector, where activities are not easily specifiable or monitorable, and exit has no

meaning. The U.S. Forestry Service has worked to build a sense of commitment to shared objectives among its staff, a quality deemed critical to effective performance given the isolated nature of the job, the geographical dispersion of the forest rangers, and the lack of specificity of outputs.

5.75 More generally, the civil services in France, Germany, Japan, and Singapore all sought to ensure that the loyalties of a small group of people were fundamentally aligned with the interests of the state. Job security in the civil service was meant to foster this alignment of interests. This notion has worked in some contexts but not in many others. As discussed in the next section, the experience of successful countries suggests that building this commitment and motivating and attracting capable staff require long-term career rewards, adequate pay, and mechanisms to instill an esprit de corps.

5.76 *Strengthening mechanisms of voice.* Instituting credible bureaucratic controls takes time. Where internal monitoring and enforcement capacity are weak, clients and beneficiaries—or voice—can provide potentially powerful pressures to improve performance and help reduce the costs of monitoring until these capacities are built up. Partnerships or co-production with the community in the provision of the services, even indirectly, creates stronger incentives to press for better service. Feedback mechanisms such as the client surveys used in India, Nicaragua, and Uganda increase transparency and improve accountability by making more people aware of the agency's performance,. Citizen charters, or public commitment to minimum standards of service provision—as applied in Belgium, Malaysia, Portugal, and the United Kingdom—can provide external and internal pressures to meet performance targets and help focus the attention of clients and staff on service quality. Issues pertaining to voice and participation are discussed in Chapter 7.

Building Motivated, Capable Staff

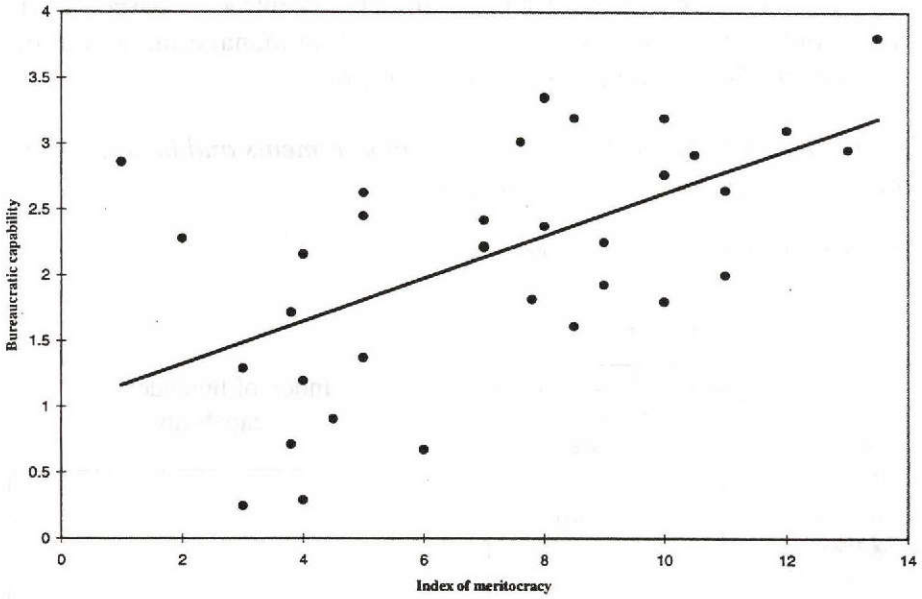
5.77 Whether making policy, delivering services, or administering contracts, capable and motivated staff are the life blood of an effective state. Efforts to build a competent and motivated, civil service usually focus almost exclusively on pay. But other elements are also vital, including merit-based recruitment and promotion and esprit de corps. Meritocratic recruitment and promotion restrain political patronage and introduce competitive pressures to attract and reward more capable staff. Esprit de corps encourages identification with an organization's goals, reduces the transactions costs of enforcement, and builds internal partnerships and loyalty.

5.78 A recent cross-country research study helps show why these measures matter. The study constructed an index representing meritocratic recruitment and promotion and adequacy of pay based on an examination of institutional arrangements in thirty countries. The index is correlated with economic growth as well as with investors' perceptions of bureaucratic capability, even after controlling for the effects of income and

education (Figure 5.5). Putting in place institutional arrangements for recruiting and motivating capable staff can yield high payoffs.

Meritocracy enhances bureaucratic capability

Figure 5.5 Meritocracy and bureaucratic capability



Note: Controls for income.
Source: Evans and Rauch 1996.

Merit-based recruitment and promotion

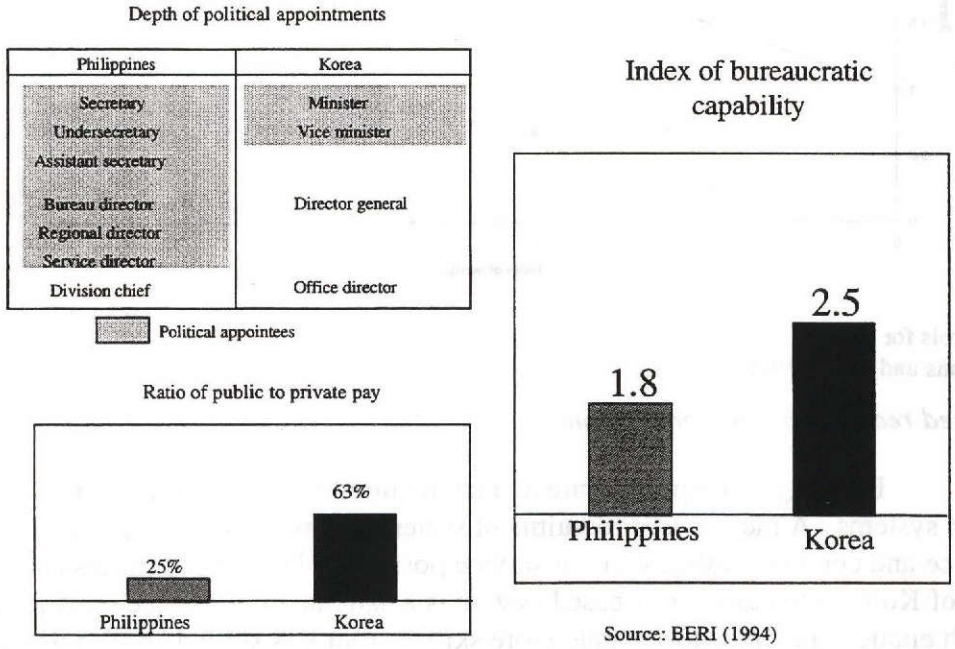
5.79 Building a competent bureaucracy requires merit-based recruitment and promotion systems. A merit-based recruitment system brings high-quality staff into the civil service and confers prestige on civil service positions. In many countries (Japan, Republic of Korea) the basic merit-based system is a national civil service entrance exam with tough enough standards to separate more skilled from less skilled applicants. In some countries, school performance is the primary filter. In Singapore, for example, recruitment is based on high standards of academic performance and rigorous personal interviews. Some countries require a graduate degree from a reputable university. Others relay on a combination of exams, school performance, and graduate degrees.

5.80 A merit-based promotion system is also essential for motivating high-quality performance. That includes specifying clear objectives and criteria for upward mobility and offering long-term career rewards. When promotions are personalized or politicized, civil servants focus instead on pleasing their superiors or influential politicians, and efforts to build prestige through tough recruitment standards are undercut. In Korea, for instance, promotion is based on a formula that combines seniority with merit-based elements. In India promotion is determined by seniority alone.

5.81 Many countries have had trouble instituting meritocratic recruitment and promotion systems. Brazil, Mexico, Peru, and Venezuela, for instance, have been unable to do so except in isolated enclaves, partly because political appointees are granted extensive powers. In many countries the state thus becomes a massive source of jobs recruited on the basis of connections rather than merit. In East Asia political appointments are more common in the Philippines than in neighboring high-performing economies like Korea (Figure 5.6). In Kenya political appointments based on tribal allegiances have contributed to overstaffing and expanding managerial tiers in the state-owned Kenya Post and Telecommunications Corporation.

The Republic of Korea's reliance on merit-based appointments and better pay has made its bureaucracy more capable than the Philippines

Figure 5.6 Bureaucratic competence, meritocracy and pay



5.82 Even countries that have managed to install merit-based recruitment and to limit political appointments can suffer from rampant political interference (through transfers). An absence of merit-based promotion can also erode incentives for performance. The Indian civil service provides a clear example: senior civil servants are transferred frequently, and seniority is the only basis for promotion (Box 5.7). As a result the once-legendary Indian civil service is no longer perceived as a model of efficiency, effectiveness, and integrity.

Box 5.7 India—An elite civil service gasping in the political winds

The Indian Administrative Service (IAS), successor to the Indian Civil Service (ICS), the legendary "steel frame" of the British Raj, is today battling onslaughts to its relevance.

The Service's strengths lie in its extraordinary pool of skills and talents, its field experience, and its understanding of government functionings. Among its weaknesses are the rancor it has generated among other services at the central and state levels, the flourishing corruption among its employees, the increasing rarity of impartial policy advice, political and caste alignments, incompetence going unpunished and initiative unrewarded, and the "transfer industry" in some states (where the average tenure of field officers may be as low as eight months).

The ICS (never more than 500 at its peak) was an elite service entrusted with the administration of the British Empire in India. The IAS (numbering about 3,500) has a much wider and more challenging role as an agent of change. The recruitment process, designed to select about 70 recruits from about 200,000 applicants, is one of the most competitive and objective in the world. Excellent recruits are drawn from across the social and educational spectrum. Critics, however, have questioned the system's efficacy because the IAS is staffed by generalists who are less skilled than the technical specialists who are recruited into East Asian bureaucracies.

Overrecruitment to the IAS and other services in the 1970s and 1980s has generated massive congestion within the ranks unnecessary creation of posts to accommodate officers, and frustration among officers, compounded by a sharp fall in living standards relative to the private sector and in real terms. The erosion of pay and standards, combined with the far-reaching economic reforms introduced in 1991, are making the private sector—not the IAS—the coveted destination of young graduates.

5.83 Merit-based recruitment and promotion systems are of two broad but not mutually exclusive types: mandarin systems and open recruitment. Mandarin systems, such as those found in France, Germany, and Japan, are closed-entry, hierarchical systems with highly competitive entrance requirements (Box 5.8). These systems are good at grooming elite cadres but less effective at developing talent in the lower ranks. Open recruitment systems such as in New Zealand, the United Kingdom, and the United States, provide a more flexible, decentralized, and increasingly market-driven system of civil service recruitment. While offering more flexibility in allowing managers to match job requirements with skills, including hard-to-find technical expertise, such systems can make it difficult to maintain professional standards and esprit de corps.

Box 5.8 Recruiting and grooming the best and the brightest: Mandarin and open systems

Countries have adopted two broad approaches to meritocratic recruitment: "mandarin" or closed-entry, hierarchical systems; and open recruitment systems with lateral entry and more flexible entry mechanisms.

Mandarin systems foster the notion of a "chosen elite" in government service. Highly selective recruitment takes place on a centralized basis, generally ensured by rigorous entrance examinations and high test scores. Upon entering the service, elite cadres, who are mainly generalists, are placed on a fast track into the best jobs in government. But they are mainly hired into a career stream or corps rather than specific jobs. France and Japan best exemplify the mandarin recruitment system. At France's National School of Administration, elite civil servants are put through a one-year professional internship followed by fifteen months of coursework for high-profile careers in government. Japan's Tokyo University produces Japan's administrative elite, most of whom have law-generalist backgrounds that may be supplemented through in-service technical training. Variants on this elite grooming system are found in Singapore, where two-year "cadetships" rotate promising recruits, or in Germany, where a "practicum" offers a practical, on-the-job internship for potential elite cadre candidates.

Open recruitment systems emphasize more flexible, decentralized, and increasingly market-driven civil service recruitment. The U.S system stands in stark contrast to elite models, permitting horizontal entry without age restrictions and providing considerable interclass (though not necessarily interagency) mobility. It has replaced its centralized competitive entrance exams with profession-specific exams and granted more autonomy to individual managers in hiring. The United States, like Australia, counters its horizontal recruitment mechanisms with a Senior Executive Service aimed at building an elite group from within the civil service. The boldest approach to open recruitment and career development is found in countries pursuing the new public management reforms that have devolved recruitment responsibilities even further. In New Zealand, for example, agency managers can hire staff at market salaries.

Mandarin, elitist models have drawbacks when applied in countries lacking high-quality general education systems. But countries with critical shortages of well-qualified human resources may find mandarin systems useful as the basis for a selective rather than a comprehensive approach to personnel development. Moreover, a prestigious elite can have spillover effects in motivating other parts of the civil service.

More open recruitment systems give managers greater flexibility in matching job recruitments with skills, including hard-to-find expertise. They provide better motivation to lower-level employees who aspire to higher-level positions. And open systems discourage civil service insularity by bringing in staff with fresh perspectives and ideas. The downside is that professional standards are less easy to maintain across the service, as in the core set of common public service values or esprit de corps.

Adequate compensation

5.84 Building prestige through merit-based recruitment and promotion makes employment in the civil service attractive. But if compensation in the public sector trails far behind that in the private sector, prestige alone will not make up for the difference.

5.85 A rough benchmark for evaluating the adequacy of public sector compensation is the relative differential between public and private sector compensation, with some discount for the greater security of civil service employment. Comparing public and private salaries is made difficult by the need to take into account differences in nonsalary allowances, job requirements, and the like. In general, though, civil servants nearly everywhere are paid less than their private sector counterparts. Singapore stands at one extreme, with public sector salaries that average 114 percent of private sector salaries and are higher than equivalent salaries of senior officers in the United States. In the Philippines, public pay averages 25 percent of private wages; in Somalia, 11 percent. In Kenya the disparity between public wages grew by 3 percent a year during 1982-92. Contributing to the erosion of public sector wages were fiscal austerity measures during the 1980s that tended to lower real wages rather than employment. A study of twenty-seven countries over 1972-92 found that government wage bills have been reduced primarily by lowering real wages rather than by cutting employment.

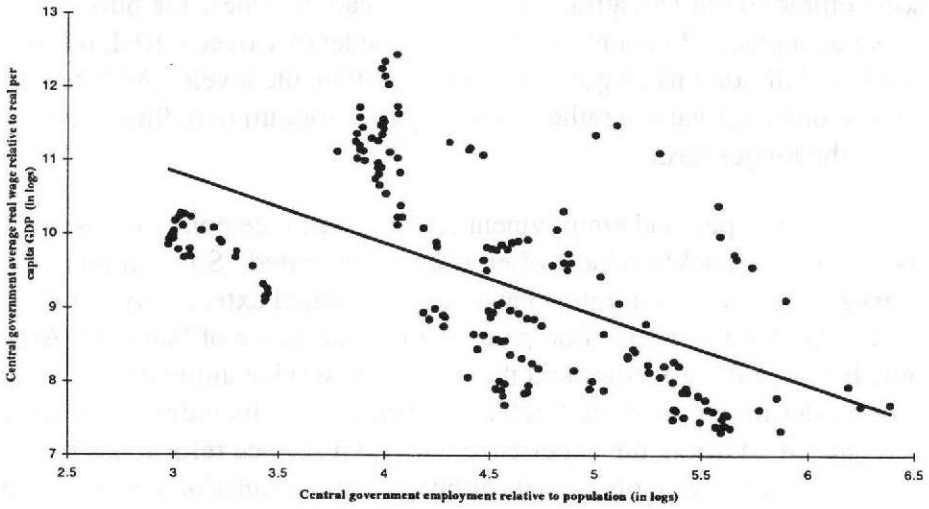
5.86 In addition to the overall erosion of public sector wages relative to the private sector, a central problem in many developing countries is the low level of remuneration for higher cadres, which makes it hard to attract and retain high-quality staff. Wage compression—whereby the wages of higher-level civil servants are allowed to erode more than the wages of the lower echelons, often for political reasons—is thus a key problem in many countries. A study of ten African countries found that the ratio of

the salaries of the highest- to the lowest-grade civil servants declined from 13:1 to 9:1. Across-the-board increases do not solve this problem.

5.87 In many developing countries in Africa and elsewhere, average wage erosion has been coupled with expanding employment, especially at lower skill levels (Figure 5.7). Governments have become employers of last resort and dispensers of political patronage, offering jobs to family, friends, and supporters. As a result individual wages have often been low even though the overall wage bill has been high. Moreover, growth in the wage bill has often outpaced expenditures on operations and maintenance, leading to the familiar story of teachers without textbooks and extension workers without bicycles.

As public employment has risen, wages have fallen

Figure 5.7 Pay and employment in twenty African countries, 1972-93



Source: Data from Kraay and van Rijckeghem 1995.

5.88 Prompted by a desire to improve public sector salaries and the need to correct aggregate fiscal imbalances, countries have embarked on civil service reform strategies, to reduce employment, decompress the wage structure, and raise average pay. These efforts have met with mixed success. A study of civil service reform efforts between 1981 and 1991, found that wage bill reduction and salary decompression were achieved in less than half the cases. Employment was reduced in more than half the cases, but reversals were sometimes reported later, and the size of the cuts were rarely adequate to finance substantial salary increases for higher-level staff. In Peru, for instance, some 250,000 workers were cut from the civil service over three years, but 163,000 of them were subsequently rehired; in addition, poor targeting of the cuts resulted in the departure of the most qualified staff.

5.89 This mixed and often disappointing experience with civil service reform nevertheless provides some lessons for future efforts. First, strategies for civil service

reforms have focused exclusively on pay and employment issues and within that, on reducing numbers (wage bill and employment). These are important, but so are other complementary elements—reorienting strategic policy priorities, merit-based recruitment and promotion, performance measurement and orientation, mechanisms to improve accountability, and building esprit de corps. In Uganda civil service reform has dramatically reduced the numbers of central government employees (from 320,000 in 1990 to 134,000 in 1996), increased average pay, and decompressed pay scales. To improve performance, however, the focus has now shifted to complementary mechanisms that strengthen the performance orientation of civil servants and increase their acountability. These include greater clarity of purpose and task, measurement of outcomes, and client surveys for key services.

5.90 A more careful sequencing of reforms is called for, starting with wage decompression. Wages at the top of the scale can be raised to attract higher-quality people and concentrate scarce skills in strategic areas, even if wages at lower grades are reduced, making employment less attractive for lower cadres, where the bulk of overstaffing has taken place. In countries that are considerably overstaffed, reforms have been too modest to really downsize governments to sustainable levels. And they have tended to be of the one-shot variety rather than a steady program to redimension government over the longer term.

5.91 Inevitably, pay and employment reforms will face political obstacles, although fears of political backlash have often been exaggerated. Some countries have viewed civil servants as partners in reform and have consulted extensively with them to find politically acceptable solutions. For instance in the province of Santa Fe, Argentina, a close dialogue between the governor and the local civil service union helped in agreeing on measures for modernizing provincial public administration, including expenditure cuts of some 10 percent. In addition, the experience with civil service reform has helped develop a good set of technical tools—civil service censuses, functional reviews, the design of severance packages—for managing and implementing the process more effectively. But civil service reforms will generate losers, who can be important constituencies of the political leadership and therefore a force to be reckoned with. The political economy of reforms is discussed further in Chapter 9.

Building esprit de corps

5.92 Effective and capable bureaucracies have a shared commitment to an organization's objectives. This esprit de corps includes a common understanding about what is desirable and undesirable behavior, manifested in formal and informal norms and grounded in some set of objectives, and a devotion to upholding the honor of the group based on this common understanding. An esprit de corps creates internal partnerships or a high degree of coherence among group members, gives them a strong sense of purpose and belonging, and imposes self-discipline that guides members toward achieving the group's objectives. In many ways esprit de corps is a manifestation of a large amount of social capital. King Arthur's Knights of the Round Table, the samurai in Japan, and even the mafioso of past generations all embodied some form of esprit de corps. A few of

today's civil services are said to do so as well, including those in Chile, France, Germany, Japan, the Republic of Korea, and the United Kingdom. Most bureaucracies do not however.

5.93 It is not impossible to develop esprit de corps among civil servants. Singapore's civil service is well known for its coherence and sense of purpose, characteristics that barely existed in the early 1960s. In just three decades the country's civil service evolved into one of the world's most reputable. Getting there has been difficult, but the steps have been straightforward. Prospective recruits are taken from the top 200 (less than 5 percent) of the graduating class at the National University of Singapore (and more recently, the Nanyang Technological University) and put through a one-year training program. Their education and training give the recruits a common understanding of what is expected of them as a civil servant and helps build trust among them. The meritocratic promotion system gives officials a stake in achieving the goals of the agency. The single-mindedness of the leadership and its continuous efforts at imbuing the civil service with its desired values help strengthen the bond between civil servants. Some of the lessons from Singapore are being transferred to Botswana through twinning arrangements that emphasize teamwork and group performance as key ingredients of successful performance.

5.94 Worker dedication and commitment are not confined to industrial countries or to East Asia. In Brazil's poor northeast Ceara region, steps to increase worker commitment dramatically improved the quality of public services delivered (Box 5.9). The state government promoted a sense of "calling" among workers and

Box 5.9 Building worker dedication to the job—good government in Ceara, Brazil

In 1987 the state government of Ceara, Brazil confronted a crippling fiscal crisis and a legacy of mediocre performance. Yet within four years, the fiscal crisis had been overcome and the quality of services improved dramatically. Vaccination coverage for measles and polio more than tripled, from 25 percent to 90 percent of the child population. The public works construction program employed more than one million unemployed farmers during droughts. And the business extension and public procurement program for small firms saved more than 30 percent over its previous purchases.

Much of the credit for this success is owed to the civil service. The state government contributed in an unusual and sometimes inadvertent way to public workers' new-found dedication. It created a strong sense of "calling" and mission around key programs and their workers. It did so using public information campaigns, rewards for good performance, public screening methods for new recruits, orientation programs, and sheer boasting through the media about its successes. At the same time workers carried out a larger variety of tasks than usual, and often voluntarily. Workers were able to provide more customized service because they had greater autonomy and discretion. Greater discretion did not result in greater opportunities for rentseeking. This was because of two other mechanisms—hemming in and new pressures to be accountable. On the one hand workers wanted to perform better in order to live up to the new trust placed in them by their clients. This in turn was the result of the more customized arrangements of their work and the public messages of respect from the state. On the other hand the communities where these public servants worked monitored them more closely. The state's publicity campaigns and similar messages had armed citizens with new information about their rights to better government and about how public services were supposed to work. Thus government played a powerful role in monitoring, but it did so indirectly.

These mechanisms created a virtuous cycle in which workers in Ceara reported feeling more appreciated and recognized, not necessarily by superiors but by their clients and the communities where they worked. This, in turn, reinforced their dedication to the job.

conferred new prestige on their jobs. These feelings were reinforced by innovative practices such as worker participation and self-managed worker teams, multitasking, and flexibly organized or specialized production. These practices involved greater worker discretion and flexibility, greater cooperation between labor and management, and greater trust between workers and customers. Such experiences also underscore the importance of intangible rewards—recognition, appreciation, prestige, and awards—in motivating staff, over and above the adequacy of pay and meritocratic recruitment and promotion.

Conclusion: Toward an Effective Public Sector

5.95 Building the institutions for an effective public sector is essential for enhancing state capability. But this focus on institutions is very different from the traditional approach of technical assistance projects, which emphasize equipment and skills and administrative or technical capacity. The emphasis here is on the incentive framework that guides the behavior of government agencies and officials. Reforms need to focus on creating incentives for public officials to act in the public interest, while restraining arbitrary action.

5.96 Some developing countries have been unable to institutionalize the basic underpinnings of a professional, rule-based bureaucracy. An important priority is to establish the credibility of rules and reduce the deviation between informal norms and formal rules. This includes getting hard budget limits, implementing policies (for example, budgets) as approved, making the flow of resourses predictable, instituting accountability for the use of financial resources, and restraining on political patronage in personnel policies.

5.97 Where these preconditions are absent, the new public management reforms must be introduced cautiously. If informal norms deviate significantly from formal rules (for instance, in budgets or personnel practices), introducing new formal rules will not by itself change incentives. Where countries have been unable to institutionalize credible controls over inputs, giving managers greater flexibility will only encourage arbitrariness and corruption. And introducing performance and other output-based contracts will make stringent demands on scarce capacity to specify and enforce contracts for complex services. Nevertheless, countries can begin by providing greater clarity of purpose and task and by introducing performance measurement on a selective, sequential basis. When output measurement is strengthened and credible ex post controls over inputs are instituted, managers can be granted more operational flexibility in exchange for greater accountability for results.

5.98 Instituting a professional, rule-based bureaucracy will take considerable time. In the meantime, some other measures can be implemented more quickly, and some of these measures can even generate early payoffs. Public sector capability can be enhanced by promoting more competitive pressures and partnerships in policymaking and service delivery.

5.99 Well-functioning policymaking mechanisms make transparent the costs of competing policies and encourage debate and consultation among all stakeholders. Using competitive markets for contestable services can lower the costs of delivery and improve service quality. And contracting out easily specified activities through competitive bids can reduce the burden on overstretched capacity and build partnerships with markets and NGOs to improve efficiency. Voice mechanisms and other feedback from clients can help generate external pressures for better performance while internal capacity and enforcement mechanisms are built up.

5.100 None of these measures free the public sector from the need to regulate markets and enforce contracts. No longer a direct provider the public sector must become a partner and facilitator. And that requires attracting and retaining capable staff. Rule-based restraint on political patronage in recruitment and promotion, and more competition through meritocracy will be necessary to build this capability. In countries where rapid employment expansion took place at the lower levels, reforms to reduce employment are inevitable. Raising upper-end salaries to attract capable staff can be done even within constrained wage bills by reducing wages at the lower end of the scale.

5.101 There is bound to be some opposition to these reforms by those who stand to lose. But as discussed in Chapter 9, windows of opportunity for reform can open and widen. Reform-minded governments should seize these opportunities to build consensus, address the obstacles to change, and initiate and sustain reforms to build an effective public sector.

Chapter 6 Restraining Arbitrary State Action and Corruption

6.1 An effective state can make a powerful contribution to sustainable development and poverty reduction through the collective actions it undertakes. But there is no guarantee that state intervention will benefit society. Given its monopoly on coercion, the state has the power to intervene arbitrarily in economic activities. Combined with the pervasive problems of asymmetric information within the state apparatus, this power creates opportunities for public officials to engage in actions—rent seeking and corruption—that promote their own (or their allies') welfare over the general public's. Thus the task of building state institutions is to establish and nurture mechanisms that provide flexibility for state agencies to intervene when appropriate and create incentives for public officials to act in the public interest, while restraining arbitrary state action and corruption.

6.2 Chapter 5 focuses on building the capability of the public sector or the executive. This chapter discusses broader mechanisms to restrain arbitrary state action and corruption. The first section examines mechanisms of checks and balances within the state—such as judicial independence and separation of powers—that promote the credibility and accountability of the state and serve as formal instruments of restraint. The second section analyzes of the causes of corruption and proposes some remedies.

Formal Checks and Balances

> *In framing a government to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.*
>
> — James Madison, Federalist 51

6.3 Restraining the potential use and abuse of state power is a big challenge for state reform. An even bigger one is to do so in a way that allows flexibility in the actions of the state's agencies. The misuse of state power creates serious problems of credibility. Uganda's expropriation of properties and harassment of capital-owning and entrepreneurial Asian minorities under Idi Amin let a legacy of distrust that initially created enormous problems for the current administration when it tried to attract private investment. In Chile more than a decade of painstaking institutional change was required following Allende's nationalization of industries and firms during the 1970s to convince the private sector that investing in Chile would be profitable over the long term.

6.4 Arbitrary and capricious state actions undermine more than a state's credibility. They undermine the rule of law more broadly by weakening the force of whatever rules the state has set in place. They foster conditions that encourage state officials to place themselves "above the law" and that tempt others in society to circumvent the laws. Under these conditions, development bogs down.

Instruments of restraint

6.5 Sustainable development generally calls for formal mechanisms of restraint that hold the state and its officials accountable for their actions. To be enduring and credible, these mechanisms must be anchored in core state institutions or, if institutions are too weak, international mechanisms that can substitute temporarily. The two key formal mechanisms of restraint are a strong, independent judiciary and the separation of powers.

6.6 *Judicial independence and effectiveness.* Sustainable development requires institutional arrangements for resolving disputes among firms, citizens, and governments—clarifying residual ambiguities in rules and enforcing compliance. Although societies have devised a broad array of formal and informal mechanisms to resolve disputes, formal judiciaries hold a unique position because of their special relation to the state. They alone have access to the coercive authority of the state apparatus to enforce their judgments. And, they alone have the formal authority to rule on the legality of actions by the legislative and executive branches. This special relation to the state puts the formal judiciary in a unique position for holding the executive and the legislative branches accountable for their decisions and for underpinning the credibility of a country's business and political environment—and thereby supporting sustainable development. Whether judiciaries actually play this role depends on whether three key requisites of effectiveness are in place: judicial independence, judicial enforcement, and efficient judicial organization.

6.7 Judicial independence is the most important source of restraint. Whatever the precise character of judicial relations with the legislature and the executive, all industrial countries—and many developing countries—rely on the judiciary to hold the executive authority accountable under the law and to interpret and enforce the terms of a written constitution.

6.8 India provides a striking recent example of judicial authority as it extends to the other organs of the state. Since January 1996 India's Supreme Court has ruled on a series of cases brought by citizens to direct the executive on issues ranging from removing garbage in Delhi to shutting down polluting industries and endorsing the method of privatizing telecommunications. In addition, the court has found against the government in high-profile cases involving corruption. But some people now argue that judicial activism has overstepped constitutional bounds, and is excessively restraining the executive's freedom of action.

6.9 Judicial independence has repeatedly been compromised in some countries, and in no country has the judiciary been immune from political efforts to override its decisions. Legislatures and executives have used a variety of strategies to rein in their judiciaries:

- Judges of the Superior Court in Malta were suspended one hour before a case challenging executive actions was to be heard.

- Successive Pakistani governments in the past chose to appoint temporary judges, whose lack of tenure made them more vulnerable to political influence.

- Though the Ukraine constitution declares that courts are independent of the executive, judges remain largely dependent on local authorities for their housing. Judges who have ruled against city officials in housing disputes appear to be particularly susceptible to long delays.

6.10 Judicial effectiveness also depends on the power of enforcement. In practice that means that other branches of the state must make unequivocally available the instruments for effective enforcement, including court staff authorized by law to serve court documents, to seize and dispose of property, and to turn the proceeds over to the winning party. In many countries this enforcement capability is constrained. In Poland, for instance, bailiffs are not under the control of judges but are employed by the Ministry of Justice. Thus, though judges are competent and reasonably efficient, enforcement is slow and often ineffective because the number of bailiffs has not kept pace with the rising caseload.

6.11 The development of relationships among the judiciary, legislature, and executive that ensure judicial independence and reliable enforcement is a gradual process. Studies show that private sector confidence in the rule of law increases with each year a stable regime remains in place. More broadly, as Box 6.1 illustrates for Peru, the success of third party mechanisms for enforcement depends in large part on citizens viewing the mechanisms as legitimate. In countries where judicial institutions are weak, it may be at least as important to demonstrate to citizens and firms the potential benefits of a well-functioning judiciary and to win support for good laws and impartial enforcement as it is to proceed with wholly technocratic programs of judicial reform.

Box 6.1 How popular participation improved property rights and dispute resolution in Peru

Until 1989 Peruvians living in marginal urban settlements and rural areas did not enjoy the security provided by formal ownership of their real property (70 percent of the population in urban areas and 80 percent in rural areas). The traditional system of property registration (Registro de Propiedad Inmuebile) was run by the Ministry of Justice, and conflicts were resolved by the judiciary. The system was perceived by poor urban and rural owners as a system for the rich, who could better afford the high transactions costs.

In the early 1980s, an NGO, the Institute of Liberty and Democracy (ILD), began a campaign to improve the property rights of poor Peruvians. ILD began with extensive public hearings to collect complaints, identify reasons why citizens do not formally register their property, and provide information on the potential benefits and costs of registration and secure property. The ILD coupled this participatory process with a study of the laws and regulations governing property registration and enforcement. Based on its diagnosis, the ILD developed concrete proposals for reform—that were publicly debated and fine-tuned starting in 1986. Although the professional monopolies—such as lawyers associations and notaries—who held a stake in the old system, strongly opposed the proposed reforms, community-level support carried the debate.

In 1989 a new formal property registration system was enacted into law. The new system dramatically reduced transactions costs and uncertainty by reducing the power of the professional monopolies. Instead the system uses community norms, such as neighbors vouching for a party's ownership claim, to establish property rights and resolve conflicts. Subject to administrative requirements specified by the law, any

lawyer is permitted to serve as a third party verifier, sign the property titles, and resolve conflicts in the field. Contested or complicated cases are resolved by the new system's chief registrar—appointed by the Ministry of Housing, not the judiciary. Only after these mechanisms have failed can the conflict be taken to a judge.

By 1994 the new system (Registro Predial) had registered nearly 120,000 entries. Between 1994 and 1996 it registered an additional 170,000. Spurred by its demand-driven design, the system continues to evolve, and initiatives are under way to expand it nationwide.

6.12 The third component of judicial effectiveness is the organizational efficiency of the judiciary, which is needed to avoid long delays in clearing cases. A case takes an average of 1,500 days to clear in Brazil and Ecuador, 700 days in the United States, and 100 days in France. Although severely long delays raise the transactions costs for dispute resolution and may block access for some potential users, the internal effectiveness of the judiciary is less critical than judicial independence and enforcement. As discussed in Chapter 3, despite cumbersome and costly procedures judicial judgments can strengthen credibility in countries as long as the decisions are perceived to be fair.

6.13 *Separation of powers.* Judiciaries may be capable of enforcing rules, but if the public has little faith in the stability of rules, the state's credibility can be compromised. The classic constitutional mechanism for restraining legislative change is horizontal or vertical separation of power.

6.14 Power can be divided horizontally among the judiciary, the legislature, and the executive and vertically power between central and local authorities. The patterns of a country's political party organization—from a small number of highly disciplined parties to a large number of parties whose members hew only loosely to a vaguely defined party line and that can govern only by forming multiparty coalitions—also influence the extent to which political power is concentrated or diffused.

6.15 The broader is the separation of powers, the greater will be the number of veto points to be navigated to change any rule-based commitments. Thus, the separation of powers increases confidence in the stability of rules. Multiple veto points can be a double-edged sword, however, since they make it hard to change not only beneficial rules, but harmful ones as well.

6.16 In many developing countries there are few effective checks and balances on the actions of political leaders, even where there is formal separation of powers. In some countries legislative oversight is weak because of poor capacity and inadequate information. In others the executive dominates a compliant legislature. But as with the development of a well-functioning judicial system, the formal elaboration of constitutional checks and balances or their more effective institutionalization is a gradual process.

6.17 *International mechanisms.* To some extent international restraints can substitute for limitations in the ability of national institutions to enforce rules or to credibly signal that rules will remain reasonably stable over time. One option is to use international adjudication to underpin the domestic judicial system. Confidence in the

Jamaican judicial system is buttressed by the fact that the United Kingdom's Privy Council serves as its appellate court of last resort. Because of the weaknesses of the Philippine judicial system, many firms (domestic as well as foreign) prefer to adjudicate their contracts offshore. In Singapore private arbitration services have developed precisely for that purpose.

6.18 Cross-border agreements are a second mechanism for strengthening commitments for which there is no firm domestic institutional anchor. On the trade front examples include the European Union and the North American Free Trade Agreement; on the monetary front the West African franc zone and perhaps over the next decade the European Union. To be sure, sovereign countries can still reverse course on, say, trade or monetary policy by withdrawing from multicountry agreements. But they would have to calculate not just the benefits and costs of the policy reversal but also the broader costs of reneging on an extraterritorial commitment for which their partners will hold them accountable. For most countries the threat of international censure means that they will be less likely to reverse course.

6.19 Agreements with multilateral organizations, such as the International Monetary Fund or the World Bank, that include policy "conditionality" can have a similar function for some countries. These conditionalities can be viewed as a sign of national commitment to the policies that are included as conditions. Countries with weak domestic commitment mechanisms can strengthen their credibility by binding themselves to pay a penalty should they reverse course. World Bank guarantees, by performing this same kind of commitment function, hold the promise of accelerating the flow of private finance to developing countries.

Building in flexibility

6.20 Instruments of restraint are a vital foundation for sustainable development. But they must be complemented by institutional arrangements that build in flexibility for the executive branch in formulating and implementing policies and adapting to new information and changing circumstances.

6.21 As discussed in Chapter 5, countries have tried a variety of institutional arrangements to promote both flexibility and restraint. Some arrangements—such as deliberation councils in East Asia and the Administrative Procedures Act in the United States—delegate substantial autonomy to executive agencies to define the substance and implementation of policy. But they also require these agencies to follow processes that introduce inputs and oversights by other arms of the state and civil society. Other arrangements rely on internal mechanisms within the executive branch to promote flexibility within restraints. These include the devolution of managerial authority to executive agencies within set budgets and performance targets or specified rules for financial accountability.

6.22 But even if bureaucracies are embedded in processes that provide ample opportunities for others to contribute inputs and oversight, the risk remains that individual officials will pursue personal rather than organizational goals. Self-seeking behavior can degenerate into corruption when private interests wield their influence illegally and secretly and so can circumvent the legal and bureaucratic requirements that are meant to restrain such behavior. It is to these and other related issues of corruption that we now turn.

Controlling Corruption

> *A Congressional appropriation costs money.... A majority of the House Committee, say $10,000 apiece—$40,000; a majority of the Senate Committee, the same each—say $40,000; a little extra to one or two chairman of one or two such committees, say $10,000 each. Then seven male lobbyists at $3,000 each; one female lobbyist, $10,000; a high moral Congressman or Senator here and there—the high moral ones cost more.*
> — A U.S railroad company owner in Mark Twain and Charles Warner, *The Gilded Age: A Tale of Today* (1877)

6.23 Mark Twain's damning tale was a thinly veiled caricature of corruption in the U.S. Congress in the 1870s. Twain's novel followed closely on the heels of the infamous Crédit Mobilier scandal, in which two prominent businessmen brazenly bought their way into the U.S. Congress. This past year in India a blockbuster movie, *Hindustani,* expressed an extreme form of popular outrage over corruption. The movie depicts horrific tales of callous politicians, bureaucrats, and policemen willing to let patients die and poor pensioners starve unless state officials are paid their (un)due share.

6.24 Fiction thrives on exaggeration. But it is also a mirror that society holds up to itself to reflect entrenched problems. These tales—a century and continent apart—suggest that corruption is neither new nor confined to a particular corner of the world. They also suggest a problem that has deeply affected the lives and imaginations of citizens and businesspeople the world over.

6.25 Today, citizens demand of their officials greater probity and the new transparency in domestic and global markets brings corruption more quickly to the public eye. In the past few years allegations of corruption have contributed to the fall of governments throughout the world. Two ex-presidents of the Republic of Korea have been prosecuted and indicted. The ex-president of Brazil has been impeached on charges of corruption. In Belgium in October 1996 more than 250,000 people protested against the government's handling of a pedophile ring and alleged corruption in judicial appointments and enforcement. And a fierce debate has erupted over campaign finance and its influence on public policy in the aftermath of the 1996 U.S presidential election.

6.26 Corruption is the abuse of public power for private gain. It is symptomatic of the more general problem of perverse underlying incentives. Corruption flourishes

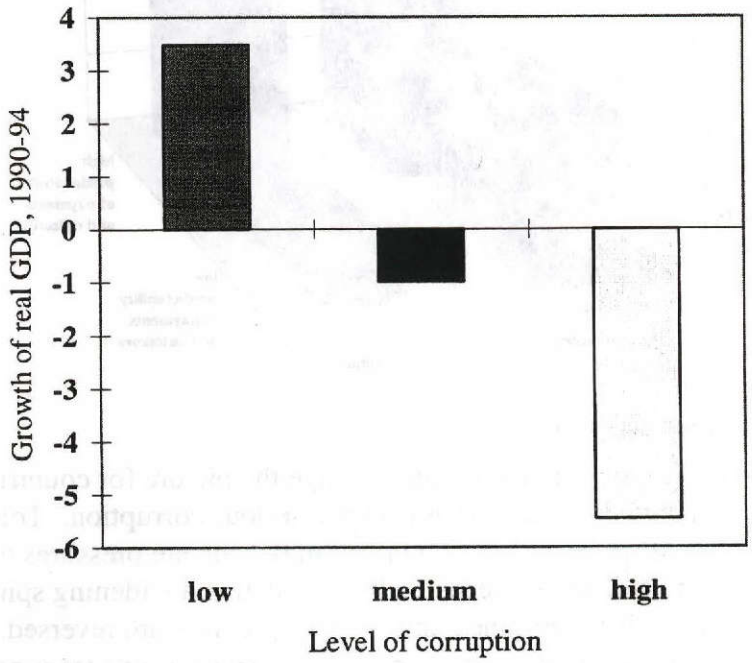
where distortions in the policy and regulatory regime provide opportunities for it and where institutions of restraint are weak.

6.27 Corruption violates the public trust and corrodes social capital. Even though a small side payment for a particular service may seem a minor offense, corruption can have far-reaching externalities. Unrestrained, seemingly minor infractions can accumulate until they destroy political legitimacy and make even noncorrupt officials and the general public less likely to comply with the rules.

6.28 Cross-country evidence reflects a negative correlation between the level of corruption (as measured by the survey of businesspeople) and both investment and economic growth (Figures 6.1 and 6.2). A World Bank survey of businesspeople in sixty-four countries identified corruption as an important obstacle to business operations (see Chapter 3). Anecdotal and survey data also reveal the high cost to the poor of petty corruption.

Corruption is associated with lower investment and growth

Figure 6.1 Corruption and growth in fifty-nine countries, 1990-94



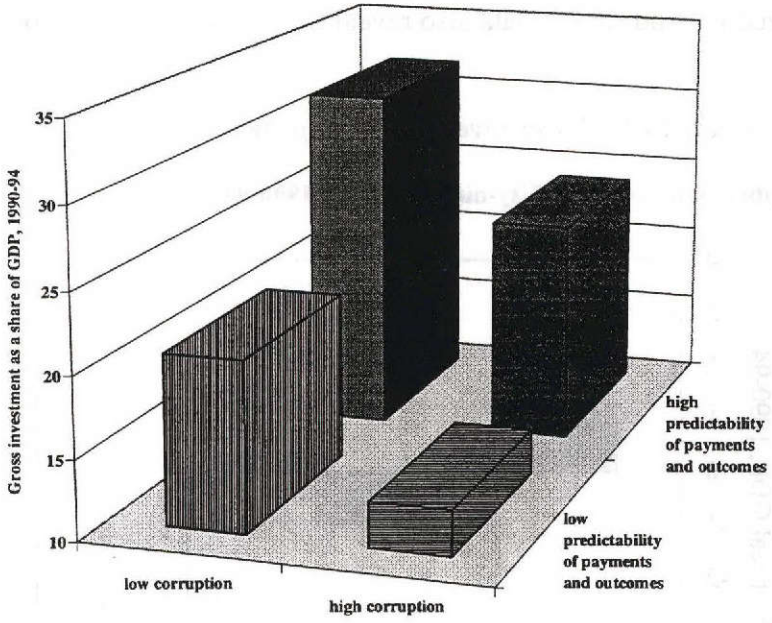
Note: controls for income and education.
Source: Brunetti, Kisunko and Weder 1997.

6.29 Despite such evidence, there remains a certain degree of ambivalence toward corruption in many parts of the developing world. One argument often heard is that corruption greases the wheels of commerce and that without it there would be no transactions and no growth. Apparently supporting this contention is the finding that some countries (including a few in East Asia) that are ranked among the most corrupt by various surveys are also among the fastest growing. The survey of businesspeople carried

out for this Report provides some insights into this apparent paradox. Predictability (both the predictability of payments and the predictability of outcomes) is an important mediating factor. Countries with similar levels of corruption can differ dramatically in their rates of investment. Countries with high predictability of corruption have significantly higher investment rates (Figure 6.2). Still, corruption is not costless in its effects on economic performance. No matter how high the degree of predictability of corruption in a country, its rate of investment would be significantly higher if the levels of corruption were lower (see Figure 6.2).

High levels and low predictability of corruption can discourage investment

Figure 6.2 Corruption and investment in fifty-nine countries, 1994



Note: controls for income and education.

6.30 The longer-term dynamics also change the picture for countries that have experienced high levels of economic growth despite serious corruption. Tolerating corruption that siphons off payments of 10 percent may generate pressures to increase the take to 15 or 20 percent. Corruption feeds on itself, creating a widening spiral of illegal payoffs until development is undermined and years of progress are reversed. And the very growth that permitted corruption in the past can produce a shift from productive activities to an unproductive struggle for the spoils. Over time, corruption becomes entrenched, creating powerful resistance to reform.

Causes of corruption

6.31 Incentives for corruption arise whenever public officials have wide discretion and little accountability. Politicians, bureaucrats, and judges control access to

valuable benefits and can impose costs on private citizens and businesses. Public officials may be tempted to use their position for private gain by accepting bribes, while private individuals may be willing to make illegal payments to get what they want from government. Thus a necessary condition for corruption is that public officials have control over benefits and costs.

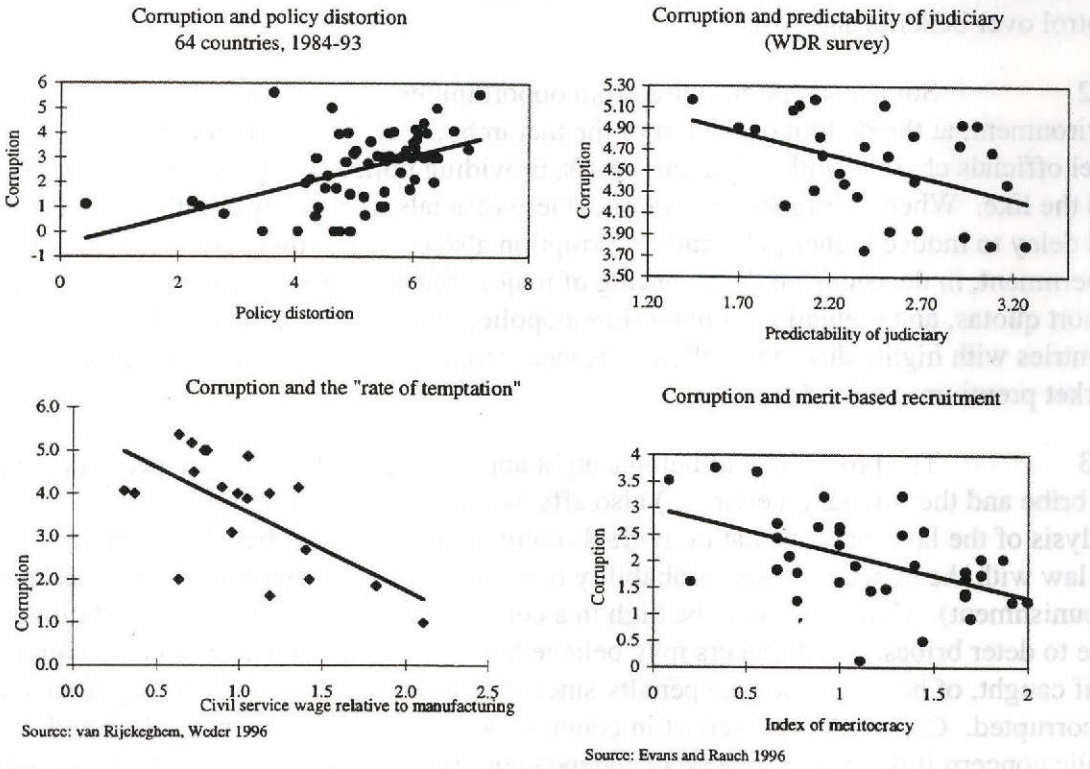
6.32 Some corruption stems from opportunities generated by the policy environment, at the bottom or the top of the hierarchy. Payoffs are frequent to lower-level officials charged with collecting tariffs, providing police protection, issuing permits, and the like. When corruption in endemic, these officials may create additional red tape and delay to induce higher payments. Corruption also occurs at the highest levels of government, in decisions on the awarding of major contracts, privatization, allocation of import quotas, and regulation of natural monopolies. Corruption is more prevalent in countries with highly distorted policies (as measured by variables such as the black market premium; Figure 6.3).

6.33 The probability of being caught and being punished (for the person paying the bribe and the official receiving it) also affects the level of corruption. Economic analysis of the law suggests that individuals compare the expected benefits of breaking the law with the expected costs (probability of being caught and punished times the level of punishment). Corruption may be high in a country where the government system does little to deter bribes. Lawbreakers may believe that there is little chance of being caught or, if caught, of having to pay the penalty since they believe that the system of justice can be corrupted. Corruption can persist in countries with substantial press freedom and public concern if there is little hope of independent judicial resolution of important cases. The survey of businesspeople in sixty-four countries found a negative correlation between reported levels of corruption and judicial predictability (Figure 6.3).

6.34 Finally, corruption may also thrive if the consequences of being caught and disciplined are low relative to the benefits. Officials frequently control the dispensation of benefits and costs whose value far exceeds their salaries. Corruption becomes especially likely if public pay does not reflect private wages for similar work. In countries that pay their officials very low wages, officials may try to maintain a minimal middle-class standard of living by supplementing their pay with illegal payoffs. The risk of losing a low-paying civil service job because of a corruption investigation is not a serious threat if legal private sector rewards are higher. Hence corruption is often positively associated with the extent of public-private pay differentials, or what may be termed the "rate of temptation" (see Figure 6.3). But simply raising civil service salaries may not reduce corruption. Pay reform must be combined with credible monitoring and law enforcement. Merit-based recruitment and promotion mechanisms that restrain political patronage and create a more impartial public service are also associated with lower corruption (see Figure 6.3).

A distorted policy and legal framework and inadequate pay encourages corruption

Figure 6.3 Causes of corruption, various countries



Reducing corruption

6.35 Several countries have managed to reduce endemic corruption over time. The progressive reduction of the power of U.S urban political "machines" of the nineteenth century is a case in point (Box 6.2). Containing corruption requires an understanding of the benefits and costs under the control of public officials. Many officials remain honest despite considerable temptation, and many ordinary people and businesses refuse to pay bribes despite the promise of large short-term gains. Others succumb. It is unwise to deal with the possibility of corruption by assuming that government officials are of higher moral standing than the rest of the population.

Box 6.2 Urban machines in the United States and progressive reform

In the late nineteenth and early twentieth centuries many U.S. cities were dominated by political machines, defined by one scholar "as a political party in which a boss oversees a hierarchy of party regulars who provide private favors to citizens in exchange for votes and who expect government jobs in return for their services." Machine cities also typically made corrupt, collusive deals with private businesses seeking contracts, franchises, or protected markets. The politicians driving these machines operated—and flourished—in nominally democratic environments.

Machines were costly. Per capita spending in machine cities was 34 percent higher for general administration and 17 percent higher for police and fire services—all areas with lots of patronage jobs. To

take one extreme case, in Boston between 1895 and 1907 the population increased by 23 percent while the number of city clerks increased by 75 percent—and productivity fell by half.

The progressive movement in the United States had as one its main goals the reform of machine-dominated cities. Reform frequently meant property tax reform. Seth Low, New York's reform mayor in the early 1900s, was distressed by the favoritism shown to wealthy property owners, and introduced a plan to assess property at market value. The plan increased the assessed value of real estate, lowered the tax rate, and increased revenues. The budget was cut by $1.5 million as patronage appointees were removed from office. Similar policies were followed by the reform mayors of many other U.S cities.

Reform also involved municipal franchises. In Philadelphia, for example, the city council awarded a gas franchise in return for contributions to the Republican Party. In 1905 the reform mayor, John Weaver, vetoed the bill, appointed a supporter to a key position on the city council to ensure the veto would be upheld, and arrested machine adherents for alleged corruption.

Cities dominated by machines paid a cost in terms of inflated budgets and inequitable tax and spending systems. Although many people benefited from the jobs and patronage dispensed by the machines, the losers eventually organized to win elections in many cities. The wave of reform mayors effected real change that persisted even when the machines were returned to power, mainly because reforms were popular and hard to reverse.

6.36 The incidence of bribery and other forms of malfeasance depends not just on the potential gains and risks but also on the relative bargaining power of the two parties. Further, there is a cost in controlling corruption. Thus, reforms must consider the marginal costs as well as the marginal benefits of anticorruption strategies; the efficient level of bribery is not zero.

6.37 Corruption cannot be effectively attacked in isolation. It is a symptom of problems at the intersection of the public and private sectors and needs to be combated through a multipronged strategy. Recent reforms in Uganda illustrate such an approach (Box 6.3).

Box 6.3 Fighting corruption in Uganda

Uganda, long plagued by systemic corruption in the past, has launched a multipronged battle against it. This effort enjoys strong support from top leaders, who seem committed to the goal of sound governance.

In the immediate postcolonial period Uganda was a kleptocratic state. By 1967 the regime ruled without holding elections. These beginnings set the stage for Idi Amin's rise to power in 1971. Under Amin government became little more than a system of organized crime used to extract rents from the public. There were many forms of rent seeking, including support for economically irrational projects, excessive military expenditures, kickbacks on state contracts, import controls, and expropriation of Asian properties. Emerging from civil war in 1986, the new Ugandan government under President Yoweri Museveni inherited a weak, underpaid, and overstaffed civil service (including thousands of "ghost workers") with a thin and porous tax base.

Cleaning up the civil service will be a long-term process, but Uganda is making progress. The multipronged effort includes policy reform and deregulation to remove opportunities for rentseeking; civil service reform to streamline the civil service, improve remuneration, and provide training and a code of ethics; revival of the Public Accounts Committee of Parliament; strengthening the auditor general's office; and a public relations campaign and prosecution of corruption under the authority of an inspector general with powers to investigate and prosecute. The anticorruption campaign is a critical component of a larger reform effort that has earned Uganda the renewed interest of domestic and foreign investors and one of the highest sustained rates of economic growth in Africa over the past five years.

Much remains to be done before corruption will be under control. The inspector general, however, has reported significant prosecutions against common examples of rent seeking (such as customs and procurement fraud), which should have a deterrent effect.

6.38 One thrust of this strategy is to ensure a professional, rule-based bureaucracy with a pay structure that rewards civil servants for honest efforts, a merit-based recruitment and promotion system to shield the civil service from political patronage, and credible financial controls to prevent the arbitrary use of public resources. Nineteenth century reforms in industrial countries such as the Northcote-Trevelyan reforms in England (Box 5.1) were instituted explicitly to curb pervasive political patronage and corruption, and to build a professional bureaucracy subservient to the rule of law. The details of such a system are described earlier in Chapter 5.

6.39 A second thrust is to reduce the opportunities for officials to act corruptly, by cutting back on the discretionary authority of individual officials. A third thrust is to enhance accountability by strengthening the mechanisms of monitoring and punishment—using not only criminal law but also oversight by formal institutions and ordinary citizens. These second and third elements of an anticorruption strategy are discussed in the rest of this chapter.

6.40 *Reducing opportunities to act corruptly.* In general, any reform that increases the competitiveness of the economy will reduce incentives for corrupt behavior. Thus policies that lower controls on foreign trade, remove entry barriers for private industry, and privatize state firms in a way that ensures competition will contribute to the fight corruption. If the state has no authority to restrict exports or to license businesses, there are no opportunities to pay bribes in those areas. If a subsidy program is eliminated, any bribes that accompanied it will disappear as well. If price controls are lifted, market prices will express scarcity values, not bribes.

6.41 In reducing official discretion, desirable regulatory and spending programs that have strong justifications must be reformed, not eliminated. Corruption in collecting taxes is not rooted out by abolishing tax collection. A corrupt police force cannot simply be closed down. Several measures have proved effective in reducing official discretion in ongoing programs:

- *Clarify and streamline laws in ways that reduce official discretion.* Mexico's customs reforms cut the number of steps in the customs process from twelve to four and streamlined the steps to reduce delays.

- *Contract for services with a private company, perhaps an international firm with no close ties to the country.* When Indonesia contracted with a Swiss firm for customs pre-inspection and valuation and for help in collecting import duties, corruption declined. Contracting out monitoring functions is pointless, however, unless the country makes use of the reports it receives—and that does not always happen.

- *Make rules more transparent.* Government might favor simple nondiscretionary tax, spending, and regulatory laws as a way of limiting opportunities for corruption. Sometimes, though, a certain risk of corruption is tolerated because the benefits of a discretionary approach to program administration exceed the costs of corruption. Transparency and publicity, however, can help overcome the incentives to corrupt behavior even in such cases. Thus police officers must have discretionary authority to make law enforcement decisions on the spot, but public complaints about mistreatment can restrain abuses.

- *Introduce market-based schemes that limit the discretion of regulators.* This approach also has the virtue of producing an economically efficient allocation of resources. The sale of water and grazing rights, pollution rights, and import and export licenses can improve the efficiency of government operations while limiting corruption.

- *Adopt administrative reforms that introduce competitive pressures into government.* Open, competitive bidding for public procurement can reduce opportunities for corrupt deals. Creating overlapping, competitive bureaucratic jurisdictions can substantially diminish the bargaining power of individual officials. Since clients can turn to a second official and if the first demands a bribe, no single official has the power to extract a very large payoff so long as applicants are qualified for the service. And if it is the applicants who are seeking illegal benefits, overlapping enforcement areas can help to check payoffs as well. For instance, when the state wants to control illegal businesses police officers can be given overlapping enforcement areas to reduce opportunities for corruption.

6.42 *Strengthening mechanisms for monitoring and punishment.* Independent watchdog institutions that are part of the government structure can also curb corruption. Countries have experimented with a variety of approaches:

- Some countries have independent anticorruption commissions or inspector generals that can investigate allegations of corruption and bring cases to trial. The most famous is the Hong Kong's Independent Commission against Corruption which reports exclusively to the governor general and has extensive powers (Box 6.4). Singapore and Botswana have similar institutions. Recent actions by Uganda's independent inspector general have helped bring corruption cases to light (see Box 6.3).

- Ombudsmen hear citizen complaints and can help increase the accountability of government agencies. Under the Ombudsman Act of 1991 South Africa has established a public protector to investigate

alleged improprieties (malfeasance, corruption, human rights abuses) by public officials and to prepare reports, which are usually made public. The office cannot initiate legal actions, but it can refer cases to offices that can.

- Some public agencies, such as the School Construction Authority in New York City, have established internal units to ferret out corrupt contractors and propose ways to reorganize the agency to reduce corruption.

- Whistleblower statutes protect and reward public employees who report the malfeasance of co-workers or government contractors. The United States, for example, has a statute that rewards workers who report irregularities in government contracts. An incentive for reporting is often necessary since people who report on co-workers are frequently ostracized. Such measures are hollow, however, unless prosecutors follow up, courts are incorruptible and efficiently run, and penalties are severe enough to deter potential offenders.

Box 6.4 Hong Kong's independent commission against corruption

Corruption was endemic in Hong Kong during the 1960s. Its entrenched character is suggested by an expression popular at the time: people had the choice of "getting on the bus" (actively participating in corruption) or "running alongside the bus" (being a bystander who did not interfere with the system). "Standing in front of the bus" (reporting or resisting corruption) was not a viable option.

Spurred to action by a scandal involving a high-ranking police officer, the governor established the Independent Commission Against Corruption (ICAC) in 1974. The Commission reports only to the governor and is independent of the police force. ICAC Officials are paid more than other government workers and cannot be transferred to other departments. No one can leave the ICAC to work for senior officers who have been the subject of an investigation. The ICAC has the power to investigate and prosecute corruption cases as well as to sponsor public education campaigns. In addition to the ICAC's independence, the government's commitment to reform was indicated by the initial appointment of a person of unquestioned integrity to head the Commission and by an initial policy of investigating and prosecuting "big tigers."

Early efforts to clean up corrupt syndicates within the police force, however, met with protests. The ICAC initially backed down and granted an amnesty for offenses committed before January 1, 1977. This setback was harmful to the Commission's prestige, but it was able to recover with a vigorous public education campaign. Public surveys public carried out between 1977 and 1994 indicate that public perceptions of corruption have fallen significantly. Indirect evidence suggests that active corruption has declined as well.

Still, the ICAC is not without problems. The main is that it reports only to the governor. An anticorruption commission reporting to an autocratic ruler could be used as an instrument of repression against political opponents, and the ICAC has not been immune to such charges. The ICAC's widespread powers of the ICAC could be abused in systems less committed to the rule of law. A series of oversight committees and an independent judiciary check the ICAC, but even so an occasional scandal surfaces. As a check on its power, such an agency might report not to the chief executive but to the legislature, as does Uganda's Inspector General or the U.S. General Accounting Office. A tough, independent anticorruption agency is a potent tool and represents a credible long-term commitment. But there should also be checks on its ability to be misused for political ends.

6.43 Watchdog organizations should focus not only on who receive bribes, but also on who pays them. Penalties should be equally severe on both side—usually a multiple of the bribes received or paid. Penalties should also include the prospect of being barred entirely from contracting with the government for a period of years. Industrial countries with strong monitoring capacity can enforce such measures for their multinational companies when they conduct business overseas.

6.44 Citizens groups can also be an important check on the arbitrary abuse of power by government—if people can organize into associations and nonprofits and if they can find out what is happening. Governments should publish budgets, revenue collection data, statutes and rules, and proceedings of legislative bodies. Financial data should be audited by independent authorities such as the U.S. General Accounting Office. Unaudited, secret funds or extrabudgetary funds available to chief executives are an invitation to corruption.

6.45 Freedom of information acts in the United States and a number of European countries are an important tool of effective public oversight. A recent EU directive requires member states to pass freedom of information laws covering environmental information. Such laws enable citizens to obtain government information without having to show how their lives are affected by it. The availability of information helps citizens discipline public officials at the ballot box and through other avenues of protest (such as legal challenges and direct petitions to decisionmakers).

6.46 Information is of little value, however, unless there are mechanisms for using the knowledge gained to influence government behavior:

- In countries with democratic electoral systems citizens can vote out of office officials believed to be corrupt or incompetent, thus giving politicians an incentive to stay honest and work for the interests of their constituents. (However, if corrupt payoffs are used to buy individual benefits for voters, knowledge of corruption may do little to stop it.)

- If courts are independent and citizens can sue to force the government to comply with the law, another route is opened up to control government malfeasance.

- Public exposure of corruption through the media is another option. Even undemocratic rulers are likely to be sensitive to public opinion if only to avoid being overthrown. A free press can be a vital check on abuses of power, especially in countries that lack other means of constraining politicians and bureaucrats.

6.47 Yet even if both information and the means of punishing corrupt practices are available, individual citizens are unlikely to act alone. Laws that make it easy to establish associations and nonprofits can help resolve this collective action problem.

Such groups might not only seek information from government, but also supply information to government about citizens' opinions of the quality of public services. As discussed in Chapter 7, the nonprofit Public Affairs Centre in Banaglore is engaged in a promising experiment to publicize the performance of public agencies is in India. The international nonprofit organization Transparency International is working to mobilize citizens around the world to fight corruption and to publicize the track record of individual nations. Yet precisely because open information can be so potent in promoting government reform, many countries limit such groups or make it costly for them to organize.

Conclusion: Balancing Flexibility with Restraints

6.48 Pressures for reform are on the rise everywhere. Private entrepreneurs and firms want the credibility of state actions anchored by a well-functioning system of property rights. Citizens are demanding more responsive and effective delivery of services and greater probity in the use of resources. At the same time globalization is increasing demands for a more agile state, one that can respond quickly to changing circumstances. These pressures have magnified the state's dilemma: how to check arbitrary decisionmaking without building rigidities that inhibit innovation and change. The fundamental challenge is to devise institutional arrangements capable of sustaining a workable balance between flexibility and restraint. Countries with strong institutions or track records of following through on commitments may have room to respond flexibly (even at the cost of some corruption), but countries with dysfunctional and arbitrary governments may not.

6.49 States in many developing countries have exhibited behavior that is symptomatic of an imbalance between flexibility and restraint. They have generally not been credible, accountable, responsive, or agile. In several countries the capricious exercise of unconstrained state power together with high levels and unpredictability of corruption has undermined development. States with too much flexibility and not enough of restraint may find that their actions are not viewed as credible, and so their investment and growth suffer.

6.50 These countries need to strengthen formal instruments of restraint—judicial independence, effective separation of powers—to enhance the credibility and accountability of the state. International commitment mechanisms can serve as a short-term substitute while these institutions are built up.

6.51 But these actions may not be sufficient in countries where endemic and entrenched corruption has undermined key functions of the state. Strengthening formal instruments of restraint is only one element of a multipronged strategy to control corruption. Reforming the civil service, reducing opportunities for officials to act corruptly (for instance by increasing competition and reducing the discretionary authority of individual officials), enhancing accountability are other essential steps. Strengthening mechanisms for monitoring and punishment involves not only the use of criminal law but

also oversight by formal institutions such as statutory boards and ordinary citizens—voice and participation. These can help not only in controlling corruption but also in many other functions of the state, such as policymaking and service delivery. It is to these issues of using voice and participation to enhance state capability that we now turn.

Chapter 7 Bringing the State Closer to People

7.1 People are the means and the ends of development. But people have different degrees of power, different interests, and different resources. It is often the wealthy or more powerful in society whose needs and preferences are reflected in the formulation of policy goals and priorities. The poor and marginalized, on the other hand, face significant obstacles in achieving effective representation and voicing their needs and concerns to public officials and policymakers. As a result the poor and other less vocal groups are often badly served by public policies and services, even those that should benefit them most.

7.2 Meeting collective needs at the lowest cost to society requires a state that is both responsive to a broad range of citizen needs and accountable for the public choices it makes. This chapter argues that the voice of people can make government more responsive and accountable by bringing to bear pressures for greater transparency in decisionmaking and by monitoring the provision of public goods and services. Concrete mechanisms that can help ensure that policies and programs better reflect societal interests are examined. In addition, partnerships among government, business, and civic organizations are discussed as alternative mechanisms for enhancing the supply of collective goods. Finally, the chapter considers the prospects and pitfalls of decentralization in creating pressures for better matching of government services to local preferences, strengthening local accountability, and facilitating local economic development.

Greater accountability and responsiveness through participation

7.3 Nearly all societies have grappled with the issue of how the state can best reflect the needs and interests of the population. Today this issue is as pertinent as ever, with the broader spread of education and information and the growing pluralism of nations creating new pressures on states to listen and respond to the voices of their citizens. A sample of public opinion around the world suggests that peoples' belief in government remains solid but that state performance on several counts is falling short of expectations (Box 7.1).

Box 7.1 Public opinion and the state

People's views on the state vary widely, reflecting perceptions of wide-ranging political and economic variables. To assess these perceptions and concerns, public opinion surveys have been carried out in various countries and regions. For example, a 1991/92 survey found that 54 percent of respondents in the United Kingdom and the United States believed that their leaders did not care what happened to the average citizen, and that 49 percent of respondents in the United Kingdom and 44 percent in the United States felt excluded from the decisionmaking that directly affected their lives. Even so, satisfaction with the way their democracies are developing is relatively high in Western Europe and North America—ranging from 54 to 64 percent of respondents. By contrast, in Latin America and the transition economies of Eastern Europe only 30-40 percent of respondents were satisfied with the way their democracies are working. In Latin America this negative perception may be related to the fact that 52 percent of respondents in a twelve-nation survey felt that the administration of elections in their country was fraudulent.

In Europe public support for the state and its services has been consistently strong since the 1970s. In 1990 large majorities—more than 70 percent—in seven Western European nations still believed that the government

should provide health care, services to the elderly, aid to the unemployed, and assistance to industry, as well as reduce income differences. A poll across the fifteen EU countries found that 51 percent of citizens think that their governments should maintain current social benefits and protection levels, compared with 12 percent who think that they should be cut considerably to enhance EU competitiveness in world markets.

In Latin America 69 percent of citizens believe that the state should intervene to reduce income differences between the rich and the poor. Latin American respondents also regard as critical the government's role in maintaining law and order, but 65 percent have little or no confidence in the judiciary or the police force. Only 24 percent have some confidence in these institutions. These results closely mirror the concerns voiced by the region's entrepreneurs that are reported in Chapter 3.

In India a 1996 survey found that despite strong support for the democratic system, voter trust in their representatives has fallen since 1971. Trust in some public institutions was also low, particularly the police (28 percent) and the bureaucracy (37 percent). Still, the India poll found strong popular participation and involvement in politics, with the number of respondents participating in a social organization or political party doubling between 1971 and 1996.

In contrast to Europe, Latin America, and to some extent Asia, where statist traditions remain strong, in the United States, 80 percent of respondents in a recent poll mistrusted the government because of its perceived inefficiency and waste. In addition, public support for welfare programs, particularly targeted welfare spending, has declined in recent years. A 1993 poll found that only one-sixth of Americans thought that the welfare system was working very well or fairly well, while in 1995 two-thirds thought that too much was being spent on welfare programs.

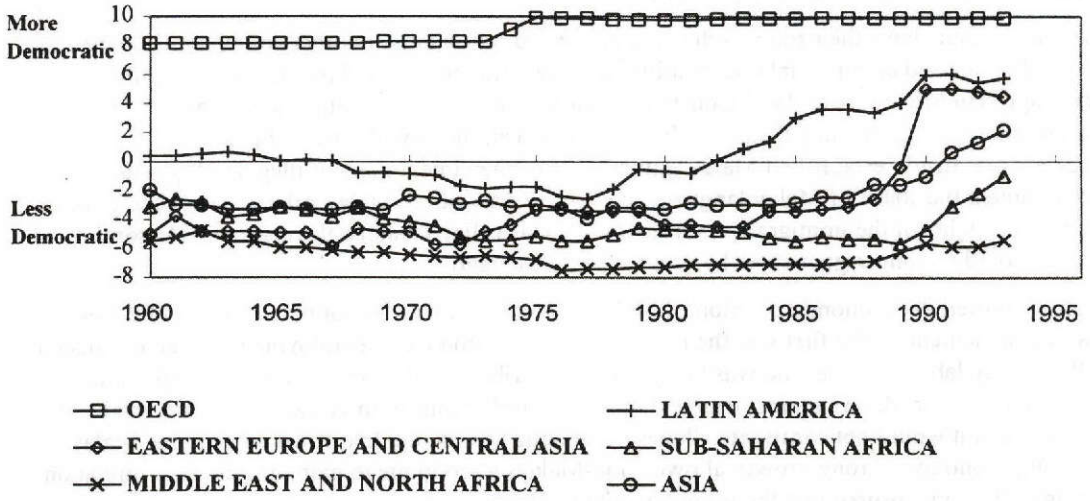
Electoral participation

7.4 Elections are the primary manifestation of citizen voice in a democratic society. Through elections citizens express their preferences for particular politicians or political parties, and they evaluate the performance of incumbents and hold them to account for their actions in office. In recent decades the number of democratically elected governments has increased, giving many citizens new opportunities to articulate their voice through the ballot. In 1974 only 39 countries—one in every four—were democratic. Today 117 countries—nearly two of three—use open elections to choose their national leadership, and two-thirds of the adult population in developing countries is eligible to participate in national elections (Figure 7.1). The trend is especially striking in Eastern Europe and Central Asia, where dramatic events in 1989 sparked a series of major political changes across the region. These events had repercussions in other regions as well, particularly in Sub-Saharan Africa. In Latin America the gradual movement toward democracy started somewhat earlier. Today all but two countries have elected governments and close to 13,000 units of local government are electing their local leadership (mayors), compared to less than 3,000 in the late 1970s.

7.5 Fundamental to the representivity of elections is the principle of one person one vote. Without the necessary safeguards, however, political interference and electoral fraud can seriously affect the representivity and therefore the legitimacy of electoral outcomes. In a twelve-nation survey in Latin America, for instance, 52 percent of citizens felt that the administration of elections was fraudulent in their country and only 30-40 percent satisfied with the way democracy was working (see Box 7.1). Constitutional and institutional arrangements also affect the ability of minority interests to gain effective representation. For example, a study of a number of European parliamentary democracies in the 1980s shows that women's parliamentary representation and voter turnout are higher in systems based on proportional

representation than in systems based on the winner-take-all principle. Where there is a greater representation of women's interests in parliament, there is better protection of women's interests through policies relating to maternity leave, child care and flexibility in retirement systems. The results of this study do not undermine the effectiveness of elections as a mechanism for voice, but they do caution against simple generalizations about the representivity of various electoral arrangements.

Figure 7.1 States have become more democratic since 1980



Source: "Polity III: Regime Type and Political Authority, 1800-1994" ICPSR, Keith Jaggers and Ted Robert Gurr, September 1996.
Note: See technical note at the end of the main text for information on variable definitions.

Diversity and representation

7.6 In some instances electoral arrangements have been changed to ensure adequate representation of minority groups. As the number of ethnic conflicts around the world attests, perceptions by some groups that they are not moving ahead as rapidly as other groups (in incomes, assets, employment) can be a powerful source of frustration. Such frustrations can spill over into direct conflict if the lagging groups lack adequate means of representing their concerns. If political elites mobilize ethnic differences in their own political competition, this can add further fuel to societal tensions. In the contemporary world states play a significant part in shaping ethnic relations through two channels:

- The expansion of political authority, which enables states to create a competitive arena for the distribution of state resources and access to education, employment, land, and credit.

- The extension of political patronage, whether for administrative convenience or for enhanced control, lets governments select certain ethnic groups to receive patronage.

7.7 While ethnic differences and conflicts are a part of most societies, some societies have managed them better than others. Techniques for ameliorating ethnic conflict include dispersing the "points of power" (decentralization or devolution) supporting electoral arrangements that encourage interethnic cooperation (electoral incentives and coalitions) and giving preferences to less privileged ethnic groups in public sector employment and other areas. Box 7.2 describes how two of these approaches—constitutional change and preferential policies—were used in Malaysia and Mauritius. By addressing some of the basic rules of the game, including elements of the political or institutional structure, both countries were able to find a sustainable way of managing ethnic differences.

Box 7.2 Managing multiethnic societies in Malaysia and Mauritius

Ethnic divisions in Malaysia have their roots in the colonial period, when large numbers of ethnic Chinese and Indians immigrated to take jobs and commercial opportunities that were not being filled by the native *bumiputra* population, the largely agrarian Malays. The 1957 Constitution enshrined consociational principles achieved through extensive negotiation among the major groups. In 1971, however, the new Parliament passed a constitutional amendment that firmly established Malay primacy. The amendment made it illegal to "question publicly or even in Parliament the status of Malay language, the sovereignty of the Malay rulers, the special position of Malays or the citizenship rights of the immigrant communities." This ruling changed the nature of electoral campaigns, since parties could no longer gain votes by arousing ethnic antagonisms.

A second initiative boosted the economic position of Malays through the New Economic Program (1970-90). The program had two main elements. The first was the promotion of full, productive employment and an expansion of the supply of skilled Malay labor. The second was the gradual redistribution of asset ownership. Preferential university admissions standards for Malays almost tripled bumiputra enrollments, to three-quarters of the total. The government made it clear that it would not confiscate Chinese economic wealth, but that it would promote Malay participation in a growing economy. Strong growth allowed non-Malays to continue to gain, despite discrimination, while the New Economic Program ensured that the growth would be shared.

Mauritius has four major ethnic groups—Indo-Mauritians, Creoles, Chinese and Muslims. The designers of the electoral system, anxious to avoid democratic structures that might exacerbate the country's ethnic divisions, structured the system to force the main parties to seek support from all communities. Moreover, Mauritian governments have generally chosen broad-based growth and distribution policies over specific ethnic preferences. Formal preferences in employment and in education have never been used. And all governments since independence have been required to form multiethnic coalitions in order to assume and maintain power. Growth with redistribution has tended to blunt the appeal of communal politics.

Alternative strategies for voice and participation

7.8 Voting rules and electoral incentives can be reformed to improve representivity, but the simple fact that elections and referendums are held infrequently (Switzerland is an exception, with an average of eight local referendums each year since 1945) limits their scope for communicating information about societal preferences. In most societies, democratic or not, citizens seek representation of their interests through other means: as taxpayers, as users of public services, and increasingly as clients or members of nongovernmental and voluntary associations. Against a backdrop of competing social demands, rising expectations, and variable government performance, these forms of voice and participation are on the rise.

7.9 One of the most visible changes in recent years has been the rapid growth of NGOs. Since the late 1980s the number of NGOs operating in parts of Africa and Asia has almost doubled. In Eastern Europe and the CIS the number of NGOs may have increased three

or four fold from a very low base before 1989. In some OECD countries, operating expenditures in the voluntary or NGO sector now account for almost 4 percent of GDP.

7.10 NGOs have myriad organizational forms and functions, ranging from labor unions to professional associations to neighborhood groups and philanthropic trusts. Among the most active NGOs today are those providing services directly to individuals and communities, ranging from health and education to microcredit, vocational training, and professional services. In OECD countries many NGOs operate in sectors alongside public providers. In Japan and the United Kingdom, for example, a large percentage of nonprofit organizations are found in the education sector. In the United States they figure prominently in the health sector. But unlike public providers, most NGOs are not obliged to cater to the general needs of the population, making it simpler for them to provide services of a particular type and quality to particular groups.

7.11 In most developing countries service-delivery NGOs are small in scale, working in communities and settings beyond the reach of government or private providers or where their reach is weak. In the Palestinian territories, for example, an estimated 1,200 NGOs provide 60 percent of primary health care services, up to half of secondary and tertiary health care, and most agricultural services, low-cost housing schemes, and microcredit. In Cambodia some 200 NGOs provide microcredit to rural and urban entrepreneurs in the absence of alternative government programs for poverty alleviation. The numerical importance of these NGOs reflects their ability to substitute for weak public sector capacity and to mobilize funds from a range of different sources, including national and international organizations.

7.12 Not all NGOs are involved in service delivery, however. Others include research and civic education groups, advocacy organizations, and professional and business associations that represent particular interests or seek to educate the public about issues in their collective interest. The Socio-Ecological Union in Belarus, for example, is actively engaged in public education about industrial pollution and its consequences. The West Africa Enterprise Network is a business-oriented network with some 300 members from twelve nations representing the interests of domestic entrepreneurs in dealings with government. In India the Working Women's Forum with a membership of more than 100,000 workers in three southern states, links grassroots groups with a national union. The recent growth of intermediary organizations reflects the larger movement toward democracy in many regions and, in some countries, the need to bridge the "missing middle" between citizens and the state. Unlike the electoral process, however, where all votes are counted equally, not all these organizations are equally representative, either of their clients' interests or of the public interest more broadly.

7.13 Most intermediary NGOs tend to be one step removed from ordinary citizens; by contrast, grassroots organizations, community-based groups, or peoples organizations engage them directly. In Umu-Itodo, Enugu State, Nigeria, for instance, the Community Development Committee formed in 1986 has been responsible for numerous development and infrastructure projects that have had a direct impact on this isolated community. The Committee has an elected executive consisting of members from each of the village's segments; villagers rank it as the most relevant and effective organization in the village. Similar locally based organizations

include rotating credit associations, farmers associations, village cooperatives, mother and child clubs, parent-teacher associations, and even religious congregations. These associations are valuable not only for their ability to meet basic needs, but also for the role they play in building trust and a sense of public connectedness among individuals excluded or distanced from the formal political process. Even so, organizations such as these also face limitations, including narrowness of membership and representation, limited management capacity, and the risk of co-option by traditional power holders or political factions.

The institutional basis of participation

7.14 The depth and intensity of collective actions by citizens obviously differ by social and institutional setting. One explanation for these differences lies in what researchers call *social capital*, or the informal rules and norms that facilitate collective action by citizens. In settings with widely shared rules and norms conducive to collective action, horizontal association between people is common. Where such rules are weakly developed or not widely shared, associational activity also tends to be weak. But the absence of such rules is not necessarily a permanent condition. They can be generated by participation itself, and here governments can play a positive role. Government efforts to improve the management of irrigation systems in Taiwan (China) and the Philippines have yielded numerous collective responses from farmers in managing operations and maintenance and collecting water user fees. By accepting comanagement of water resources by farmers, public officials achieved a substantial improvement in irrigation management. In Ceara Brazil, a case illustrated in Chapter 5, community monitoring of an innovative health program provided the basis not only for a highly successful program but also for more effective cooperation among community members on other issues of common interest.

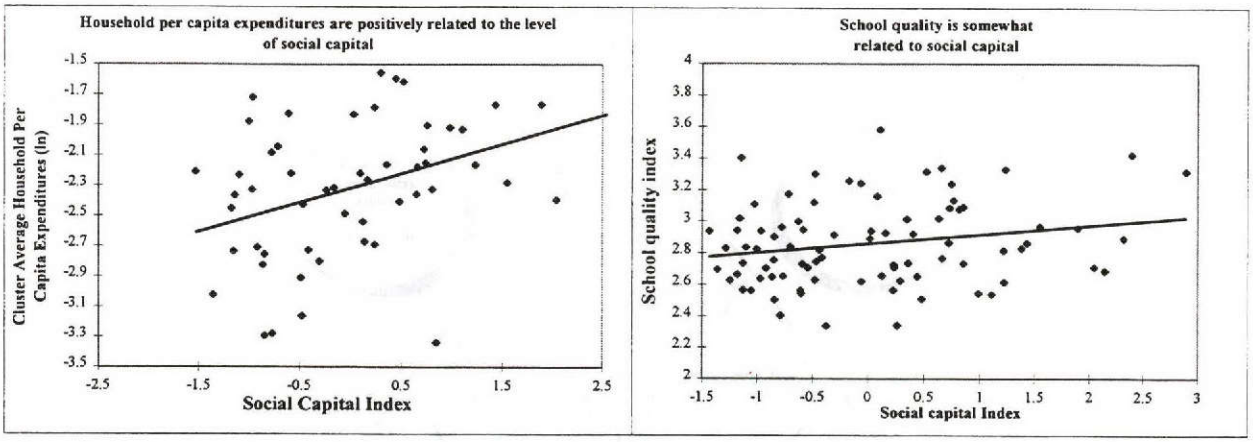
7.15 The debate about the contribution of social capital to economic and social development has only just begun. But some studies are already demonstrating its potential impact on local development and on the performance of public agencies (Box 7.3).

Box 7.3 Social capital, government responsiveness, and improved well-being

A study of regional government in Italy during the 1970s and 1980s found that although political and economic failures were widespread, some regional governments, particularly those in the north, had performed well. Northern regional governments were notable for developing innovative day-care programs and job training centers, promoting investment and economic development, managing the public's business efficiently, and satisfying their constituents. Regional governments in the south, by contrast, had much weaker responsiveness and performance. The study attributed the performance of northern governments to the external pressures created by dense networks of civic associations and citizen involvement in public affairs affecting their everyday lives.

A recent study of villages in rural Tanzania found that households in villages with high levels of social capital (defined by the degree of participation and horizontal voluntary association) have higher adjusted per capita incomes than households in villages with low levels of social capital. Controlling for other nonsocial capital determinants, there also appears to be a strong correlation between village well-being and village social capital. Although no general conclusions about the impact of social capital on government performance could be made, the study points to a number of important linkages, including a positive association between social capital and quality of local schooling (see figures). The implication is that where parents are able to organize to monitor and pressure local government into maintaining local schools, school quality is enhanced. Even though the direct benefits of

schooling accrue mainly to individuals, the public good element of monitoring local government performance accrues to all.

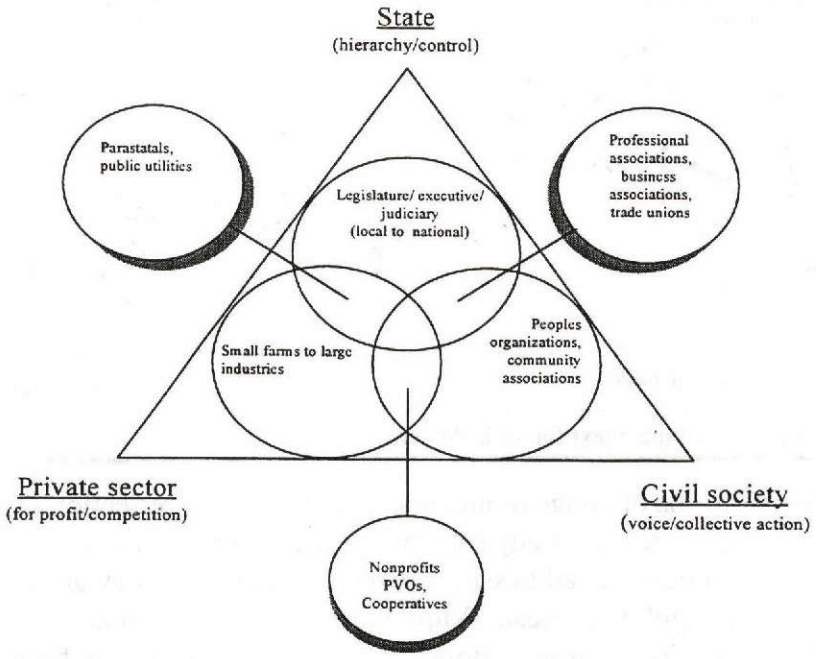


Note: See technical note at the end of main text for variable definitions.

7.16 The myriad forms of nongovernmental activity are one reflection of the heterogeneity of needs and preferences in any society. At the same time there are no guarantees that these organizations are adequately addressing citizens needs or that they are genuinely concerned with promoting the public interest. While most organizations achieve high quality in the services they provide, some suffer from serious problems. In Bangladesh, for example, 87 percent of teachers in the many nongovernmental schools are untrained. Many schools suffer from poor-quality teaching, inadequate community participation, and weak accountability. Some NGOs are created opportunistically, to advance the interests of narrow and privileged constituencies, often at the cost of the less vocal and less powerful. And the same rules and norms that facilitate collective action among citizens can preserve inequalities and power differences, especially gender inequalities, within communities.

7.17 Still, considering the many obstacles facing ordinary citizens, particularly the poor, in articulating and pressing their needs, these associations play a vital role in channeling voice and in building capacity for participation in public affairs. And the organizations that genuinely seek to work in the public interest can be valuable partners in economic and social development. Working from this premise many governments are searching for new institutional arrangements for the provision of public goods that involve both the private sector and groups in civil society (Figure 7.2). The question we now turn to is in what ways (and with what effect) can the state seek the participation of people in the design and implementation of public policy?

Figure 7.2 The state, markets, and citizens are beginning to work together in new ways



Improving institutional capability

7.18 Improving state capability by increasing opportunities for voice and participation has three key dimensions. First, when citizens are able to express their opinions, formally or informally, and press their demands publicly within the framework of the law, states acquire some of the legitimacy they need to govern well. Broad-based discussion about policy goals can also reduce the risk that a powerful minority will control the direction of government. And states that achieve legitimacy in the eyes of citizens are allowed more flexibility in policy implementation and have an easier time engaging citizens in the pursuit of collective goals. This does not mean that "Western-style" democracy is the only solution. In fact, experience from parts of East Asia suggests that where there is widespread trust in public institutions, effective ground-level deliberation, and respect for the rule of law, the conditions for responsive state intervention can be met.

7.19 Secondly, where markets are absent, as is the case for most public goods, the voice of people can reduce information problems and lower transactions costs. Where incentive problems and weaknesses in capacity lead to inefficient public services, user groups and citizen associations can also inform and pressure public officials to improve effectiveness. A recent user assessment of the water supply system in Baku, Azerbaijan, for example, revealed not only significant problems of water leakage and water-related health problems, but the high costs the city's unreliable water supply imposed on low-income consumers. Interestingly, users also revealed their willingness to pay between two and five times more than the current water rates for a reliable and safe water supply.

7.20 Third, no matter how dedicated, hard-working, or public spirited state officials are, they cannot anticipate all the public goods and services that citizens desire. The emergence of private and NGO alternatives to public provision therefore helps to meet the gaps in public goods provision, while ensuring that the goods and services to which individuals are willing to devote their own resources will be provided. NGOs are both partners and competitors in the delivery of public services. And together with citizen voice, they can create useful external pressures on governments to improve public service delivery.

7.21 There is no blueprint for finding the appropriate balance of voice, participation, and bureaucratic control in the provision of public goods. It depends on the capabilities of specific public agencies and on the characteristics of the public good or service being provided. For both efficiency and equity some degree of centralized government control and coordination is critical for goods and services characterized by jurisdictional spillovers, economies of scale, or distributional concerns. In the technical and often sensitive area of economic management, for example, some insulation of decisionmaking from the pressure of political lobbies is desirable. In setting standards, say in the provision of basic education, there is also an important role for centralized decision-making. But the process by which broad policy directions and standards are set should not be insulated from public discussion. And in the management of common property resources, the production of basic infrastructure, and the delivery of essential services there is considerable scope for involving people directly in policy formulation and implementation.

Participatory mechanisms

7.22 Some of the mechanisms for fostering voice and participation, particularly at a macro level, are discussed in Chapters 4 and 5, but a few merit restatement here. While it is generally accepted that some areas of public decisionmaking require insulation from political pressures, there are areas where public and private interests coincide to such an extent (increasing agricultural production, reforming the health care system) that some level of public-private deliberation is not only desirable but critical to success.

7.23 In East Asia, through the institutionalization of public-private deliberation councils comprising representatives of labor unions, industry, and government, policymakers were able to get broad agreement on economic policy issues and the necessary commitment to intervene quickly and flexibly. Other nations with very different institutional settings such as Botswana, Senegal, Chile, Mexico, and the United States, have also sought to implement deliberative mechanisms on issues ranging from economic policy to institutional reform.

7.24 By embedding the voice of powerful interest groups in mutually acceptable rules, public-private deliberation mechanisms can reduce transactions costs by reducing the scope for opportunistic behavior. But the process is not always successful. Systematic evaluations of performance are not available, but a number of conditions and characteristics appear to affect success. These include broad enough representation and public education for the process to have widespread support, technical support and assistance to the councils, and an emphasis on building trust and mutual monitoring among participants.

7.25 But deliberative mechanisms are unlikely to enable governments to be effective in the long run if their policies appear illegitimate or unresponsive to crucial societal demands. Thus, the ability to render policy reform or programs intelligible to citizens is crucial, and a number of mechanisms are being tried to facilitate this. Media coverage of debates on the budget are one example. In Singapore a Division of Public Feedback systematically gathers feedback on a variety of national policies and invites interest groups to public hearings with ministers and senior officials. As discussed in Chapter 5, legislation can also strengthen public accountability and responsiveness by requiring agencies to announce and enforce service norms and standards, provide public information, and respond to consumer complaints.

7.26 Specific techniques and mechanisms for consulting users and intended beneficiaries can be instrumental as well at the micro level for improving public service quality. As the cases in Box 7.4 illustrate, feedback mechanisms such as client or user surveys can provide valuable information about an agency's performance and the type and quality of services reaching consumers. Simplified surveys such as the report card used in Bangalore, India, can be particularly useful when institutional capability is limited.

Box 7.4 Client surveys to motivate service improvements in India, Uganda, and Nicaragua

In several countries client surveys have helped motivate better public sector performance. By tapping the experience of citizens—the clients of public services—and having them monitor and evaluate services, surveys have helped identify problems and design and implement innovative solutions.

In Bangalore, India "report cards" ask citizens and businesses to rate the public agencies they use to solve problems or get services. The report cards, administered by an NGO called the Public Affairs Centre Bangalore, assess the quality and costs of citizens' interactions with public agencies. In the first round of report cards the Bangalore Development Authority, responsible for services such as housing, scored the lowest in several categories, including staff behavior, quality of service, and information provided. Only 1 of 100 respondents rated the authority's services as satisfactory. Rather than viewing the results as a threat, the authority's director took them as an opportunity, launching a citizen-government initiative to address delivery problems. Other agencies in Bangalore have also taken action based on the report costs. And groups in five other Indian cities, including Mumbai, have started their own report cards.

Working with NGOs and communities, Uganda's government is also surveying views on service delivery. The first survey found that just 11 percent of rural households had ever been visited by an agricultural extension worker. Several districts have incorporated the survey findings into their district plans. One district has instituted further training for extension workers and is lobbying the central government for permission to spend more of its budget on extension workers.

Nicaragua's surveys, like Uganda's, were initiated by the government. The first survey, in 1995, found that 14 percent of bus riders had been assaulted on a bus. It also found that 90 percent of bus drivers did not respect the official fare of 85 cordobas, by not returning the 15 cordobas of change to riders. Moreover, the survey revealed that people were willing to pay higher bus fares. Based on these findings, the fare was raised to $1.00. In a follow-up survey in 1996, 90 percent of users said that the official rate is respected.

7.27 But no mechanism for consultation automatically reaches all the appropriate individuals or groups. There are costs to acquiring and providing information, and the low-income or subordinate position of some groups in society makes them nearly invisible to public officials. In consulting with users or clients, every effort must be made to identify all relevant social groups and ensure that representatives of the groups are included in the process.

7.28 As well as increasing the flow of information to public officials, techniques for citizen or client consultation can introduce more openness and transparency into the system. As more people become aware of the performance of specific agencies or officials, it is more likely that people will act collectively to exert pressure on the agency to perform better. At the same time public agencies will have less opportunity for arbitrary action.

7.29 But no mechanism for consultation automatically reaches all the appropriate individuals and groups. There are costs to acquiring and providing information, and the low-income or subordinate position of some groups in society makes them nearly invisible to public officials. In consulting with users or clients, every effort must be made to identify all relevant social groups and ensure that representatives of all groups are included in the process.

7.30 Improving government performance does not end with improved consultation. There is also compelling evidence to suggest that arrangements that promote participation by stakeholders in the design and implementation of public services or programs can improve both the rate of return and the sustainability of these activities.

7.31 A good example comes from the education sector. Problems of weak monitoring and supervision of local schools are a perennial problem for governments. But experiments in a number of countries are showing that these problems can be addressed by increasing the involvement of parents and communities in school management. In New Zealand, elected boards of trustees that manage schools are composed of parents of children at the school. Legislation enacted in Sri Lanka in 1993 established school development boards to promote community participation in school management. In Mauritius, parent-teacher associations have been so successful that government funds are being used to further stimulate partnership. Many countries have also found that communities participate in school management are more willing to assist in school financing.

7.32 Yet effective citizen involvement in school governance does not come easily. Training is often required and can be effective in both literate and less literate communities. New Zealand realized after it had embarked on its reform that intensive training was required for newly elected trustees. Jamaica is training parents to help manage schools. Botswana found it difficult to attract qualified people to lower secondary school boards of governors, especially in rural areas. ActionAid in Uganda is providing community training in two districts for parent-teacher associations and school management committees, a direct example of government-NGO cooperation.

7.33 Citizen participation may also be crucial for programs for the management of natural and common-property resources, such as grazing lands, wildlife, forests, and water sources. Exclusive bureaucratic control of such resources has proven inadequate in many different institutional settings, in some cases leading to direct confrontations between the users of these resources and the public officials seeking to manage them. In India, for example, government schemes established to manage community resources such as community woodlots have been conceived as top-down measures applying administrative and legal procedures. They

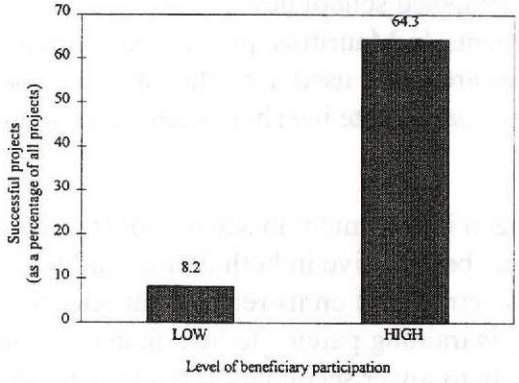
have done little other than to diminish the resources available to the poorest people. And in forest management, conflicts between users and public officials have been notorious and intense.

7.34 Practices are changing, however, and with some striking successes. In Gujarat, India, after numerous conflicts between communities and forest guards, joint forest protection committees and profit sharing arrangements have been established between the local government and community groups. The result has been reduced conflict and increased productivity of the land. In Zimbabwe the CAMPFIRE program seeks to return the benefits of protecting and conserving wildlife to local communities. In Mali and Senegal national programs for joint management of forest areas by communities (assisted by NGOs) and government are being implemented with some early signs of success. A quantitative assessment of the performance of rural water supply projects in Africa, Asia, and Latin America found that high levels of beneficiary participation were positively correlated with project rates of return (Box 7.5).

Box 7.5 Does participation improve project performance?

Using data from 121 diverse rural water supply projects in forty-nine countries in Africa, Asia and Latin America, a recent study tested the relationship between participation and project performance.

Participation was measured on a continuum ranging from information sharing to in-depth consultation to shared decisionmaking and control over decisionmaking. The authors found a strong correlation between successful projects and beneficiary participation. Of the forty-nine projects with low levels of participation, only 8 percent were successful. But of the forty-two projects with high levels of beneficiary participation, 64 percent were successes (see figure).



Case studies elsewhere support these conclusions. The first phase of the Aguthi Rural Water Supply Project in Kenya was conducted without community participation. The project, which involved piped water systems, was so plagued with problems that it came to a standstill and had to be redesigned. Working with project staff, local leaders, organized as the Aguthi Water Committee, mobilized community support for the project. Following public stakeholder conferences community members began to contribute labor and funds. Phase II of the project was completed on schedule and within budget. The communities continue to pay monthly tariffs for the new water service, and operation and maintenance of the system is handled successfully in cooperation with the relevant government agency.

7.35 The same study also revealed, however, that among the highly participatory projects, only half reached women. The explanation was found in factors specific to women's participation, including women's time constraints and cultural barriers to participation. Consequently, participatory mechanisms are required that explicitly seek women's involvement,

from holding separate meetings with women and men to ensuring adequate representation of women on local management committees. The payoff to such efforts lies not only in their attention to the process but also in their ability to minimize the potentially lower returns of poorly designed or managed programs.

Implications for public agencies and officials

7.36 These illustrations suggest that in the provision of certain local public goods or shared services—where the people who pay are also the direct and principal beneficiaries—using the institutional capacity closest to the client can greatly improve the quality of public action. Capable states are therefore likely to be those that strengthen and increase the efficiency of local organizations and associations rather than replace them. But reaching out to citizens as co-managers or co-producers does not take place in a vacuum, nor is it costless or quick to implement. To get users or clients to become partners, public agencies often must invest considerable time and energy in building ties with communities and in building commitment among their own staff.

7.37 In a pioneering case in Recife, Brazil, where the introduction of low-cost condominial sewers in low-income neighborhoods changed the relationship between the state agency and the sewer users, it took two years for public officials, working intensively and in multidisciplinary teams with residents, to figure out how to make the condominial sewer system work. Even once the process was better understood, successful implementation took another four to six months in each neighborhood. An evaluation of the project showed, that by fostering an active and vocal constituency, the scheme not only generated considerable savings, it also put in motion mechanisms for accountability that were critical for good agency performance.

7.38 Greater responsiveness means changing not only the way state agencies work with clients, but also the way state agencies are organized and reward workers. Effective participation is more likely when opportunities for internal participation exist within the public agency. In addition, the overall incentive environment must reward higher-level staff for responsiveness to clients and must provide adequate support to street- or field-level workers in their efforts to work with clients. Without such measures resistance to working with clients can be high, creating an atmosphere that is incompatible with a more participatory approach.

7.39 Working closely with people also often requires redefining tasks and responsibilities, reallocating staff resources, and developing new mechanisms for learning and experimentation. Some recent examples show this:

- In Benin the Ministry of Health gave local health management committees decisionmaking control over resources. Committee members are elected democratically; anyone may serve, provided that at least one member is a woman. The committee is directly involved in preparing the health center's annual budget for submission to the ministry. It is responsible for collecting and accounting for funds paid to the health center for services and drugs. Representatives of local committees sit on the board of the government's new

drug procurement agency, which is one way of keeping the agency accountable, and on the Health Sector Coordinating Committee, which gives local representatives a voice in national policy.

- In Rajasthan, India, the challenge of implementing small integrated watershed development projects forced staff from different disciplines to work together. Government field staff were told to "start with what you know, what you have resources for, and what people want." Staff were given the freedom to conduct small experiments and to try whatever they thought might work. No penalties were applied for failed experiments, and successful innovations were rewarded. Significant progress was made in developing area-specific technologies for watershed management.

- A combination of measures undertaken in the Philippines over more than two decades has led gradually to the full integration of gender issues with the government's agenda. Measures have included Focal Points for Women's Concerns, a group of highly motivated individuals within government agencies tasked to stimulate, coordinate, monitor, and provide technical assistance on gender issues; programs to sensitize government officials to gender issues, as well as training programs at all levels of the bureaucracy; active involvement from networks of NGOs in providing hands-on technical assistance to public agencies; and participatory mechanisms for planning, implementing and monitoring policies and programs for women.

The enabling environment

7.40 Government can also support participation indirectly through its influence on the enabling environment. States have great power over individuals and organizations through the information they make public and, more specifically, through the laws they enact and administer. The rule of law that protects both the person and personal property is important to a healthy, vibrant civil society. While specific legal issues are beyond the scope of this chapter, it is worth noting here that governments can facilitate participation by safeguarding the right of people to organize, to gain access to information, to engage in contracts and to own and manage assets. The constitutions of Bolivia, Brazil, Colombia, and the Philippines explicitly encourage the development and participation of NGOs at all levels of decisionmaking. In Singapore the government helps NGOs recruit staff, allocates unused government buildings at nominal rents, and funds up to half the capital and operating costs of facilities run by NGOs for social welfare purposes. Without a credible legal environment that places requirements on NGOs and public agencies for openness and transparency, legitimate organizations are deprived of an opportunity to develop or, perhaps worse, the door is left open for unhealthy or corrupt NGO activities that taint the reputation of the entire sector. The objective is to strike the right balance between regulations and reporting requirements that foster NGO growth while guarding against possible corruption or malpractice.

7.41 The benefits of greater consultation and partnership with civil society are visible not only in improvements in service quality and rate of return, but also in the greater flexibility afforded to public agencies and officials in the way they intervene. But without effective monitoring this flexibility can give rise to capricious or arbitrary action by public officials. Again, the right balance is crucial between participatory mechanisms and enlightened governmental control. The next section examines some of these concerns in the context of debates about decentralization and the fostering of greater public accountability from below.

Decentralization—matching services with local preferences

7.42 Decentralization offers the chance to match services and other activities more effectively with local demands and preferences and to build more responsive and accountable government from below. But there are also pitfalls to decentralization, including the possibility of increased disparity across regions, loss of macroeconomic stability, and institutional capture by local factions, especially in highly unequal societies. This section focuses on some of the factors explaining recent trends in decentralization, and some areas where it has been shown to have a positive impact, including bringing citizens into public affairs and stimulating local economic development. The following sections explore some of the pitfalls of decentralization and some lessons for managing decentralization successfully.

What drives demand for decentralization?

7.43 Decentralization includes a variety of multidimensional processes (Box 7.6). These include *administrative deconcentration*, or the transfer of functions from higher to lower levels of government; *fiscal decentralization,* or the ceding of influence over budgets and financial decisions from higher to lower levels; and *devolution,* or the transfer of resources and power to lower-level authorities, that are largely independent of higher levels of government. Rarely does decentralization embrace all these elements, and the wide diversity of experiences suggests that availability and quality of data on forms of decentralization vary as well.

Box 7.6 Multiple dimensions of decentralization

Decentralization efforts are driven by a variety of demands and motives. In most cases governments are driven to action by a combination of international and top-down and bottom-up pressures. The course of action and the institutional forms of decentralization takes also differ widely. Rondinelli and Nellis define decentralization as "the transfer of responsibility for planning, management, and the raising and allocation of resources from the central government and its agencies to field units of central government ministries or agencies, subordinate units or level of government, semiautonomous public authorities or corporations, area-wide, regional or functional authorities, or nongovernmental private or voluntary organizations."

Decentralization refers not to a single phenomenon but rather to many different phenomena that can be represented only by multiple dimensions. Conyers identifies five types of institutional change involved in decentralization efforts: the functional activities over which authority is transferred; b) the type of authority or powers that are transferred to each functional activity; the level(s) or area(s) to which such authority is transferred; the individual, organization, or agency to which authority is transferred; and the legal or administrative means by which authority is transferred. Leonard and Marshall, investigating the effects of decentralization on the poor, proposed a typology based on four dimensions that can be represented in a matrix containing twenty-four subtypes of decentralization.

Table 7.1 Different trends in subnational finance around the world

	Subnational expenditures as percentage of total government expenditures		Subnational revenues as percentage of total government revenues		Trend
	1974	1994	1974	1994	1974-1994
Argentina	*25*	*44*	*25*	*37*	↑↑
Australia	47	49	20	27	↗↑
Brazil	*30*	*37*	*23*	*25*	↗↗
Canada	61	60	39	43	→↗
Chile	2	*9*	2	*5*	↗↗
Colombia	25	*33*	16	*18*	↑↗
France	18	18	6	13	→↑
Germany	44	*40*	34	*30*	↘↘
Indonesia	11	*15*	3	*3*	↗→
Malaysia	18	*14*	13	*8*	↘↘
Spain	9	*34*	5	*12*	↑↑
South Africa	*25*	*41*	*4*	*11*	↑↑
Thailand	17	8	5	5	↓→
UK	33	*28*	15	*8*	↘↓
USA	45	45	33	36	→↗
Zimbabwe	*26*	*25*	*24*	*15*	→↘

Note: The standard measures of fiscal decentralization are used to trace trends and variations in fiscal intervention of subnational governments. These are subnational government own (direct) expenditure share of total government expenditure and subnational government own revenue share of total government revenue. These measures define the extent of expenditure and revenue decentralization respectively. For subnational government data, the sum of intermediate and local government has been used. Adding to those consolidated central government expenditures (net of transfers) results in overall (general government) public expenditures. Data in italics: years closest to 1974, and 1994 respectively.
Source: IMF-GFS, various years.

7.44 Richer and larger countries tend to be more decentralized in terms of the share of subnational governments in overall public expenditures and revenues. In the aggregate, however, industrial countries have become slightly more centralized since 1974 (Table 7.1). This holds especially for Germany and the United Kingdom, while Australia, France, Spain, and the United States are continuing to decentralize central government functions to local levels. Developing countries, most of which went through the nation-building phase of development in the aftermath of colonialism in the 1950s and 1960s, have become more decentralized since the 1970s (Table 7.1). Striking examples include Argentina, Brazil, and Colombia. In both groups of countries decentralization has been significantly larger for expenditures than for corresponding revenue.

7.45 Recent trends in decentralization can be tied to at least three factors: changes in the minimum necessary size of government, political changes, and dissatisfaction with central government services:

- *The minimum size of self-sufficient government has declined.* New technological options and new demands from citizens, producers, and consumers mean that some of the advantages that kept countries, regions, and provinces working together under a central government may be of lesser importance (for example, security) or irrelevant. In Europe and North America the pressure from global markets is creating a strong demand for local and regional governments that can better provide the infrastructure and skilled labor force needed by transnational businesses.

- *Political changes have given way to local demands.* Centralized authority in the former Yugoslavia, Czechoslovakia, and Soviet Union collapsed once the unifying force of the Communist Party collapsed. Elsewhere, regions and subnational governments benefited from the political vacuum created before and during regime changes, as in Argentina, and Brazil in the late 1980s, and South Africa in the 1990s.

- *Countries often turn to local and regional governments following prolonged failure of the centralized state to provide essential services.* In the second half of the 1980s Colombia initiated decentralization and political reform that reversed a long tradition of centralism. A new government changed direction, transferring social service delivery to the local level and opening up the rigid political appointment system to local electoral choice. Similarly, in Venezuela and other countries in South America, active local governments have changed the responsiveness of local administration and the quality of services provided, often dramatically. In the Basque region of Spain and in Cuzco and Puno, Peru, regional or ethnic groups pushed for autonomy and for more responsive and accountable local government.

A framework for thinking about decentralization

7.46 Recent political and economic developments have heightened interest in the kinds of intergovernmental arrangements that may be desirable in particular countries. Should countries establish rules that favor decentralization of fiscal and economic actions or is centralized decisionmaking process more consistent with good policy? Do countries have much choice in the matter? The answer is likely to depend on many factors specific to each country and on an appropriate mix of policies and effective rules.

7.47 Theory posits that public goods and services are provided most efficiently by the lowest level of government that can internalize the benefits and costs. Table 7.2 gives an illustration of some of the demand and supply characteristics of goods and services that influence this decision. For some local goods, such as those with common property characteristics, organizations below the level of local government—such as forest or water user associations or NGOs—may be the most appropriate institutional mechanism for delivery. More generally, where there preferences or demands are heterogeneous, local governments can better match supply to suit local tastes. Decentralized service provision can also enhance efficiency and

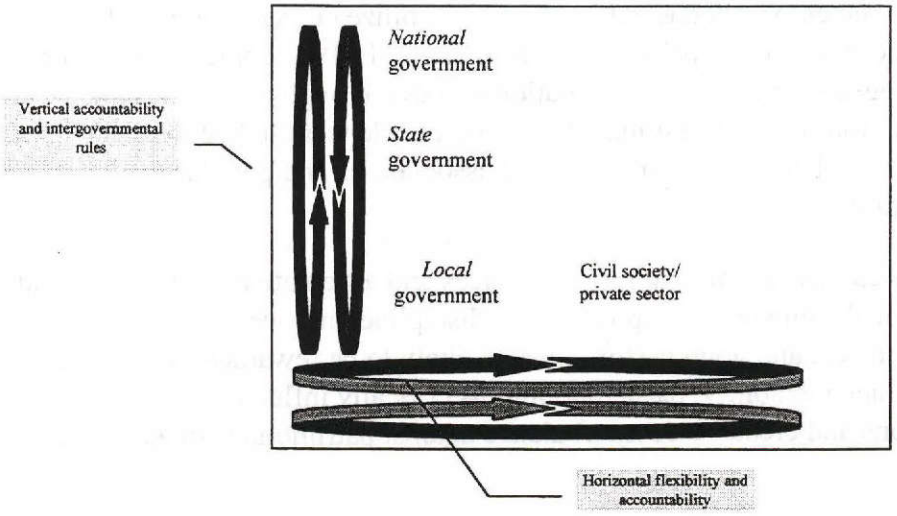
interjurisdictional competition in supply, providing consumers (at least in theory) with the option to exit to other jurisdictions. Where there are economies of scale or interjurisdictional externalities (such as interurban highways) on the supply side, or minimum standards (primary schooling) and spatial consumption externalities on the demand side, however, centralized control is likely to be preferred over decentralization.

Table 7.2 Demand and supply characteristics of local and national public goods

	Demand-side characteristics	Supply-side characteristics
Local	Heterogeneous tastes Common-pool characteristics	Interjurisdictional competition
National	Spatial consumption externalities Minimum consumption standards (equity)	Economies of scale Interjurisdictional externalities.

7.48 Matching services to local preferences can lead to lower transactions costs (particularly information costs), efficiency gains, and incentives to local economic development. But the benefits and costs of decentralization vary by setting. Experience suggests, that decentralization is unlikely to work unless there are effective institutional arrangements to foster accountability at the local level, and fiscal restraint between local and national governments. This is best explained in terms of two separate but interrelated sets of relationships facing local governments. The first consists of horizontal relationships between local government and citizens, NGOs, and private businesses. Institutional arrangements, such as local elections or referendums, provide incentives for cooperation, accountability, and local government performance. The second set of relationships is vertical, between levels of government. Most countries have institutional arrangements that define the role and functions of each tier of government, particularly in intergovernmental fiscal relations. Vertical rules and horizontal incentives are essential if local governments are to perform their functions well (Figure 7.3). The next section discusses some of the ways in which horizontal relationships can encourage local governments to enhance responsiveness, mobilize resources, improve service delivery, and stimulate private sector development.

Figure 7.3 Vertical rules and horizontal incentives shape the capability of local governments



Accountability and incentives to performance

7.49 *Citizen participation.* In theory, decentralization provides a means for avoiding majoritarian tyranny by moving government closer to people and facilitating local definition of issues and problems, especially by minority groups. Where public office is contested and people can participate and decide on representatives at different levels of government, the number of political choices citizens can make also increases, thus stimulating competition between governments. Local participation can also mean greater confidence in and acceptance of policy decisions by constituents. Thus decentralization can therefore increase local options for policymaking while holding local officials accountable for what they do and how they do it.

- In Bandiagara, Mali, a highly respected peasant organization, Molibemo, focuses on integrating self-help approaches with the country's recent efforts in decentralization. In preparation for the election of local councils, Molibemo set up advisory bodies that train villagers for assuming their future electoral roles. More villagers appear to be articulating their interests to government officials as a result of Molibemo's efforts.

- Oaxaca and Chiapas are among the poorest states of Mexico. They have similar resource endowments and potentials and a high percentage of poor and indigenous populations, but the outcomes of antipoverty programs are generally regarded as good in Oaxaca, while neighboring Chiapas has a bad record. The major difference seems to be participation in policy decisions and implementation. Oaxaca has a long tradition of participatory mechanisms for indigenous populations and the poor. In Chiapas the denial of such options, together with widespread corruption of local officials, has resulted in poor service performance and rising tensions, including armed conflict since early 1994.

- In Porto Alegre, Brazil, an innovative process of public investment planning and management was launched in 1989 to mobilize citizen groups to take part in the process of municipal budget formulation. In 1995 some 14,000 people were engaged in the budget formulation process through assemblies and meetings. Indirectly, an estimated 100,000 people were linked to "participatory budgeting" through local associations and popular organizations.

7.50 When people can choose among public services and articulate their concerns and preferences effectively political competition imposes some discipline on governments. Incompetence is usually punished, and good performance is likely to be rewarded. In addition to providing better chances for accountability, participation thus critically influences behavior within local public institutions and creates a counterbalance against patrimonialism and elitist policymaking.

7.51 Increased local participation can also provide important incentives for decisionmakers to adopt innovative administrative and management strategies. Recent evidence from Latin America, particularly Colombia, suggests that once local policymakers are held accountable for their actions and made aware that their jobs depend to a large extent on citizens' assessments of their performance, they are likely to be more concerned with the quality of their staff and the tools they have to run their offices efficiently and effectively. In Quito, Ecuador, a prolonged fiscal crisis in the late 1980s provided incentives to mobilize local resources in several areas. Rejecting an internationally financed offer to update its municipal cadastres through high-tech aerial photography and relying instead on local staff and knowledge, Quito's local government not only brought its budget back into balance within three years, it also exported its adapted financial management tools to neighboring countries.

7.52 *Local service provision.* Many governments in Latin America and Asia have responded to fiscal crises and citizen concerns, by decentralizing service provision and developing new arrangements with NGOs and local businesses. While relatively little evidence is available on the relationship between decentralized governance and educational quality or health status, for example, the experience appears to be quite mixed. The following examples highlight some of the positive features of decentralized service provision.

- In the 1980s the primary education system in the state of Minas Gerais in southeastern Brazil faced many of the problems common to the education systems in developing countries: high repetition rates, low graduation rates, and low achievement levels. Contributing to these chronic problems were inadequate funding, poorly trained teachers, teacher absenteeism, rigid teaching techniques, and overregulated and centralized management. In the early 1990s a new government enacted measures to grant financial, administrative, and pedagogical autonomy to elected boards in each local school composed of teachers, parents, and students over the age of sixteen. Each school now receives a grant based on enrollment and special needs, and it is up to the board to decide how to spend these funds and other monies

raised locally. Participatory measures have helped overcome long-standing patronage in school management, and greater transparency has led to increased operational efficiency. Early results are encouraging, indicating a 7 percent increase in scores in science, 20 percent in Portuguese, and 41 percent in mathematics.

- In Teocelo, Mexico, decentralization has created opportunities to organize resources for health in a more efficient way by identifying the population's needs and designing strategies to foster participation through community organization and health education. Coverage of the population increased in preventive and curative care, the quality of services improved enormously, infant mortality rates fell, and the productivity of service delivery increased by as much as 400 percent for many activities. Patients reported that the attitude of health personnel and the quality of services had improved greatly.

- A self-help initiative in Karachi, Pakistan, focused on upgrading the neighborhood sanitation system. With small investments of less than $40 per house, the Orangi Pilot Project, founded and assisted by an ex-civil servant with support from the BCCI foundation and strong involvement of the community, has worked lane by lane since 1980. Since then some seventy percent, or 6,300 lanes, have been linked to the sanitation system. Neighboring alleys outside the project still have garbage-strewn open sewers.

7.53 *Local economic development.* Local private sector participation can play a crucial role in decentralization, shaping the incentives at the local level. Entrepreneurs strongly influenced the pace of development and intergovernmental relationships in industrial countries. Property-owning classes that had command over local resources exercised considerable pressure on public entities. To spur expansion, private actors and public officials were encouraged to cooperate. Many of these growth processes began in local environments. Members of the business community often participated in local parliaments. Provided that rent-seeking is minimized by effective competition policies—a function for higher levels of government—a strong local private sector may promote better administrative performance. And local governments that provide and maintain credible frameworks for local economic development end up promoting private investment that, over time, increases local government revenues.

7.54 Examples of how local governments have affected local economic development and how decentralized institutional arrangements eventually contributed to growth can be found throughout the world.

- The small cities of Greenville and Spartanburg, South Carolina, have the highest foreign investment per capita in the United States. More than 215 companies from eighteen countries are located in these cities, including seventy-four that are headquartered there. Visionary decisionmakers with a strong private sector approach to local development have established a solid

base of innovative small and medium-size enterprises that employ a workforce whose skills are regularly upgraded.

- Effective networks between regional and local government entities and local businesses have been established in Andalusia, one of the poorest regions in Spain. Founded by the regional parliament, the Institute of Industrial Promotion of Andalusia seeks to promote small and medium-size locally owned industrial enterprises by involving the stakeholders of a key set of industries in formulating and implementing a competitive strategy and establishing links to public and private financial institutions. The strategy has been extremely successful in enhancing the competitiveness of the marble industry in Macael.

- The city of Wuhan, in central China, dramatically increased its access to foreign investment. In July 1992 the city government resolved to transform the old Wuhan and build a new one on a large scale. City officials relaxed their policies on foreign investment in two development zones, opened a third, passed local regulations to supply foreign investors with a legal foundation, strengthened the management of real estate and land rentals, and undertook several infrastructure investments to improve the hard environment for foreign investment . As a result, in 1992 alone the number of foreign projects approved for the city was more than two and a half times the total for the previous eight years with a threefold increase in total capital. Not satisfied, the city government organized a huge investment promotion mission in 1993 that garnered agreements worth $5 billion from Singapore and Hong Kong.

7.55 Despite such encouraging cases, experience suggests that successful decentralization may be short-lived or nonreplicable unless there are effective rules for intergovernmental collaboration. Horizontal incentives for improved performance tell only part of the story. In education, for example, higher levels of government may be needed to prevent fragmentation and to minimize differences in the quality of education in different communities. In health the appropriate allocation of responsibilities across levels of government is not often clear. Immunizations, tuberculosis surveillance, and vaccine storage all need strong effective management from higher levels of government. In addition, localities may not provide the right framework for policy formulation and implementation. Consequently, more important than rigidly pushing functions down to communities and municipalities and artificially separating levels of government is finding the *right balance* between the roles of different governmental levels to ensure that high-quality services are provided in a timely manner. As the following sections describe, there is a need for credible rules to guide such a strategy.

Pitfalls of decentralization

7.56 In many cases decentralization does not represent a carefully designed sequence of reforms aimed at improving overall performance by the public sector. Many reforms take

place in politically volatile environments in which the level of trust is low and policymakers respond unsystematically to emerging demands from below. Such weak policy frameworks can lead to serious economic problems, including loss of macroeconomic control, regional disparities and inequalities in service provision, and misallocation of resources as a result of local capture. Clear-cut rules are needed for intergovernmental relationships that specify the range of responsibilities for each level of government.

Macroeconomic dimensions of intergovernmental finances.

7.57 Macroeconomic control is regarded as a function of the central government. Centralization, or strong central guidance, in budget and financial matters was critical in ensuring sound public finances and a reliable framework for economic development in most industrial economies. Because decentralization increases the number of actors and budgetary accounts, countries facing serious budgetary and inflationary pressures are confronted with additional challenges and risks in embarking on decentralization.

7.58 Intergovernmental fiscal relations affect the macroeconomy primarily through three channels: the assignment and sharing of tax bases and expenditures, the match up of tax and expenditure assignments, and levels of subnational borrowing.

7.59 *Assignment and sharing of major tax bases and expenditures.* Serious macroeconomic imbalances can occur if major tax bases are inappropriately assigned. In India, for example, important tax bases have been assigned to subnational governments while the central government, with a growing public debt and pension liabilities, has but a small and inefficient tax base, consisting mainly of income, foreign trade, and excise taxes. The sharing of major tax bases also has the potential to reduce the magnitude of deficit reduction at the central government level. This happened in Argentina in the early 1990s when increased tax revenues following a tax reform had to be shared with provincial governments. Provincial governments essentially took a free ride on central governments tax efforts and used the extra revenue to expand their civil service.

7.60 Expenditures with national benefits and costs—national public goods—should be the responsibility of the central government. These include expenditures for stabilization and redistribution. Many expenditures at the local level also affect income distribution, such as residential zoning laws in industrial countries and the provision of health and housing subsidies in transition economies and many developing countries. In addition, because the benefits of local public expenditures tend to be concentrated in the jurisdiction of subnational government whereas the costs are spread out across the nation, subnational governments have an incentive to spend beyond their means and to shift the financing costs to other subnational governments. The effect on national fiscal policy can be severe.

7.61 *Subnational borrowing.* Borrowing by local governments can contribute to macroeconomic instability when the central government fails to impose hard budget constraints when there is no lack of good public expenditure management for monitoring debt obligations, particularly when there are multiple lenders; and when there is asymmetric information between borrowers (subnational governments) and lenders (central government and international capital

markets). In China, for example, provincial governments are not allowed to run budget deficits and finance them through borrowing. But in the early 1990s nearly unchecked borrowing by state enterprises at the subnational level contributed to an overheating of the economy and presented a significant risk to economic stability (Box 7.7). In Estonia local governments finance infrastructure projects by borrowing from domestic banks and issuing bonds. At the end of 1994, local government debt stood at around 1 percent of GDP and 16 percent of local government revenue. In Brazil states have a debt exceeding $100 billion, close to the levels of total federal and central bank debt. Unless the growth of debt is curtailed, the federal government will have to reduce its own spending, raise taxes, or resort to inflationary financing to cover subnational indebtedness.

Box 7.7 Pitfalls to avoid in intergovernmental relations: The cases of Brazil and China

Democratization and constitutional revisions in the 1980s increased the amount of resources under subnational control in Brazil and the degree of local autonomy in their use. Local governments now account for half of total public spending.

Although decentralization shifted resources downward, there was no corresponding clarification and expansion of local responsibilities. Subnational governments were not prepared to assume new tasks, and were neither required to perform specific functions nor prohibited from performing functions already performed by other levels of government. As a result local governments used much of their windfall to expand staffing and undertake questionable new projects. There is little evidence that the efficiency of public sector spending whole improved. Decentralization also increased the fiscal deficit as major states used their increased political autonomy to extract federal resources. By the mid-1990s subnational debt accounted for nearly a third of a growing federal deficit.

Brazil's experience shows that political and fiscal decentralization do not guarantee improvements in public sector efficiency and may threaten macroeconomic stability. To achieve its objectives, fiscal decentralization must be accompanied by a corresponding decentralization of expenditure responsibilities, state and municipal governments' institutional capacities should be improved, and the federal government should impose hard budgets in its fiscal and financial relationships with subnational governments.

China's experience in the early 1990s demonstrates the pitfalls of decentralization that is not accompanied by parallel reforms and macroeconomic safeguards. Since 1978 central authority over investment and allocation decisions had been gradually decentralized to provincial governments, enterprises, financial institutions, and even households. This was a crucial element of China's economic liberalization and a key factor in the economy's impressive growth over the past two decades.

At the same time, however, three consequences of decentralization undermined the central government's control over macroeconomic aggregates:

- Government revenues as a share of GDP declined precipitously. Economic decentralization contributed to growing competition in the industrial sector, lowering the profits of industrial state enterprises that had been the main source of tax revenues. Increasingly autonomous local governments further weakened tax revenues by granting tax exemptions to improve the after-tax earnings of the state enterprises under their control.
- The growing autonomy of local governments made it difficult for the central government's investment planning system to control the investments of provincial governments and state enterprises under their control. Since tax revenues at the provincial level had declined and were inadequate to cover these investments, local branches of the state banks were usually prevailed on to lend for these projects.
- Local branches of the Central Bank were given discretionary authority over 30 percent of the Central Bank's annual lending to the financial system. When local branches of the state bank needed additional resources to support investments by local governments and state enterprises, they turned to the local branch of the Central Bank for an infusion of liquidity.

The resulting overheating of the Chinese economy in 1992-93 posed considerable risks to stability. Inflation climbed to its highest point in several decades. Real GDP growth reached an amazing 14.2 percent in 1992 and 13.5 percent in 1993. Eighty percent of growth came from growth in investment, most of it by state enterprises under the supervision of provincial governments.

The authorities responded quickly with a combination of measures. The most important of these were administrative restrictions on investments by provincial governments and state enterprises and a reassertion of authority by the Central Bank over lending to state banks. These measures and others helped navigate the economy to a soft landing. By 1995 inflation had fallen below 7 percent, while GDP growth had been maintained at around 9 percent.

7.62 Any of these channels can lead to undesirable macroeconomic outcomes. Some of the channels are quantitatively more important in some countries than in others, and some have long-run effects on macroeconomic imbalances. Whether they generate macroeconomic instability, therefore, depends on the relative importance of each channel, the relative strength of central and local government policymaking and policy implementation and the central government's macroeconomic management objectives such as growth and price stability.

Regional disparities and inequalities in service provision

7.63 Equality in living standards and in access to public services is an overarching goal—and sometimes a constitutional mandate—in many countries. Centralization allows the national government more discretion in reducing regional income disparities by managing regional differences in levels of public service provision and taxation. With decentralization such options may no longer be guaranteed or may be difficult to implement. Wealthier local governments and regions may also benefit disproportionately from greater taxing powers.

7.64 In China, for example, provincial disparities in real per capita incomes have been growing in recent years. Per capita income in the richest province, Guangdong, is now four times greater than that in the poorest, Guizhou. Some provinces on the southern coast, such as Fujian, Guangdong, and Hainan, have done better than the western, interior provinces largely because of their central location for transport and communications and their proximity to Hong Kong. These natural advantages have been reinforced by official policies that favor coastal provinces, including tax breaks to foreign investors locating in special economic zones near the coast, large allocations of credit (relative to population) through China's government-directed banking system, and registration requirements that discourage the poor from migrating to the booming coast.

7.65 In Russia income inequality across oblasts is high, with per capita income in the richest oblast about ten times that in the poorest oblast. Regional inequalities in per capita expenditures were estimated to have risen to 1:7 by 1992, with better-off regions receiving higher budgetary expenditure allocations and urban areas relatively underserved. Subnational taxation or sharing of federal revenues from natural resources on an (origin) derivation basis could create even larger fiscal disparities among subnational governments. Russia's experience highlights the need to design appropriate equalization schemes to deal with rising inequality during periods of accelerated growth or macroeconomic stabilization.

Resource misallocation as a result of local capture

7.66 Economic and financial distortions may also arise from the abilities of subnational governments to gain from weaknesses in the central government. In the absence of agreed intergovernmental rules, local units may benefit from sources of income (rents) that have not been formally distributed under an appropriate fiscal decentralization scheme.

7.67 In Poland, for example, with the development of self-government at the local level, many local authorities have begun to act like pressure groups, with a strong inclination to extract more benefits from the government for local clienteles. As a consequence inequalities have risen among jurisdictions leading to new forms of social conflict. In Brazil, where decentralization was reportedly motivated by the political repudiation of two decades of military rule, local governments have seen a substantial increase in their share of revenues and in their taxing powers but no corresponding expansion of local expenditure responsibility. Local governments now have more money to spend but they are no more accountable for the quality of their services than they were before the reform (see Box 7.7).

7.68 In Pakistan decentralization has been accompanied by the subtle politicization of intergovernmental relationships. Provincial governments, which have expanded their roles in the provision of education and other local public services since the 1960s, have increasingly adopted intrusive, centralist behavior toward municipal governments. Instead of being encouraged to assume new tasks and responsibilities, municipal governments are being denied opportunities to succeed while Pakistan's intermediate level of government benefits from a halfway approach to decentralization.

7.69 Industrial countries with decentralized mechanisms have a strong legal framework that ties subnational governments to enforceable rules and often mechanisms that can counterbalance negative outcomes, including fiscal transfer policies, equalization schemes (Box 7.8), hard budget constraints, and limitations on local borrowing. Some countries have experimented with participatory mechanisms (for example, blue-ribbon commissions) that bring stakeholders together and provide options for feasible and manageable policies within a mutually agreed timeframe.

Box 7.8 Calculating fiscal equalization grants

Fiscal equalization programs compensate provinces with below-average fiscal capacities. In addition to safeguarding national objectives of providing minimum levels of public services across the nation an equalization program can foster the participation of member provinces in a federation and thus is often viewed as the glue that holds a federation together. Economic literature has long recognized that equalization is justified on grounds of horizontal equity and, in recent years, that under certain conditions it can promote economic efficiency.

In Pakistan, for example, one recent proposal is the adoption of a representative tax system to equalize fiscal capacity across regions. Such a system measures the fiscal capacity of a province by calculating the revenue that could be raised if the government used all the standard sources of revenues at the nationwide average intensity of use. In this way the fiscal capacity of below-average provinces is brought up to the median, arithmetic mean, or other norm. Using the arithmetic mean of all provinces as a standard, a province's equalization entitlement for a revenue source is determined by the difference (if positive) between the average potential yield at the national average rate of taxation in all provinces in aggregate, and the potential yield obtained in a province when the national average tax rate is applied to its revenue base.

Since data on tax bases and tax collections required to implement a representative tax system are published regularly by various levels of government in many countries, implementing such a system would not impose new data requirements and could be implemented as a federal fiscal equalization program in lieu of revenue sharing by the population.

Lessons from successful decentralization

7.70 Ideally, policymakers would embark on decentralization by gradually phasing in the reassignment of expenditure authorities and responsibilities, the reassignment of revenue authorities that are compatible and consistent with previously defined expenditure needs and responsibilities, and development of a system of intergovernmental grants to cover fiscal gaps between expenditures and revenues at the local level and to correct imbalances in efficiency and effectiveness, preferably with built-in incentives for local resource mobilization.

Assigning expenditure and revenue authority

7.71 Assigning revenue and expenditure authority is complex. Information on the spatial distribution of benefits and taxes is imperfect, and economies of scale in revenue collection and in the production of services may partly negate the efficiency advantages of a decentralized system. In addition, the costs of alternative options for service production are often unknown. Possible tax and expenditure assignments are shown in Table 7.3.

Table 7.3 Possible tax and expenditure assignments for each level of government

Central taxes	State taxes	Local or provincial taxes
Value-added tax	Individual income tax	Property taxes
Individual income tax	Surcharges on national taxes	Vehicle taxes
Corporate income tax	Retail sales taxes	User charges
Excise taxes	Excise taxes	Licenses and fees
Natural resource taxes	Property taxes	
Customs duties	Vehicle taxes	
Export taxes		
Central expenditures	**State expenditures**	**Local or provincial expenditures**
Tertiary health care (infectious diseases, research)	Secondary health care (hospitals, curative)	Primary health care
University education	University and secondary education	Primary and secondary education
Roads and highways (intercity)	Roads and highways (intercity)	Roads and highways (intracity)
Public transportation (intercity)	Public transportation (intercity)	Public transportation (intracity)
Water and forestry	Air and water pollution	Air and water pollution
Defense	Water and forestry	Solid waste, water, sewer, fire
	Police	Land use and zoning
		Housing
		Cultural policy
		Tourism
		Police

Designing intergovernmental grants

7.72 Intergovernmental grants are important sources of revenue for many subnational governments. Between 1970 and 1992 grants from the central government financed 64 percent of expenditures by local governments in Brazil. In South Africa, grants from central government to newly elected provincial governments account for about 90 percent of total revenues of the provincial governments. By their nature intergovernmental grants tend to divorce local spending from local resources and the benefits of providing local public services from the costs. The separation of benefits and costs and the limited ability of local governments to mobilize revenues from their own sources can reduce the transparency of the local government budgetary process and the accountability of local governments to local citizens, leading to inefficient and inequitable delivery of public services. Thus any system of intergovernmental grants in developing countries must be designed with extreme care.

7.73 While there is no blueprint for an optimal system of intergovernmental grants, a good system of intergovernmental grants should have certain characteristics. It should be predictable and transparent and embody some of the principles set forth in Table 7.4.

Table 7.4 Principles and best practices in grant design

Grant objective	*Grant design*	*Best practices*	*Practices to avoid*
Bridging fiscal gap	Reassignment of responsibilities Tax abatement Tax base sharing	Tax abatement in Canada Tax base sharing in Canada, Brazil, Pakistan and South Africa	Deficit grants Tax-by-tax sharing, as in India and Pakistan
Reducing regional fiscal disparities	General nonmatching Fiscal capacity equalization transfers	Fiscal equalization programs in Australia, Canada, and Germany	General revenue sharing with multiple factors
Compensating for benefit spillovers	Open-ended matching transfers with matching rate consistent with spillover of benefits	Transfers for teaching hospitals in South Africa	
Setting national minimum standards	Conditional nonmatching block transfers with conditions on standards of service and access	Roads and primary education grants in Indonesia Education transfers in Colombia, Chile.	Conditional transfers with conditions on spending alone Ad hoc grants
Influencing local priorities in areas of high national but low local priority	Open-ended matching transfers (with matching rate varying inversely with fiscal capacity)	Matching transfers for social assistance in Canada	Ad hoc grants
Stabilization	Capital grants, provided maintenance is possible	Limited use of capital grants while encouraging private sector participation by providing political and policy risk guarantees	Stabilization grants with no future upkeep requirements

Appropriate rebalancing

7.74 Clear-cut rules are essential for imposing restraints on actors at each level of governmental. Equally important seems to be the process by which rules are agreed on. While, in principle, rules could be imposed from the top-down to restrain arbitrary action of all participants, experience suggests that such agreements are difficult to achieve and may not be sustainable. This is particularly the case for developing and transition economies. Lessons from a variety of countries indicate that key policy decisions are more likely to be sustained when they are based on a broad consensus among stakeholders. Thus decentralization is more likely to be successful with institutional settings and processes that allow for articulation of interests and consensual policymaking as, for example, in the European Charter of Local Government of 1985.

7.75 In the absence of agreed-on guiding principles, what can governments committed to decentralization do to get the process started? There are some country models. In the early 1990s the government of Uganda established a consultative process with different stakeholders—community groups, agricultural producers, government representatives—to decide on the best way to proceed with decentralization. A decision favoring a staged and gradualist approach emerged from the process. Other countries have chosen commissions consisting of informed leaders from different levels of governmental, ministries, academia, and sometimes unions and business associations, drawing on foreign advice where necessary. South Africa's recent experience is interesting in this respect. The new constitution calls for a fiscal commission to deal with the intergovernmental structure of the country. The president, in charge of setting up the commission, provided different representatives with a constitutionally guaranteed forum for articulating their interests. Although too early to judge its success, the process created a sense of expectation from below and demands for designing appropriate measures of decentralization.

7.76 Commissions may serve short-term interests well. Over the longer term, however, more durable solutions may be needed that allow for formalized representation of subnational governments' interests in overall policymaking and legislation. Examples include second chamber institutions, such as the U.S. Senate or the Bundesrat in Germany. Such arrangements provide an institutionalized mechanism for articulating interests from below while providing the means to develop accepted and credible rules for intergovernmental collaboration that are essential to sustainable decentralization. They also help different tiers of government adjust to emerging needs over time.

7.77 In principle, bringing policymaking and implementation closer to the communities they serve and involving citizens in shaping policies lead to accountability and improved local checks and balances. But as the discussion of the potential for macroeconomic instability shows, government action at the central level can be undermined by actions at the local level unless there is a strong pattern of fiscal restraint and enforceable rules that control tiers of government as well as intergovernmental relations. In most federalized systems effective checks and balances between lower and higher levels of government have evolved over a long period of time. What history tells us, paradoxically, is that unless states have achieved a certain level of centralization and effective rules—for overall macroeconomic control and sound policymaking—decentralization may be difficult to implement and may create imbalances. If

those conditions are met, whether through process or design (or both), decentralization may then create additional momentum for development.

7.78 For any strategy of decentralization, the assessment of institutional capacity and capability at various government levels is key (Table 7.5). Decentralization seems to be particularly difficult to implement in countries with certain characteristics. Weak central government capacity to manage overall fiscal and monetary policies, to enact and enforce credible rules guiding intergovernmental affairs, or to provide a framework for bringing stakeholders together are frequently impediments. So are strongly polarized relationships between or within tiers of government and extremely weak organizational capacity at the subnational level. Under these conditions responsible policymakers would do well to postpone decentralization or to pass up broad strategies in favor of a more carefully staged or sectoral approach beginning, for example, with such priority areas as education, health or infrastructure. Strong monitoring mechanisms could provide opportunities for learning and for gradually phasing in new policies. Countries that have better capabilities at the central and local levels have more options at their disposal, although their preferences may vary. What may be important in one country (say, decentralized service delivery) may not be desired (or desirable) in others.

Table 7.5 Decentralization strategy and government capacity

		Central government capacity	
		Low	**High**
Local government capacity	**Low**	• Cautious decentralization strategy with pilot testing • Delegation of some key service functions to NGOs and communities • Massive institutional strengthening at both levels (particularly in public finances) (most Sub-Saharan countries)	• Deconcentration of some priority services • Delegation of some service functions to NGOs and communities • Targeted strengthening of local entities during transfer of responsibilities (e.g. Mexico, Hungary, Thailand)
	High	• Separatist or secessionist tendencies • Delegation or devolution according to priorities of governments) (Santa Cruz, Bolivia, parts of former USSR)	• Delegation or devolution of functions according to government priorities and preferences as well as articulated needs (most industrial countries)

7.79 Since much of decentralization is heavily influenced by politics, there is unlikely to be any quick fix for solving such problems as weak accountability and responsiveness of local

government. But without tangible improvements in both horizontal and vertical accountability, improvements in overall state capability are likely to remain elusive.

Conclusion

7.80 States and citizens alike are feeling new pressures and taking on new responsibilities, yet many of the basic rules for building and sustaining an effective state have survived the test of time. States have to build institutions and frameworks for policy that sustain economic stability, respond to citizens' demands, and lead the way to improved social and economic welfare.

7.81 The evidence presented in this chapter has shown that improving the capability and effectiveness of the state rests with mechanisms to increase openness and transparency, to strengthen incentives for participation in public affairs, and, where appropriate, to bring government closer to the people and communities it is intended to serve. All these efforts build on the fundamental task of reinvigorating core state institutions. The main policy implications are:

- Ensure broad-based public discussion and evaluation of key policy directions and priorities. At a minimum this means making available information in the public interest and establishing consultative mechanisms such as advisory councils, deliberation councils, and citizen committees to gather the views and preferences of affected groups.

- Encourage, where feasible, the direct participation of users and beneficiary groups in the design, implementation, and monitoring of local public goods and services. Enhance the capacity and efficiency of local organizations and institutions rather than replace them.

- Where appropriate, adopt a carefully staged or a sectoral approach to decentralization in priority areas. Introduce strong monitoring mechanisms and make sure that sound intergovernmental rules are in place to restrain arbitrary action at central and local levels.

- At the local level focus on the processes (and horizontal incentives) for building accountability and competition.

7.82 There are always some dangers inherent in a strategy of greater openness and decentralization. More opportunities for voice and participation increase the level of demands made on the state, which can increase the risk of gridlock or of capture by vocal interest groups. And if there are no clear-cut rules to impose restraints on different tiers of government and incentives to encourage local accountability, the crisis of governance that afflicts many centralized governments will simply be passed down to lower levels. However, as the next part of the Report argues, the obstacles on the path to reform of the state are not insurmountable.

There are some clear ways to move forward, including rendering reform intelligible to citizens and the business community through communication and consensus building.

Chapter 8 Facilitating Global Collective Action

8.1 New ideas, technological change, and resource constraints are placing considerable strain on the state, calling for a reassessment of what the state should do and how to do it more effectively. Readjustments often involve changing the scope and functions of the state to match its capacity and resources and restructuring incentives in the public sector to improve performance. Many countries have already undertaken reforms to redefine relationships between the state and markets, between the state and citizens, and among levels of government. These issues, centered on the role of the state in domestic affairs, are discussed in preceding chapters.

8.2 But state responsibilities go beyond the domestic sphere. Markets are increasingly interconnected, social interactions cross national borders, and countries have become more interdependent. Often what one country does has implications for its neighbors and for the rest of the world. While the state has a duty to facilitate domestic markets and support national or local public goods, it also is being increasingly expected, both at home and abroad, to play the role of a responsible member of the global community of nations.

8.3 Underlying this expectation in part is the growing recognition that there are many goods and services that convey benefits extending far beyond the boundaries of individual countries. Protecting the ozone layer and preserving world peace, for example, are what might be called international public goods—that is, once they are provided, all nations benefit and no nation can be excluded from enjoying them. But since it is very difficult to make the beneficiaries pay for these goods, nations do not always have an incentive to produce them. And because there is no world government with the coercive power to enforce mandates, these goods may not be adequately provided.

8.4 This chapter discusses the problem of providing international public goods. The first section identifies the main categories of these goods and services and describes different mechanisms for their collective provision. The second section looks at the criteria that countries use in deciding whether to participate in the provision of international public goods. The third section examines the existing institutional arrangements through which these goods are provided and explores the scope to do more.

Funding and provision of international public goods

8.5 Until recent decades, the common policy advice for the provision of public goods relied almost exclusively on state interventions. Depending on the circumstances, the usual policy prescription might be to introduce a subsidy, a tax, a new liability rule, a new regulation, or a program for direct public provision of the good in question. But this approach has little to offer when it comes to the provision of international public goods. Without a world government, how would the community of nations ensure that international public goods are provided? Why would countries cooperate in actions for which individually they have little or no incentive to carry out?

8.6 Experience and increased understanding of how the economy works have led to the recognition of a broader set of institutional arrangements and motives for collective action. As the previous chapters discuss, the state is giving up domineering or monopolistic roles in favor of a more participatory approach involving the community, markets and local authorities. At the global level, the participatory approach goes a step further: It relies on international cooperation without the use of coercive power. Today, the key mechanisms for the provision of international public goods are based entirely on voluntary action.

8.7 For several decades after World War II the United States played a dominant role in the financing and provision of important international public goods, although it was under no compulsion to do so and was not in a position to extract full compensation for the benefits. But the country perceived a long-term self-interest in helping other nations recover from the war and in leading the efforts to reconstruct a liberal world trade and payment system. In the immediate postwar period the U.S. economy was strong enough to fund the Marshall Plan, make large contributions to the United Nations and Bretton Woods institutions, and provide foreign aid to developing countries.

8.8 Reliance on a dominant benefactor has not been the only mechanism for providing international public goods. Equally important has been the international cooperation arising from enlightened self-interest. In international markets for trade and investment countries have collaborated in developing common rules and norms of conduct and institutionalizing them through regional arrangements—such as the North American Free Trade Agreement (NAFTA), Asia and Pacific Economic Cooperation (APEC), and Mercosur—and multilateral arrangements—such as the World Trade Organization (WTO). Although based entirely on voluntary participation, these arrangements have attracted large and growing memberships, contributing much to world trade growth and welfare improvements. And although organizing and operating the arrangements is costly, members have deemed the benefits sufficient to justify the costs.

8.9 Even when the benefits are more remote and less certain, as with such public goods as international support for basic research and foreign aid, there has been no interruption or cessation in provision. Most nations that can afford to contribute have done so consistently and voluntarily. Although the size of contributions relative to the capacity to contribute varies, foreign aid flows, for example, are larger and more persistent than what might be predicted on the basis of self-interest and immediate incentives. While some foreign aid involves procurement restrictions which favor suppliers from the donor's country, it is the exception rather than the rule.

8.10 The voluntary approach has the advantage of flexibility and adaptability. It allows participants to experiment with different forms of collaboration that best suit their collective interests. And it does not preclude the important option of doing nothing at all, which might be the appropriate course when a government cannot obtain the information it needs to weigh the costs and benefits of an action. In stark contrast is the traditional approach, which relies heavily on taxation and liability rules. Such coercive

measures may actually harm the general welfare, since they seldom accommodate the divergent needs that arise under different circumstances. Imposing uniform labor standards across countries, for instance, may not be a good idea if most workers in poor countries would prefer jobs without stringent standards over stringent standards without jobs.

8.11 So international public goods are clearly being provided in the absence of a global government. But are they being provided at adequate levels? There are no objective yardsticks. Moreover, needs vary depending on the goods and the communities involved. Global climate change, for example, is of great concern to small island nations like Kiribati and Mauritius, which would lose the bulk of their land if sea levels rose by a few meters. But for people living close to the Arctic or Antartica, the threat is not as urgent. And considerable uncertainty remains about the effect and magnitude of carbon emissions, which makes it hard to determine the level of reduction required.

8.12 Available mechanisms may be seen as workable, but not always satisfactory, solutions for ensuring the provision of international public goods. And, the solutions cannot be taken for granted. The challenge for all nations is to make constant efforts to bring about voluntary cooperation, the foundation of all collective provision of international public goods.

When is cooperation desirable?

8.13 There is no simple answer to this straightforward question. For any country cooperation is a choice, conditioned by its social values and by its assessment of long-term national interest. The balance of costs and benefits in cooperating depends on the type of activity, the mechanisms, and the conditions the country faces.

8.14 There is greater recognition today not only of the existence and benefits of international public goods, but also of the implications of failing to bring about adequate provision. History has shown that the community of nations can be more fragmented than it is today, with more countries at war or more countries erecting trade and investment barriers. Without a forum for nation-states to discuss and negotiate orderly changes in national policies and environmental standards, small economies may end up having to adopt the practices of the dominant economic powers, in a process of "imperial harmonization." And failure to provide effective foreign aid or support for basic research to meet the needs of poor countries would diminish the prospects for having more vibrant economies as trading partners. International cooperation can help ensure more satisfactory outcomes than these.

8.15 But participating in the provision of international public goods is not always desirable for all countries. At the very least, cooperation can restrict a country's freedom to act. For many activities the benefits may well exceed the costs of ceding some national autonomy, but the balance is not always favorable. In many areas, such as macroeconomic coordination, there is uncertainty about what kind of joint action should

be taken. In others, such as environmental protection and climate change, there is uncertainty about the extent to which the key players will participate. These uncertainties reduce the likelihood of effectiveness and the expected benefits of cooperation.

8.16 Even without such uncertainties, the diversity in perceptions and social values can preclude some forms of cooperation. Many developing countries, for example, are reluctant to adopt the labor laws and pollution standards of more advanced countries for fear of losing their competitive advantage and jeopardizing growth. And some countries may choose not to cooperate in certain activities out of a belief that research and experimentation might lead to better solutions.

8.17 Collective provision of public goods generally requires balancing three principles—openness, diversity, and cohesion. Each principle has much merit, but pursuing any one to the extreme risks compromising the others. Openness without diversity may lead to backsliding and increased fragmentation of the world economy. Diversity fosters innovation, but may be detrimental to cohesion among countries or among communities within a country. And cohesion is a desirable goal, unless pursing it means sacrificing too much openness and diversity.

8.18 These considerations suggest that while there is much need for collective provision it is not the answer to all problems for all countries. Each country has to decide case by case whether to participate in collective actions. An appropriate global framework for organizing collective action therefore must allow for multiple approaches based on voluntary participation. One possible organizational design is to form a series of groups, each with a different objective:

- Functional groups to deal with macroeconomic policies, environmental protection, international arms conflicts, and the like.

- Regional groups to deal with multiple issues of interest to the region, including trade and investment, such as NAFTA and APEC. Unless a regional group is working toward a federation, it should be open to all interested parties, including trading partners outside the region.

- Coordinating groups linking functional and regional groups to create a broader network for all members.

8.19 This framework provides a reasonable balance among openness, diversity, and cohesion and may well be adequate to prevent fragmentation or imperial harmonization. Individual countries' interest and participation in the various arrangements any given time will vary and any particular groups may be relatively inactive for a long period. But when the timing is right, with converging ideas and circumstances, each group may witness surges of interest and activities, as with the experience during the Uruguay Round, which was a milestone for the GATT.

Ensuring more effective cooperation

8.20 There is no guarantee that participating states will always fully comply with external commitments. In the absence of global authorities with general compulsory jurisdiction, enforcement of international agreements and treaties is a matter for individual state action. When commitments are not being voluntarily honored, mechanisms are needed to ensure compliance. Recent experience in international law suggests a few such mechanisms.

8.21 Countries fail to comply with international commitments for different reasons. First, the incentives for compliance may be weak, either because of changes in political priorities or underlying economic conditions. Second, the capability needed for compliance, including the technical expertise and organizational skills to ensure timely actions, may be lacking. Third, and perhaps most common among developing countries, the requisite financial resources may not be available.

8.22 Where incentives are incompatible with international obligations, the country involved may need to reconsider its participation in the agreement. The effectiveness of the agreement or international organization is impaired if many countries simultaneously face incompatible incentives. In practice, however, member states have looked at their self-interest in broad terms, recognizing the impact of their actions on the community of nations, on their reputation, and on the possibility of future reciprocal arrangements.

8.23 Lack of capacity and financial resources is often more manageable. Many international agreements anticipate, the capacity and financial constraints of some members. Provisions can be included in the agreements to ensure that necessary personnel and financial resources are available to all members. Where needs are not fully anticipated, mechanisms for communication and supervision can be created to address emerging issues. Sorting out in advance realistic allocation responsibilities and necessary resource transfers can improve implementation and reduce violations.

8.24 Traditional legal mechanisms often fail to address the root cause of the compliance problem, relying on the breach of agreement to trigger action. This approach highlights the violation of commitment and is confrontational. Necessary remedial actions may come too late. Damage may have been done. Relations among members may sour, making future cooperation more difficult.

8.25 An alternative, more process-oriented approach promotes the observance of commitments on a continuous basis. The goal is not to condemn wrongdoing, but to bring states in compliance with their obligations and prevent violations. This approach relies to a much greater extent on communication, consultation, monitoring, the sharing of information, and technical and financial assistance.

8.26 New conventions, particularly in environmental circles, incorporate mechanisms for monitoring and facilitating compliance, including conferences of the

parties, separate secretariats, and financial assistance arrangements that ensure the submission and review of implementation reports by member countries. These bodies, however, lack the power to enforce the obligations of the conventions. They also have limited capacity to verify implementation unless there is sufficient country cooperation. More sophisticated legal agreements including some recent environmental conventions, incorporate supervision as an added element for ensuring compliance. A supervisory body can help by following up on reporting requirements and by disseminating information on the impact of the convention at the domestic level.

8.27 The noncompliance procedure established under the Montreal Protocol on Substances that Deplete the Ozone Layer is a good example of this new approach. The procedure can be initiated by any party that has doubts about correct applications of the protocol as well as by the secretariat or by a party having trouble meeting its commitments. NGOs and individuals also have access to this procedure by transmitting information to the secretariat. The Committee on Implementation may try to bring about a friendly settlement or recommend technical or financial assistance if the failure to apply the protocol is due to lack of capacity. It also can suspend the rights and privileges of the concerned party.

8.28 The continuous cooperation of national agencies is the foundation of this process-oriented approach. The building blocks include permanent communication networks, periodic reporting of implementation, periodic reviews of legal provisions, and regular meetings of decisionmaking and staff. Such facilities help raise awareness among responsible officials of the goals being sought by the agreements and the means for achieving them. The facilities also disseminate information to keep the public informed of emerging issues. The Geneva-based International Register of Potentially Toxic Chemicals, which draws on national regulatory decisions rather than international regulatory action, is a good example of such a facility.

Current provision of international public goods

8.29 The section reviews some of the challenges and opportunities facing nation-states as they seek to balance self-interest and common interest in an increasingly interdependent world.

Expanding world markets

8.30 The liberalization of trade and investment laws around the world has led to an enormous increase in the volume of world trade, direct foreign investment and portfolio investment, with a considerable and largely positive welfare impact for participants. Multilateral and regional agreements have facilitated market expansion, as increased economic interdependence has made it necessary to maintain and extend an international system of liberal trade and investment. Invigorated by buoyant trade, the global economy has grown rapidly and is likely to stay the course for the foreseeable future. But the growing markets and increasing competitiveness will leave many

unprepared countries vulnerable. To prepare for the new global environment, countries must adopt prudent, consistent, and credible policies (see Chapter 3). International collective action can help by providing a mechanism for external commitments that impart credibility to these policies.

8.31 The growing global consensus on the benefits of more liberal trade and international market expansion is reflected in the membership of the World Trade Organization (See Box 8.1). The most recent phase of multilateral liberalization (the Uruguay Round) sponsored by the WTO (formerly the GATT) led to significant reductions in both tariff (Figure 8.1) and non-tariff barriers for trade in goods and services, particularly among developing countries.

Box 8.1 The World Trade Organization—an international mechanism for giving credibility to national policy.

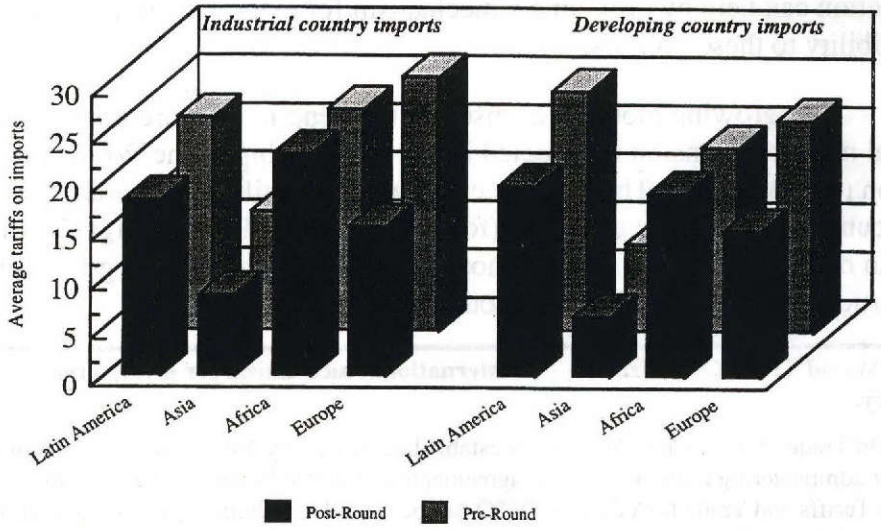
The World Trade Organization (WTO) was established in January 1995 as an apex institution responsible for administering multilateral trade agreements negotiated by its members. Unlike the General Agreement on Tariffs and Trade (GATT), the WTO can be regarded as both an institution embodying a set of rules and principles on the use of policies that affect trade flows and a market in which members exchange market access concessions and agree on the rules of the game. The WTO requires that its members ensure that their trade policies are largely nondiscriminatory and their rules and enforcement procedures transparent. The WTO also provides legal mechanisms (bindings) for countries to signal the seriousness of their commitments and improved dispute settlement procedures for resolving conflicts between member states.

In the first two years of its existence, the WTO dispute settlement system received a total of 62 cases, involving more than 43 distinct matters. Of these matters, two have completed the entire process and two further panel reports have been issued. Countries can no longer block the establishment of arbitration panels or ignore their findings, as they could under the GATT. And although they may appeal, the decision of the appeals body is final. Every stage of the process is subject to strict time limits, and countries that fail to comply face authorized trade sanctions.

The largest trading nations and customs territories continue to dominate the dispute settlement process, and the credibility of the system depends on their willingness to comply with judgments against them. But, encouraged by the nature of the WTO system, including the right to redress, developing countries are turning to the dispute settlement process far more often than they did under the GATT.

8.32 Reducing border barriers is not all it takes for a country to engage more extensively in world trade, however. Countries also need a competitive exchange rate, good availability of foreign exchange, and a transport infrastructure that can support expanded trade. Thus despite spreading trade liberalization, the share of trade in GDP fell in 44 of 93 developing countries between the mid-1980s and the mid-1990s. Such disparity in the speed and extent of integration affects how well different regions have succeeded in raising their trading volume with the rest of the world (Figure 8.2). While East Asia, for instance, has consistently expanded trade, Africa has reduced it.

Figure 8.1 The Uruguay round reduced tariffs in developing countries on imports of manufactures



Source: World Bank staff estimates.

8.33 In addition to trade, more countries are also gradually removing restrictions on cross-border movements of capital, either unilaterally or as part of regional initiatives. The number of countries with liberal or mostly liberal capital regimes has grown from 9 to 30 in the past two decades, while the number of countries with relatively restrictive rules dropped sharply from 78 to 42 (Figure 8.3).

Figure 8.2 Changes in real trade as a share of GDP, 1960-1994

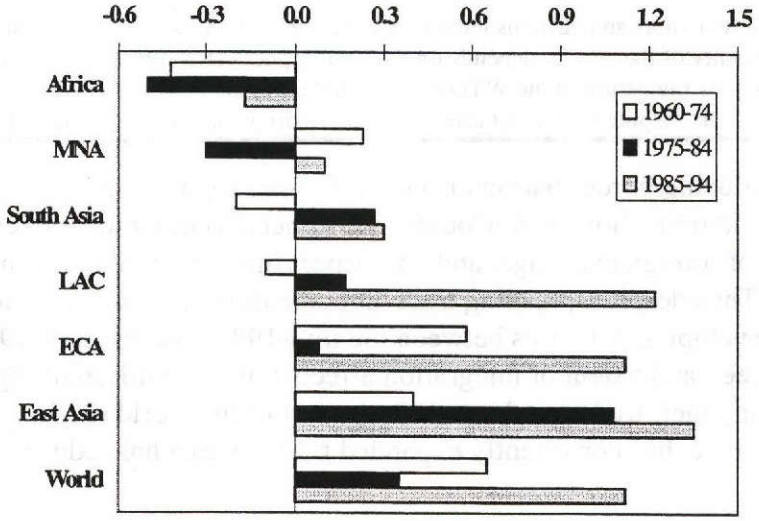
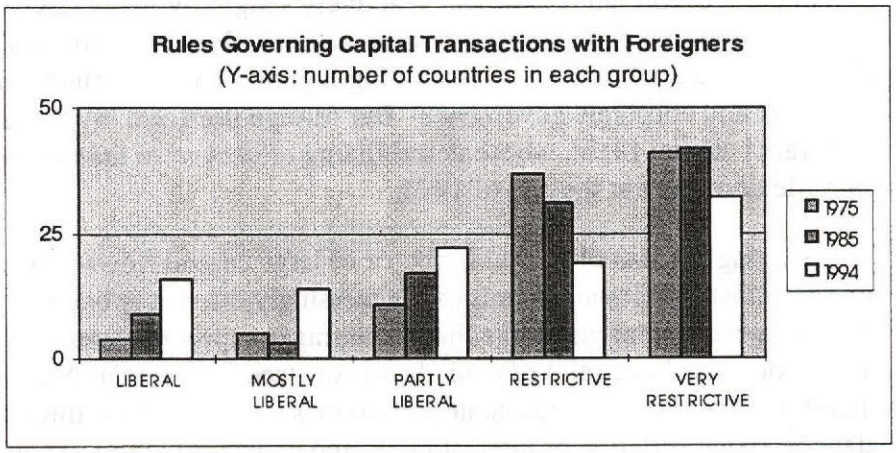


Figure 8.3 Countries are relaxing rules governing capital transactions with foreigners

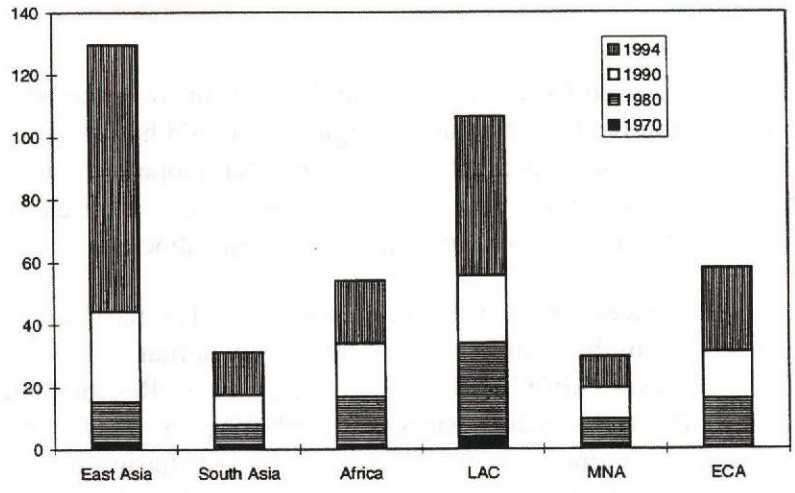


Source: World Bank

Note: Liberal means no restrictions
mostly liberal means a few restrictions by industry
partly liberal means many restrictions on size and timing
restrictive means either that foreigners are not allowed to invest domestically or that residents are not allowed to invest abroad without official approval, and
very restrictive means all cross-country capital transactions require official approval.

8.34 As with trade, there is also considerable disparity in the extent to which countries have been able to attract foreign capital. While overall private and official capital flows have expanded substantially (by about a factor of ten) in the past two decades, relatively few developing countries have benefited from them. Much of the expansion has been in private flows and, among developing regions, most of these go to East Asia and Latin America (Figure 8.4).

Figure 8.4 Net capital flows to developing regions, 1970-1994 ($ billions)



8.35 Of particular concern to developing countries is the rapid growth of private capital flows. While direct foreign investment is actively sought by many developing countries, portfolio investment is regarded with ambivalence. Foreign portfolio investors can help develop local financial markets by providing liquidity and by influencing the regulatory framework and corporate governance. But foreign portfolio investment brings with it the risk of rapid capital flight, whose destabilizing effects were dramatically illustrated by the Mexico crisis at the end of 1994.

8.36 Managing the risk of capital flight, or of large capital flows generally, has been a challenge for most developing countries. Increasingly the risk is being regarded as a welcome source of government discipline that discourages capricious and irresponsible policies and many countries have relaxed capital controls (see Chapter 3). Still, large capital flows in either direction can accentuate a country's vulnerabilities, through large external imbalances, rising inflation or interest rates, and exuberant credit expansion that could compromise the soundness of banks.

8.37 The growing concern about rapid portfolio investments flows has led to several proposals for containing them including increasing fiscal and monetary discipline at the national level, coordinating actions among central banks to ward off speculative attacks, and taxing portfolio transactions. The key is maintaining prudent fiscal policies, credible monetary and exchange rate regimes, and a sound and prudent banking system. Also helpful in moderating capital inflows are measures that reduce the public's expectations of government protection against investment losses. Some governments have curtailed their role as the lender of last resort, replacing generic government guarantees with discretionary assistance, given on a case by case basis.

8.38 But the international community has important interests at stake in addressing the risks associated with capital flows. A better understanding of the risks and more confidence in managing them would encourage countries to participate more actively in world markets. More open and better functioning capital markets in developing countries would improve the use of global resources and increase portfolio diversification.

8.39 What kind of collective actions could help achieve these benefits? Closer consultation among central banks and financial regulators could help upgrade national regulatory frameworks and financial practices. And greater cooperation among the authorities could help establish procedures for mutual assistance in crises such as the IMF's new facility to help member countries absorb external shocks.

8.40 Another concern is the growing regionalism. The past two decades have witnessed a large increase in the number of local and regional market-opening agreements including NAFTA, Mercosur, APEC, and the European Union. Regionalism is not simply about trade. It also reflects the desires of neighboring nations for greater political integration in response to common security concerns, for cost sharing for infrastructure and institutions, and for increased bargaining power in international negotiations.

8.41 Opinion is divided on the merits of regional arrangements, and the evidence remains inconclusive. Some argue that regionalism will divert attention and resources away from the more important multilateral processes and undermine progress toward global nondiscriminatory trade rules. Others contend that regionalism enables states to take market-opening measures that serve as building blocks for multilateral initiatives. Observers have also pointed out that regional agreements have set examples for multilateral agreements, as with the European Union's treatment of trade in services.

8.42 Some of the concerns about regionalism may be legitimate. But regional arrangements can be made more consistent with the more open and integrated world markets. One possibility is to open membership in such arrangements to any trading partners that wish to join rather than restricting it to countries within the region. Another is to establish, through a multilateral mechanism, a time-bound convergence process, for cutting differences between internal and external trade barriers to a stipulated minimum.

Supporting basic research

8.43 Knowledge is an international public good whose benefits accrue to all humankind. International collective action can direct research toward the needs of developing countries, where most research activities are fragmented, poorly funded, and inadequately directed. International assistance can help in assessing needs, developing a cost-effective agenda, encouraging international exchange and collaboration, and providing additional funding where it is needed. Successes such as those of the Consultative Group on International Agricultural Research (CGIAR) and the World Health Organization (WHO) suggest that the return on investment in research can be substantial.

8.44 Basic research is a classic—and global—public good. The benefits, while uncertain, are exceptionally high, often impossible to measure. The transformation of our economy—indeed our entire society—has as its basis the knowledge that emanated from new discoveries. Major developments in science, engineering, and medicine—from the computer to the green revolution to the smallpox vaccine—depend on basic research. And yet the incentives for conducting and funding basic research are extremely weak. Since the domain of benefits is global, recovering the costs is exceptionally difficult and few constituencies lobby for research. Governments in rich countries often regard research as a luxury. Governments in poor countries seldom pay it much attention.

8.45 Perhaps the greatest mismatch between returns and investment in research is to be found in developing countries. The scope for building human capital is enormous, but the process is complicated by childhood malnutrition, debilitating diseases, and degradation of the natural resources that support agricultural production. New knowledge can make a dramatic difference in people's lives, as with the eradication of smallpox, the containment of malaria and river blindness, and the significant increases in agricultural productivity made possible by the green revolution. But these successes are few and far between. And new breakthroughs are unlikely unless continued support for well-directed efforts is assured.

8.46 In developing countries research suffers from disadvantages that go beyond poverty. First, research activity generally is given low priority. In Sub-Saharan, for example, less than 2 percent of budget allocations for health is spent on health research, resulting in shortages of research institutions, facilities, and scientists. Second, the limited funding for research is usually misallocated. Again in the health sector, pneumonia and diarrhea, which account for 15 percent of the disease burden in developing countries, account for only 0.2 percent of research funding. This misallocation often reflects a lack of basic information and skilled personnel needed to develop an appropriate research agenda. And third, there is little coordination and exchange by researchers across developing country borders resulting in considerable overlap in research activities and missed opportunities for cost saving.

8.47 The international community can do more to assist developing countries. Through foreign aid, donors can help governments develop a research agenda based on careful assessments of needs and help finance a higher but sustainable level of research spending. Advanced countries can also help alleviate the impact of brain drain by providing competent researchers and scientists to work with institutions in developing countries. Donors can help establish and fund regional research institutes to encourage cross-fertilization of ideas and to limit the redundancy of fragmented research activities. And international institutions can also help disseminate new knowledge to promote productivity, more effective treatment of diseases, and healthier lifestyles.

8.48 International cooperation has been successful in many areas of research and in disseminating knowledge. The Consultative Group on International Agricultural Research (CGIAR), for example, was instrumental in developing more productive crop varieties and promoting more efficient and environmentally friendly production techniques. A network of sixteen agricultural research centers around the world, the CGIAR is supported by fifty nations in its primary goal of alleviating hunger in developing countries. But the benefits of its activity have not been limited to developing countries (Box 8.2).

Box 8.2 International agricultural research—benefits all around

In 1993 the United States produced about 12 percent of the world's output of wheat which is among the top ten agricultural commodities in half its states. The United States is also a major rice exporter, accounting for nearly 18 percent of internationally traded rice. Most wheat and rice varieties grown in the United States have been developed through crop improvement research. Many of its new varieties were developed through the research of two research centers in the CGIAR network—the International Center for Maize and Wheat Improvement (CIMMYT) and the International Rice Research Institute (IRRI)—both are supported in part by contributions from the U.S. government.

A recent study to measure how much the U.S economy has benefitted from CGIAR research estimated that during 1970-93 it gained between $3.4 billion and $13.7 billion from the use of improved wheat varieties developed by CIMMYT. The benefit-cost ratio for U.S. government support of CIMMYT was as high as 190 to 1. IRRI research was linked to $20 million to $1 billion in gains in rice revenues, yielding a benefit-cost ratio of as much as 17 to 1. Thus although, the U.S. investments in international agricultural research on wheat and rice were made primarily on humanitarian grounds, they have yielded direct benefits to the U.S. economy that far outweigh the costs of supporting the CGIAR. And as the study concludes, "international agricultural research is an investment in international stability and economic growth overseas, which reaps further rewards for the United States and other donor nations."

8.49 International cooperation in health research also has led to important advances. The World Health Organization (WHO), for example, has played a major role in the eradication of smallpox. But much scope remains for more collective action. Of the total spending on health research in the early 1990s, an estimated 95 percent was devoted to health problems of concern mainly to industrial countries, and only 5 percent to the health needs of developing countries.

8.50 Several research activities especially warrant more international support:

- Improving the understanding of tropical diseases, particularly those affecting children and rural dwellers of Sub-Saharan Africa.
- Controlling the spread of HIV.
- Improving treatment or prevention of noncommunicable diseases, which affect an increasing number of people in developing countries.
- Finding or developing disease- and pest-resistant varieties of such crops as cotton, cocoa, rice, and yams which play a key role in many economies.
- Developing mining and farming technology to minimize soil erosion and deforestation.

Protecting the global environment

8.51 A major threat to development comes from environmental degradation, at both the global and the local level. Global environmental issues of great concern include climate change (Box 8.3), loss of biodiversity, and protection of international waters. At the local level the most pressing problems are urban air and water pollution, deforestation, and soil and range land degradation. International collective action can help mitigate these problems through better coordination, increased public awareness, technology transfers, cost sharing, and consultation to help shape national and local policies and practices.

Box 8.3 The challenges of global climate change for international cooperation

While some doubts remain about the magnitude and urgency of global climate change, a consensus is emerging that the problem is real and potentially dangerous and that reasonable and appropriate measures should not be postponed. The Intergovernmental Panel on Climate Change has predicted that over the next 100 years the earth will warm by 1.5 to 6.3 degrees Fahrenheit and sea levels will rise by 6 to 38 inches. These changes would bring more frequent and intense droughts, the geographic spread of disease, the retreat of mountain glaciers, and storms of greater malevolence.

What major challenge does climate change pose for international cooperation? Under the auspices of the United Nations Framework on Climate Change (UNFCC), which was signed in 1992 and ratified by 159 countries, an international agreement on limiting the greenhouse gas emissions that contribute to climate change is being negotiated and may be adopted by the end of 1997. But climate change, if it brings the dire effects that are predicted, will require far bolder cooperation than has been seen to date. The cooperation

required will be political, economic, and financial—in order to meet financial needs projected to reach $50 billion a year by 2040.

Recent analysis of climate change shows that there is a strong economic rationale for adopting market-based instruments for reducing greenhouse gas emissions, such as tradable carbon emissions entitlements. In a tradable permit system countries for which the costs of reducing carbon emissions are high would buy entitlements from countries for which the costs are low. Countries that purchase entitlements would save the difference between their higher abatement costs and the price of the entitlements. (Alternatively, in a joint implementation system, contracts would be used in place of tradable entitlements, with an agreed on transfer price). A recent World Bank study estimates that cutting emissions in OECD countries by 20 percent at least cost could require global trading of $30 billion to $40 billion annually. Allowing trading would generate saving equivalent to 65 percent of global abatement costs.

The barriers to implementing this global market are largely political. The market's existence depends on governments' willingness to create and regulate it. (The financial resources for purchasing entitlements are expected to come from the private sector.) A crucial step in establishing the market will be the initial allocation of entitlements. This allocation must be determined by a global climate change protocol. Although many formulas have been suggested this contentious issue has not yet been resolved.

A second issue that remains unresolved is basic political acceptance by some developing countries of the underlying principle that climate change is best addressed through a system of transferable emissions entitlements. In part to address these concerns, the World Bank in collaboration with the government of Norway initiated a pilot program of voluntary joint implementation in 1996 that may serve as a precursor for a broader system once the political issues of binding emissions constraints and allocation of entitlements have been resolved. Ultimately, this and other incremental experiments, along with gradual political acceptance should make more effective international cooperation on climate change a reality.

8.52 International cooperation is now recognized as the cornerstone of sustainable environmental regimes. In the past two decades, the number of international environmental agreements has grown significantly. The wide array of interests at stake means that activities must be coordinated at the international level to ensure stable and predictable patterns of behavior and cooperative management systems. Although willingness to participate in international collective action implies a common objective, different groups of states have different interests at stake, and these interests must be recognized. The 1992 Climate Change Convention required that the parties to the convention give full consideration to the interests of small island countries; countries with low-lying coastal areas, arid and semiarid areas, forested areas, or areas liable to forest decay; countries with areas prone to natural disasters, drought, and desertification; countries with fragile ecosystems; and landlocked and transit countries (Article 4).

8.53 Institutional and financial support is often needed to enable certain countries to meet their obligations. The Rio conventions, for example, included a commitment by the industrial countries to provide financial resources to meet the costs incurred by developing countries in implementing the conventions. The Global Environment Facility plays a crucial role in implementing these obligations (Box 8.4).

Box 8.4 Sharing the burden of environmental protection

The Global Environment Facility (GEF) was set up in 1991 to help developing countries finance the incremental costs of new environmental investments with global benefits in four areas: climate change, biodiversity, the ozone layer and international waters. A joint undertaking of the United Nations Environment Program, United Nations Development Program, and the World Bank, GEF has led to new

institutional arrangements for the provision of collective goods. Especially interesting is the GEF's constituency system, through which it has attempted to combine representativeness with efficiency.

GEF has more than 165 member states and is governed by a board of representatives from 32 countries, each representing a constituency. There are sixteen constituencies for developing countries, fourteen for industrial countries, and two for Eastern Europe. The countries in each constituency choose a board member and an alternate, and each constituency determines its own process of consultation and decisionmaking. New members join an existing constituency.

8.54 Many of the most immediately pressing problems for developing countries—such as urban water and air pollution, and soil degradation—have relatively small global dimensions. But they have major implications for productivity, health, and the quality of life at the local level. Progress in alleviating these problems has been slow. Lack of capacity and political will at the national and local levels has been a major stumbling block.

8.55 Bringing about environmental integrity and sustainability at the local and global levels will require a coordinated international effort, one that blends careful attention to financial incentives, market forces, laws, and national interests. Equally important, the international community can help raise public awareness of the dangers of environmental degradation and thereby alter the existing political incentives, which often work against environmental integrity.

Preventing and controlling conflicts

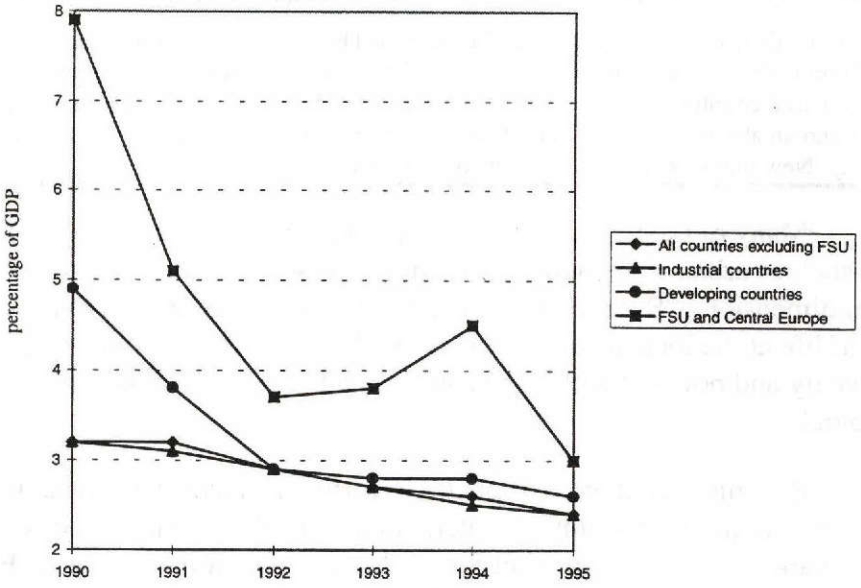
8.56 For most of the twentieth century people lived under the specter of major wars. The first half of the century witnessed two global conflicts, catastrophic destruction of lives and resources, and decades of rehabilitation and reconstruction. During the second half, the Cold War loomed large, with the threat of even greater destruction, from nuclear weapons. Global tension led many countries to devote a substantial share of national output to the military. Only in the past ten years did tensions begin to subside, providing an opportunity for nations to reduce military spending and reap the dividends of peace (Box 8.5).

Box 8.5 What are the benefits of a peace dividend?

Global military spending has fallen significantly, from about 4 percent of GDP in 1990 to 2.7 percent in 1994 to 2.4 percent in 1995 (Box Figure 8.5). This drop in sharp contrast to the rising trend of the previous two decades, resulted from the breakup of the Soviet Union, a changing political climate, increased democratization, and a fall in military aid.

But has the reduction in military spending improved growth and welfare? Empirical results vary, depending on assumptions and methodologies. Some studies show that global reductions in military spending have indeed generated a peace dividend in the form of higher output growth. Others suggest that there is no linear relationship between military spending and growth. Instead the relationship appears to be quadratic: at low levels of military spending, increased spending contributes to higher growth; at higher levels of military spending further military spendingis leads to lower growth. Once the highest-spending nations are excluded from the sample the relationship between military spending and growth is not significant for most developing countries (in peacetime). In such cases the biggest dividend ultimately may come from a country's perceived security and increased investor confidence, rather than from reductions in military spending.

Box Figure 8.5 Military expenditures (percentage of GDP)



8.57 The threat of nuclear war has been pushed aside by a proliferation of smaller conflicts—with costly problems of refugee relief and rehabilitation. Existing cooperative mechanisms have had limited success in managing these conflicts, or in helping to avoid them. The problems often spill over and engulf an entire region, as in Southeast Asia and southern Africa and now in Central and West Africa. These conflicts are not confined to very poor countries, but can also happen in relatively high incomes countries such as in Yugoslavia and Lebanon. The challenge facing the international community is to find new ways to prevent conflicts or to manage them at an early stage before they turn into tragedies.

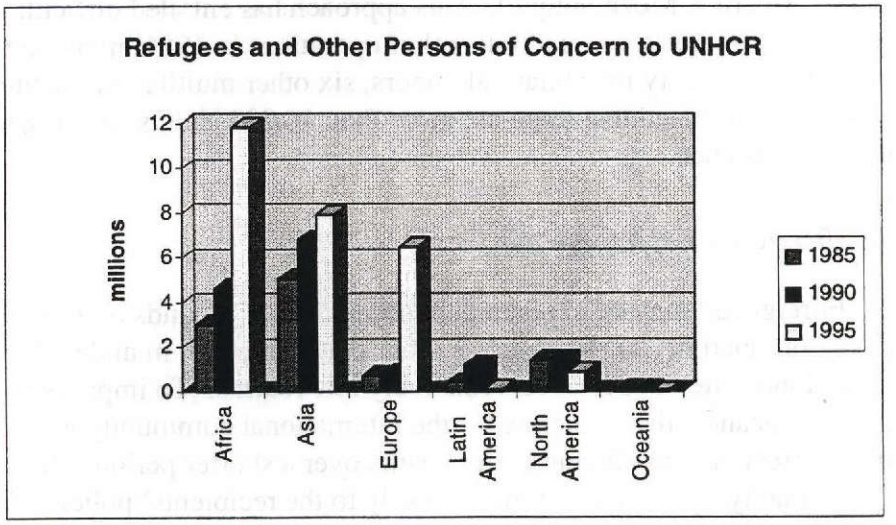
8.58 The end of the Cold War brought a sense of optimism that many of the issues that had contributed to instability and conflict would be resolved. Instead, at least thirty major armed conflicts (defined as causing more than 1,000 deaths annually) have taken place in recent years. The fragile peace settlements in Cambodia, and Mozambique now seem the exception rather than the norm. The international community has witnessed:

- Rising numbers of refugees and internally displaced persons, and a disproportionate number of women and children who lack access to the basic assets or resources needed for repatriation or rehabilitation (Figure 8.5).

- A rise in the number of humanitarian emergencies from an average of five a year in 1985-89 to twenty in 1990, twenty-six in 1994, and twenty-four in 1995.

- The erosion or total collapse of legitimacy and authority in many states, including—Afghanistan, Liberia, Rwanda, Somalia, the former Yugoslavia—as a result of extended civil war or genocide.

Figure 8.5 Africa, Asia, and Europe have seen dramatic growth in the number of displaced persons



8.59 The relationship between the refugee and the state is inextricable. States are major actors in responding to and defining refugee crises. International law defines "refugee" in relation to the state. While NGOs and receiving communities play essential roles in providing for displaced persons, the scale of displacement in recent years has required that states—unilaterally or in the framework of multilateral organizations—mobilize and deliver protection, relief, and assistance for refugees. In addition, states acting together or as members of international organizations have initiated the negotiations that have brought to an end several refugee-generating armed conflicts, including those in Cambodia, Mozambique, and the former Yugoslavia.

8.60 Nevertheless, the disincentives to cooperating on refugee issues are powerful. One is the difficulty in securing commitments where a state may perceive no direct interest of its own. Another is the prospect of burden-sharing arrangements that require a state to accept refugees into its territory, often with high political and financial costs . The case of Rwanda shows the cost of providing relief in large humanitarian emergencies. Between April and December 1994 the international community allocated about $1.4 billion for relief in Rwanda and neighboring countries. Rehabilitation efforts were gradually introduced but by late 1996 an external refugee population of about 1.5 million remained dependent on international assistance.

8.61 States also differ in their ability to avoid or limit refugee flows. Stronger states are more effective at denying entry to refugees and asylum seekers. It is often the weaker states, with limited resources, that shoulder the greatest burdens in protecting refugees and in repatriating them when conflicts end.

8.62 Today's international collective response to refugee problems relies heavily on multilateral organizations. The United Nations High Commissioner on Refugees (UNHCR) has seen its budget doubled and its mandate stretched in the 1990s. It has provided in-country humanitarian relief (Bosnia), cross-border operations (Somalia), assistance to internally displaced persons (Sri Lanka), and repatriation of refugees (Central America, Mozambique). This approach has entailed difficult coordination. In Mozambique, for example, relief operations in 1991 involved twenty-six United Nations agencies, forty four bilateral donors, six other multilateral institutions, and 180 NGOs. It is estimated that there are more than 16,000 NGOs working in relief and humanitarian assistance.

Improving the effectiveness of foreign aid

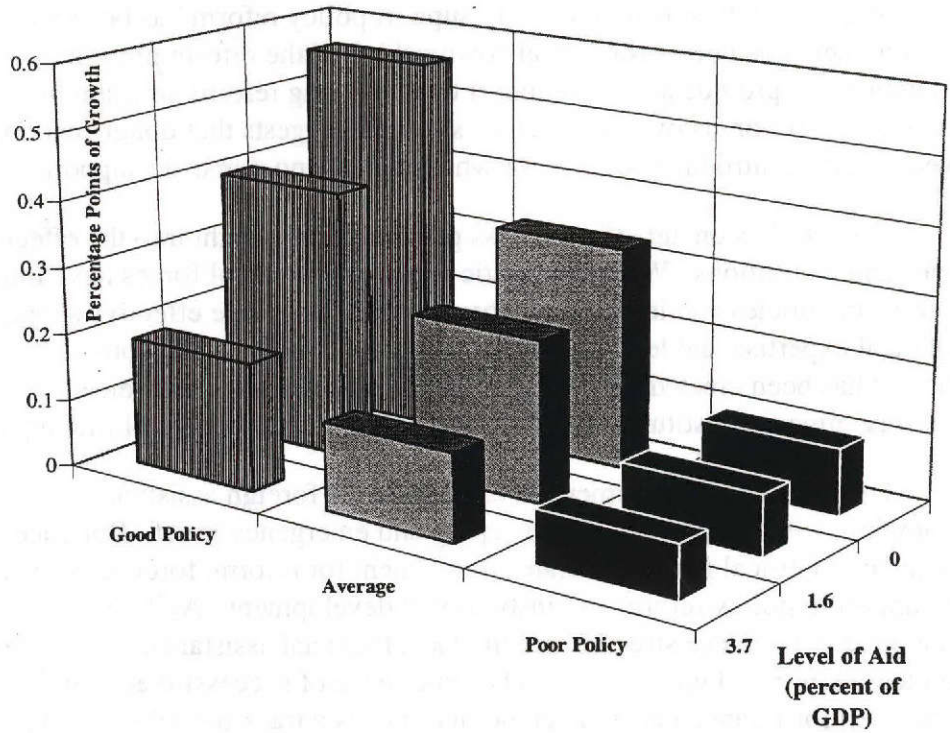
8.63 Foreign aid may be explained on humanitarian grounds or as a long-term investment in the productivity of the people in poor countries. But in undertaking such investments, the donor often has to accept relatively low returns. To improve the climate for development assistance, the challenge for the international community is to make foreign aid more effective—producing better results over a shorter period. Recent research suggests that tying foreign aid more closely to the recipients' policies can make it much more effective.

8.64 The success or failure of development projects financed by aid depends to a large extent on the quality of macroeconomic policies. Even in the social sector, the success of projects is contingent on macroeconomic conditions. A project to expand primary education, for example, is more likely to succeed if macroeconomic policies are good. If projects are the vehicle for development, macroeconomic policies can be seen as the fuel and the lubricants that keep the vehicle going.

8.65 Moreover, only in a good policy environment will foreign aid have an impact on growth. In countries that pursue the key economic policies for growth—identified by empirical research as ensuring fiscal discipline, preventing high inflation, and maintaining a reasonably open economy—foreign aid has significantly increased economic growth (Figure 8.6). Countries that have achieved a good policy environment and received significant amounts of aid in recent years—Bolivia, Botswana, El Salvador, Mali, and Uganda—have grown faster than would have been predicted by their policies alone.

In countries with a good policy environment aid significantly increases growth

Figure 8.6 Marginal impact on growth of aid equivalent to 1 percent of GDP



8.66 These results suggest that societies that put in place good economic policies and good governance structures can make effective use of financial assistance. But where these pre-conditions are not in place, foreign aid is more likely to be dissipated in rent-seeking and corruption then to lead to productive expenditures. The clear implication is that foreign aid would be more effective if it were either more systematically targeted to poor countries with good economic reform programs and governance structures or used to promote good policies.

8.67 The past decade has seen a trend toward both economic and political liberalization in the developing world, indicating an improving climate for effective assistance. For example, Ethiopia, India, and Viet Nam—large countries with good reform programs in the early 1990s—offer environments where foreign aid is likely to have a greater impact on growth and poverty reduction. But the track record of targeting aid to poor countries with good policies was weak during 1970-93. Bilateral aid showed no tendency to favor good policies, while multilateral aid reflected some favoritism toward countries with good policies, after controlling for income level and population. Clearly, a high priority for aid agencies is to more systematically channel resources to poor countries with good policies.

8.68 Can aid help poor countries improve their policies and institutions? This is a difficult but key question for the allocation of aid. While there has been little systematic research into this question, there are some suggestive results.

8.69 Structural adjustment lending to support policy reform has been more successful where there has been strong local "ownership" of the reform program. While adjustment lending can provide a useful support to an existing reform program, it is not likely to generate reform on its own: experience strongly suggests that donors cannot "bribe" governments to introduce policies for which there is no domestic support.

8.70 Case studies on aid effectiveness provide some insight into the effect of aid on policies and institutions. Where domestic social and political forces have initiated programs to reform policies and institutions, foreign aid can provide effective support by bringing technical expertise and lessons from other countries into the receptive environment that has been created. But where there is little domestic movement toward reform, assistance aimed at institution building and policy reform has had little impact.

8.71 Thus in some environments it is difficult for foreign assistance to accomplish anything beyond perhaps peacekeeping and emergency relief. But once domestic social and political forces generate a movement for reform, foreign aid can be an effective support to policy reform and institutional development. And once good policies and a good governance structure are in place, financial assistance can accelerate the transition to a more rapid growth path. The experience of successful economies shows that the need for financial aid is a temporary one: as a track record of good policies and performance develops, private capital flows increase and gradually eliminate the need for foreign aid.

Conclusion

8.72 More effective international cooperation can help expand opportunities and allow nations to cope better with the new global challenges. But each country has to evaluate the merit of cooperative endeavors and decide case by case whether it will participate. There are several areas where more cooperation could be of great value:

- Expansion and preservation of open world markets, including mitigation of the risk associated with volatile capital movements. Many developing countries would participate more actively in global markets if the risk of capital flight, were reduced.

- Basic research directed at the needs of developing countries. The green revolution, made possible by the support of the CGIAR, shows that investing in research and development can bring big returns—for both for the donors and the intended beneficiaries.

- Peacekeeping and the prevention of armed conflicts. The high human and financial costs of wars—and of associated relief and rehabilitation efforts—are well known, but existing mechanisms have not been very successful in preventing conflicts or in resolving them before they become human tragedies.

- Protection of the environment. International collective action can help mitigate both global and local environmental problems by improving coordination, increasing public awareness, transferring technology, and providing incentives for appropriate national environmental policies and enforcement.

- Improving the effectiveness of foreign aid. Tying aid more closely to recipients' policies can make aid more effective: for any level of foreign aid available to a country, economic performance rises with the quality of policy and governance. Recipients' policies appear to have influenced the allocation of multilateral but not allocation of bilateral aid.

8.73 Creating more functional and regional groups based on voluntary participation is one possible approach for fostering greater international. These groups should seek to develop common rules and mechanisms for pursuing designated objectives, while preserving a balance among the principles of openness, diversity, and cohesion.

DRAFT
(NOT FOR QUOTATION)
March 3, 1997

WORLD DEVELOPMENT REPORT 1997
THE STATE IN A CHANGING WORLD

Part D Removing Obstacles to Change

9. The Challenge of Initiating and Sustaining Reforms

10. The Agenda for Change

This draft has been prepared by a team led by Ajay Chhibber and with principal authors Simon Commander, Alison Evans, Harald Fuhr, Cheikh Kane, Chad Leechor, Brian Levy, Sanjay Pradhan, and Beatrice Weder. The work was carried out under the direction of the late Michael Bruno, Lyn Squire, and Joseph Stiglitz.

The authors would be most grateful if this draft were neither cited nor made available to others. The published version will be available on June 27, 1997.

Chapter 9 The Challenge of Initiating and Sustaining Reforms

The innovator makes enemies of all those who prospered under the old order, and only lukewarm support is forthcoming from those who would prosper under the new. Niccolò Machiavelli, *The Prince.*

9.1 The preceding chapters have described a two-part strategy to improve the state's effectiveness. This strategy calls for reforms to better focus the state's role to its capability and to enhance that capability. Integral to this strategy is a better understanding of why some countries do not meet even the most basic requirements for sound macroeconomic management and why so few developing countries have managed to create effective state institutions. The premise of this chapter is that obstacles to reforming policies and institutions are related not only to know-how but also to the conjunction of three factors: the distributional characteristics of reform, the political strength of various groups (particularly those who would lose from reform), and the design of existing state institutions. Some reforms are politically undesirable when groups that stand to lose constitute the support base of the political leadership. But even when the political will to change exists, reforms can be derailed by constraints embedded in state institutions.

9.2 These obstacles are not insurmountable, however. And when windows of opportunity arise, a reform strategy that internalizes these political obstacles has better chances of success. This chapter examines how countries can develop such a strategy, showing that:

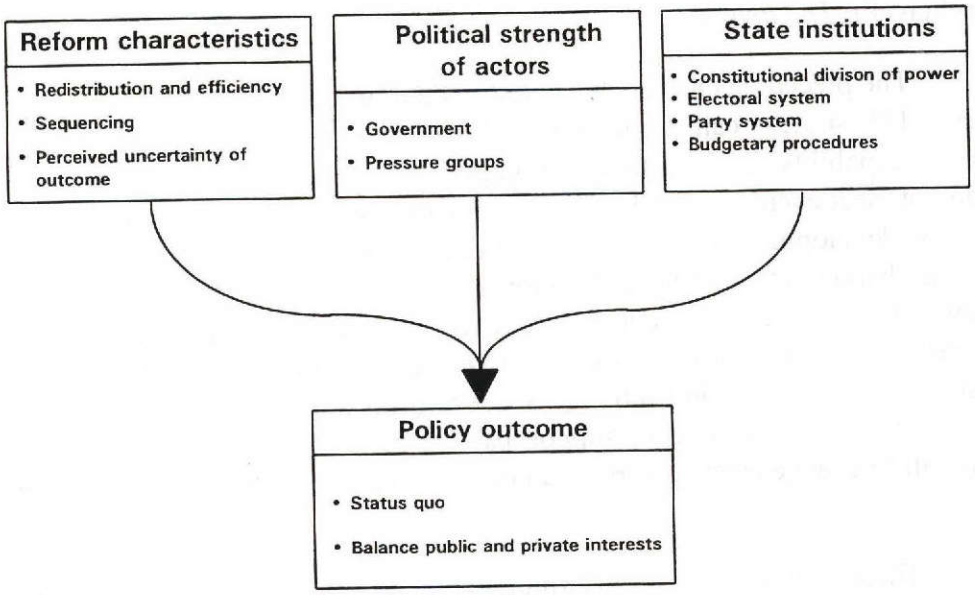
- Reforms can be derailed by politically powerful groups that stand to lose from reform, and derailment is facilitated or inhibited by the design of state institutions.
- Opportunities to overcome obstacles to reform arise from external threat, economic crisis, or the "honeymoon" period of a new administration or regime.
- Obstacles can be mitigated by tactically designing and sequencing reforms, making institutions less susceptible to capture by special interests and to gridlock, and building consensus. Reform is more likely to be embraced by political leaders with a clear vision for the future. In the absence of such leadership, the status quo is likely to prevail.

Obstacles to reform

9.3 Chief among the obstacles to reform are the powerful interest groups that stand to lose from a policy or institutional change. Resistance is even stronger when the prospective losers constitute the support base of the political leadership. In short, the redistributive effects of a reform and the political strength of groups affected by it may render some policy changes politically undesirable. Even politically desirable reforms may fail because of constraints embedded in state institutions. The political and institutional milieu under which reforms create

winners and losers matters. Policy outcomes are a multiplicative effect of reform characteristics, the political strength of different actors, and state institutions (Figure 9.1).

Figure 9.1 Determinants of policy outcomes



Distributional conflicts, uncertainty, and reform

9.4 These conflicts vary with the type of reform. Some common types of reform and the groups that stand to gain or lose from them are listed in Table 9.1. Although these groupings do not apply in all circumstances, it remains that resistance to reform is often triggered by the potential redistribution of resources to different groups. Other factors that affect the cost of policy changes, however, are reform specific. Public sector reform, which is central to reinvigorating state institutions, can be thwarted by civil servants who run the risk of losing their jobs or finding themselves worse off in private sector employment. Politicians who use public employment as a source of patronage can also block these reforms. Decentralization, for instance, raises the prospect of giving more resources to actors outside the political leadership's constituency. In Peru, a decentralization program for education was halted in the aftermath of the 1993 municipal elections, in which independents and opposition parties prevailed. This program would have transferred resources for financing primary and secondary education to provincial municipalities.

Table 9.1 Interest groups, political costs, and tactical sequencing of reform

Type of reform	Interest groups		Determinants of political cost	Tactical sequencing	Other issues
	Against	For			
Trade liberalization	Rent beneficiaries: quota holders, protected industrialists	Consumers, exporters, the treasury (if it increases revenues).	+ Redistribution – Efficiency gains	Reduce quantitative restrictions before tariffs	
Pension privatization	Trade unions Pensioners' association Bureaucracies (labor ministry, social security agency	Employers Financial institutions Young workers	+ Wealth reduction + Reduced coverage + Older median voters – Efficiency gains	Allow participants to opt out of public scheme, then phase it out.	Young workers may be willing to forgo some of their acquired rights.
Decentralization *Functional* *Political* *Fiscal*	Top officials and staff in central administration Top decisionmakers in political parties, interest groups and labor unions Top officials in ministries of finance and strategic planning (or public investment) commissions	Top officials and staff in local administrations, consumers, citizen beneficiaries, local businesses. Local decision makers in political parties, interest groups, labor unions, NGOs, voters, taxpayers Department of finance in local administration, local planning and investment units	+ Redistribution + Political contestability – Efficiency gains	Build consensus, phase in pilot program, design grant schemes	Need to mitigate horizontal and vertical fiscal imbalances, need for new schemes for allocation of grants across jurisdictions
Public sector reform Civil service Public enterprise	Civil servants, line agencies, unions, state employees and managers of public enterprise, politicians prone to patronage	Private business, rural elite, central agencies, taxpayers	+ Redundancy + Unemployment + Relative wages – Efficiency gains	Eliminate ghost workers, encourage voluntary and early retirement, ensure retrenchment without revolving door	Incentives: severance, buy-outs, capitalization scheme, training, private sector placement, credit schemes.

Note: A plus indicates that a factor increases the political cost of reform, a minus sign indicates that it lowers the political cost of reform.

9.5 *Redistribution and efficiency gains.* Ranking policy changes based on their political costs and benefits can help policymakers design the tactical sequencing of a comprehensive reform program. Although such an exercise is highly country-specific, a good starting point is to compare the expected redistributional effects of planned reforms with their expected efficiency gains. Some reforms are difficult to implement because in the short run they are perceived as merely reshuffling opportunities and incomes. Although such reforms ultimately increase the size of the pie, gains in efficiency, their short-run redistributive effects can exceed these aggregate gains. Thus, if all else is held constant, the share of resources that is reshuffled by efficiency gains may capture the political cost of undertaking reform. This approach can be applied to a broad range of reforms, including trade liberalization and labor reform (Box 9.1).

Box 9.1 Why are some reforms so politically difficult?

Efficiency-enhancing reforms are often difficult to implement because they create both winners and losers, and there may be no way to compensate the losers. Defusing opposition is even more difficult when the efficiency gains are low relative to the redistributive effects. Applying a political cost-benefit ratio to reform measures can show how much redistribution takes place for a given amount of efficiency gain. A policy that increases the income of one group without taking income away from another, for example, would have a ratio of zero.

For trade liberalization the political cost-benefit ratio is inversely related to the tariff rate, the share of imports in total consumption, and import demand elasticity. In Sub-Saharan Africa the average import tariff exceeds 30 percent, and the share of imports in total consumption is about 40 percent. Assuming an import demand elasticity of two, the cost-benefit ratio of trade liberalization is more than four. Thus, for any given amount of efficiency gain, the redistributive effects would be four times that amount. When a reform program involves trade liberalization and a stabilization program that increases output, the ratio declines significantly. A stabilization program that increases GDP growth by 1 percentage point would be sufficient to lower the ratio from four to less than one.

The political cost-benefit ratio can also be applied to labor reform, such as eliminating wage discrimination between men and women. Such a reform would generate efficiency gains, but it would also create losers. In some Latin American countries it is estimated that eliminating wage discrimination would lead to a one-time gain equivalent to 6.2 percent of GDP and redistribution of 30 percent of GDP (Box Table 9.1). The large redistribution would occur because about 21 percent of the labor force would be reallocated. This reform implies a political cost-benefit ratio of about five, since improving the allocation of labor would result in efficiency gains but would require five units of redistribution for each unit of efficiency gain. The transitional cost of reallocation and its uncertainty could add to the resistance to reform.

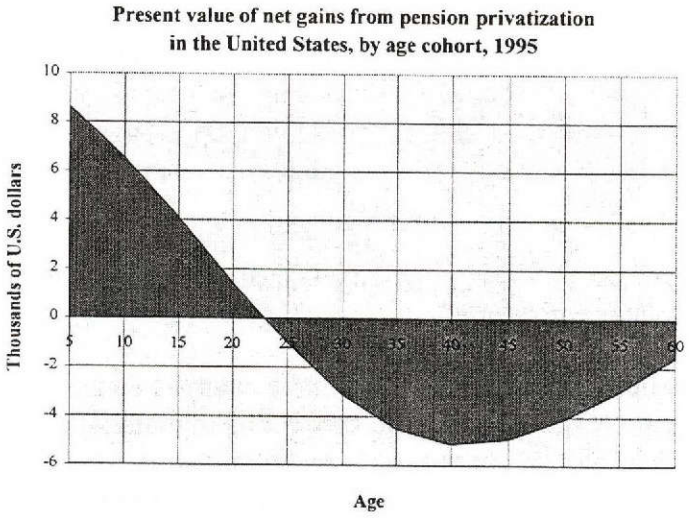
Box Table 9.1 The political costs and benefits of eliminating wage discrimination in Latin America
(percentage of GDP)

Country	Amount of redistribution (a)	Efficiency gains (b)	Political cost-benefit ratio (a/b)
Argentina	32	4.0	8
Brazil	30	8.7	3
Costa Rica	23	4.6	5
Ecuador	45	9.7	5
Jamaica	34	8.3	4
Venezuela	17	1.9	9
Average	30	6.2	4.8

Calculated from data in Tzannatos (1996)

9.6 *Pension reform.* Pension reform illustrates how conflicting interests across generations can affect policy outcomes. Most public pension schemes are unfunded and financed by payroll taxes. The resulting high marginal taxes on labor and weak link between contributions and benefits create distortions in the labor market. In mature systems these distortions are compounded by the low implicit return on pensions relative to the market return on capital. Distortions could be reduced by, among other things, strengthening the link between contributions and benefits and privatizing and funding pension schemes. Although privatizing and fully funding the U.S. pension scheme could generate net gains—including gains in efficiency—younger workers would gain and older workers would lose (Figure 9.2). This dilemma helps explain the sensitiveness of such reform. Redistribution away from the elderly also helps explains why countries in Eastern and Central Europe and the CIS are resisting increasing the pension age. In Ukraine, for instance, a uniform pension age of 65 would ease the system's actuarial imbalance, but would also and reduce the pension wealth of workers (in present value terms) by about 25 percent of GDP.

Figure 9.2 Younger workers would gain from pension reform, but older workers would lose



Source: Feldstein (1996)

9.7 The difficulty of reforming universal pension programs thus stems from the anticipated reform's redistributive effects and the power of elderly voters. Meanwhile unborn generations, who would benefit the most from reform, have no voice in the decision. The political cost of such reform in the United States has risen over time as the gap in voter turnout for the young between the age 25 to 40 and those over 65 has widened to 12 percentage points since 1964. Public pension and health care financing programs for the elderly, despite being fiscally unsustainable, face a tough political test. Even so, some developing countries have undertaken such reform. Political feasibility has often been enhanced by giving workers the option to stay in the public sector or switch to private providers, and offering various incentives for switching.

9.8 *Privatization of utilities*. Utilities in many countries utilities are inefficiently run public monopolies. Consumers would realize significant gains if these utilities were privatized and effective regulatory agencies established to watch over them. Argentina's experience is useful in understanding how different groups gain from such privatization. In 1989 Argentina began privatizing its state-run infrastructure services. All income groups have benefited from the efficiency gains induced by privatization, and these gains (relative to spending on utilities) have been similar across income groups (Table 9.2).

Table 9.2 Efficiency gains from privatizing utilities in Argentina

Income quintile	Efficiency gains (millions of 1993 US$)	Gains/expenditure on utilities (percent)
1 (poorest)	205	30
2	222	27
3	342	34
4	335	27
5	549	31
Total	1,653	30

Source: Chisari, Estache, and Romero 1996.

9.9 So why is privatization still resisted in some countries? For instance, a 1989 plebiscite in Uruguay rejected a privatization legislation. As a result, a recent study shows that, due to inefficiencies in public utilities, the average Uruguayan is pays a 30 percent implicit tax on electricity, water, and telephone services. This reluctance to implement welfare-improving reforms can be explained at least by three reasons:

- Perceived uncertainty of the outcome of reform impede the creation of a constituency for reform.
- Private operators typically must make changes that are detrimental to certain groups in order for these efficiency gains to materialize. Thus, for example, organized labor might oppose if redundant workers will lose their jobs. A survey of laid-off in Turkey found that their earnings on reemployment fell by more than 60 percent. This gives them a powerful incentive to block reform.
- Different groups may hold conflicting views about the role of the state. For instance, in many countries that have relied entirely on state utilities, many groups continue to resist privatization on ideological grounds.

Institutional design

9.10 Obstacles to reform are also determined by the institutional mechanisms various groups use to tilt policy outcomes in their favor. Thus these obstacles can be mitigated or exacerbated by the design of state institutions. Moreover, economic reforms are often undertaken in a context of deep political transformation. The duration of this transformation and its associated instability also affect policy outcomes.

9.11 Rather than attempt an exhaustive account of how state institutions can be used to block reform, we focus here on three sets of institutions: budgetary procedures, electoral and party systems, and the constitutional division of power. The point is not that institutions should be designed and changed frequently to facilitate reform, or that a single design is desirable for all countries and situations. As emphasized throughout this Report, those institutional choices involve tradeoffs between flexibility and restraint. Furthermore, problems of institutional transference and adaptation should not be overlooked.

9.12 *Budgetary institutions*. Policy outcomes are closely linked to budgetary institutions (such as balanced-budget rules). These institutions can impede economic reform by creating macroeconomic imbalances, and preventing an efficient allocation of expenditures. Chapter 3 showed how, in Latin America, budgetary institutions that lack transparency and grant considerable discretion to spending ministers are linked to fiscal deficits. Deficits arise because fiscal discipline and the alignment of spending with national priorities are compromised by decisions based on sectoral and regional interests. Budgetary institutions also matter in wealthier countries. A study found that those US states with stringent balanced -budget rules displayed better fiscal discipline. Faced with a deficit of US$100, these states would subsequently reduce expenditures by US$44. Whereas states in similar circumstances but with lax budgetary institutions would reduce expenditures by only US$17.

9.13 In many developing countries, the lack of transparent budgeting often results in significant off-budget expenditures. In Nigeria these extrabudgetary funds account for 50 percent of federal expenditures. In Peru US$300 million in extrabudgetary funds are allocated to the Ministry of the Presidency each year, preventing efficient prioritization of public funds. Rethinking the role of the state and improving its capacity are rendered more difficult because activities from which the state should withdraw remain funded.

9.14 *Electoral and party systems*. Electoral and party systems also affect policy outcomes. In fact, proportional electoral systems create many of the same problems as weak budgetary institutions. Proportional electoral systems are associated with coalition governments, which are akin to collegial budgetary procedures. Thus both systems are conducive to delays in policymaking and higher fiscal deficits. Research shows that countries with large and fragmented coalitions are associated have more difficulty adjusting to external shocks, such as the 1973-74 oil shock. Such coalitions have also been associated with lax fiscal policies. Indeed, the large debt-GNP ratios prevailing in Belgium and Italy have been partly ascribed to two decades of large and unstable coalition governments in both countries.

9.15 Brazil illustrates how electoral and party systems interact with economic policy. The social security bill proposed by the Cardoso administration in June 1996 was defeated in the lower house of the legislature because interest groups (civil servants and teachers, among others) exploited constitutionally protected privileges and a political system that discourages stable voting majorities in the congress. Although government alliance holds a majority there, reforms were blocked because deputies belonging to the alliance voted against the bill. This outcome underscores the unusual autonomy of elected officials from political parties embedded in Brazil's system of proportional representation. A 1991 study of Brazil's electoral and party system found

that representatives had belonged to an average of three political parties, and that in 1987-90 one-third of the 559 representatives had switched parties since being elected in 1986.

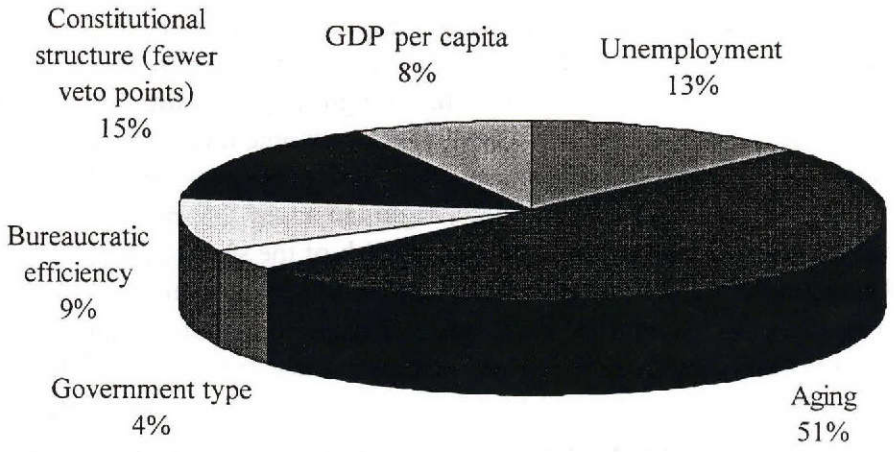
9.16 In Uruguay a number of institutions have speeded some reforms and sabotaged others. One of the peculiarities of the country's electoral system, prior to the recent reform, was that party primaries and general elections were held simultaneously. As a result the winning presidential candidate received only a minority of the total vote and had to build alliances with opponents in the parliament. In the November 1994 election the winning candidate received only 24 percent of the vote, and the three main parties each received more than 30 percent. This electoral system tends to be candidate-centered and conducive to faction. Hence, groups (such as teachers) that are able to mobilize politically reap the most benefits. Another distinctive feature of Uruguay's political system is its heavy reliance on direct democracy (through plebiscites) to decide on features of the public pension system. In 1992 voters reversed major privatization legislation. And a 1989 plebiscite, initiated by the association of pensioners, guarantees full wage indexation every three months. These institutional designs help explain why, despite having roughly the same proportion of elderly in the population (16 percent), Uruguay's spending on pensions relative to GDP is about 35 percent higher as the United States.

9.17 Uruguay implicitly recognized that its electoral system was an impediment to a well-functioning state. For this reason, a new system was approved by the parliament in October 1996. It addresses the limitations of the old system in two ways. First, it would end the double simultaneous vote by which parties can present the names of several presidential candidates. Second, there would be a second-round ballot between the two presidential front-runners if no candidate secures 50 percent of the vote. These changes are expected to strengthen party discipline and deter faction.

9.18 *Constitutional division of power.* Chapter 6 showed how and why inadequate checks and balances can lead to arbitrary government decisions and behavior. But problems can also occur when these checks and balances go too far. Indeed, the presence of many veto points in the state deliberate process can create gridlock and influence government spending. These veto points arise at three levels: the separation between the legislative and the executive branches, the division of legislative between separate houses, and the division of power between national and subnational governments. A bias toward the status quo develops when the state supports many institutional veto points, and groups that oppose change can influence at least one of these. In a presidential system gridlock can emerge when different parties or coalitions control the executive and the legislature. Witness the stalemate on budgetary issues that led to the closure of government in the United States in 1995 and 1996. The checks and balances that arise from different levels of government are typically beneficial, as shown in Chapter 7. But an ill-designed decentralization that leads to capture of local authority by special interests can prevent the adoption of sound reforms. A study has shown that, in Russia, the local governments that receive the most resources from the center have been those in persistent conflict with the center (strikes, labor unrest, separatist movements). This creates a perverse incentive that actually rewards vetoing reform.

9.19 The proliferation of veto points is thus a double-edged sword, making the adoption of any policy reform more difficult, whether desirable or not. Although the presence of many veto points may contribute to delays, it also has contained the expansion of the welfare state. As Figure 9.3 shows, the constitutional division of power ranks second only to aging in explaining changes in welfare spending. As incomes per capita increased, demand for government transfers also rose. Countries with fewer veto points in their state structure (such as Sweden and Denmark) are more receptive to these demands. By contrast, the greater number of veto points in Switzerland—a federal state with a bicameral legislature—has blocked many initiatives to expand welfare programs. Reforming the welfare state will therefore require going beyond the streamlining the functioning of transfer programs. Indeed, this was recognized by the 1992 Swedish commission on state reform, which recommended strengthening the executive by introducing a constructive vote of no confidence, allowing the government to ask parliament to vote on measures on a package rather than line by line, extending the time between elections from four to five years, and reducing the size of the parliament by half (see Box 3.3 in Chapter 3).

Figure 9.3 Multiple veto points help countries resist pressures to expand welfare (OECD 1965-93)



Source: see technical note.

9.20 *Non institutionalized veto points.* Sometimes veto points exist outside formal political institutions. Their prevalence of these veto gates also affect the predictability, and hence the credibility of policies. These veto can arise from the political clout of powerful interest groups, such as the Muslim brotherhoods in Senegal. In November 1996 the leader of one of dominant brotherhoods ordered the closing of forty primary schools. These newly constructed schools were part of a World Bank-financed project designed to increase national enrollment from 58 percent of the school-age population in 1992 to 65 percent by 1998. Allegedly, the schools were closed because of the brotherhood feared that increased primary education would come at the expense of religious schools. What makes the brotherhood's veto power akin to that of formal organs of the state is that it applies to a wide range of issues, including agricultural pricing and the environment. In 1987, under pressure from the brotherhood, the Government retracted its decision to end seed subsidies to peasant farmers. In

May 1991, despite policy to the contrary, the government cleared 45,000 hectares of forest in the Kelkhom region and gave them to a marabout for his personal cultivation. Very few political organs of the state in Senegal, if any, have such veto power. In return for these de facto veto rights, the marabouts openly support the government during elections.

9.21 In some countries it is the military rather than religious groups that exerts considerable influence on policy outcomes. Historically, in Latin America, the military has been an important political player. The reason given for past military coups was that the government had taken illegal actions(Brazil in 1964, Chile in 1973, and Argentina in 1976). The military came thus to be as a "fourth branch of government." In the region, the situation has changed, yet the military still play an important political role in many countries around the world. And although the general trend has been toward reduced military expenditure, some countries still devote a large part of their resources to defense spending (Chapter 8). Where the political clout of the military is high, further reductions may prove difficult.

9.22 *Political regime*. The choice of political regime has justifications that go far beyond economic conditions. Nevertheless, the strong links between state institutions and policy outcomes beg the question of whether obstacles to reform may be embedded in the political regime. Some observers have argued that nondemocratic regimes by having fewer veto points are more conducive to economic development. The reality is not so simple. Although some political regimes are inimical to economic growth, no regime type guarantees economic and social progress. Economic stagnation is the most likely outcome under the so-capped a "predatory state," since the focus of such a state is on the extraction of rents from the citizenry by those in power. It does so by specifying property rights in a way that maximizes the revenue of the group in power, regardless of its impact on the wealth of the society as a whole. Haiti under the Duvalier (Box 9.2), Zaire under Mobutu Sese Seko, Romania under Nicolae Ceausescu, and the Philippines under Ferdinand Marcos are prime examples of predatory states. A predatory state is inconsistent with economic development because it discourages productivity, and leads to misallocation of resources. The end result may well be total collapse of the state.

Box 9.2 The predatory state under the Duvalier dynasty in Haiti (1957-86)

Haiti became independent in 1804. A predatory state arose there between 1843 and 1915, a period characterized by short-lived rulers, often removed by coups, driven by the creation of personal wealth. Of twenty-two administrations during that period, eleven held office for less than a year, and only one managed to complete its term.

Following the U.S. occupation in 1915-34, the logic of a predatory state remained unchanged. In 1957, the democratically elected government of François Duvalier (Papa Doc) began taking that logic to a new level, starting with an unprecedented purge of civil society, the inherited army, political opposition, and other branches of government. Within two months of coming to power, Duvalier had jailed 100 political opponents. The Catholic church was perceived as a threat, and spiritual leaders were expelled. The mass media were silenced by expelling foreign journalists, and a 1958 code allowed the government to shoot reporters charged with spreading "false news." Imprisonment of the parents of striking students was made mandatory. After lifting parliamentary immunity in 1959, Duvalier dissolved both the Senate and the Chamber of Deputies. Modern military equipment was stored in the basement of the presidential palace, and more than 200 officers were removed in Duvalier's first eleven years of power. In 1964 Duvalier declared himself president for life.

The economic pillars of the predatory state were expropriation, extortion, the inflation tax, and corruption. Following a business strike in 1957, the police were authorized to open the shops of striking merchants and

distribute their merchandise. Significant resources were devoted to protecting Duvalier himself—30 percent of total expenditures during the first half of the 1960s. Agriculture, particularly coffee, was heavily taxed. Some sources estimate that Duvalier transferred more than $7 million a year out of Haiti for personal purposes. Large-scale bribes also took place through deals with foreign investors on projects that often never materialized. Extortion under the veil of "voluntary" donations was institutionalized under the Mouvement de Rènovation Nationale. A pseudo old-age pension with a 3 percent deduction was created, d government employees were forced to buy a $15 book containing Duvalier's speeches. An autonomous government fund collected taxes and levies, which were excluded from the budget an no information was given about the use of these funds.

After nearly thirty years of rule the Duvalier dynasty fell in 1986, when Jean Claude Duvalier who had inherited the presidency from his father, went into exile in France with an estimated $1.6 billion at his disposal. Haiti's history as a predatory state goes a long way in explaining its dismal economic performance. In 1965-90 growth in GNP per capita averaged -0.02 percent, and social indicators remain the worse in Western Hemisphere. Given the legacies of the predatory state, history remains perhaps the biggest obstacle to change.

9.23 The end of the Cold War, combined with pressure from citizens, could lessen the risks of extreme state capture embodied in a predatory state. As more countries have adopted elements of democratic regimes (such as free and open elections), researchers have begun to explore the link between democracy and economic performance. These investigations have not, however, reached a consensus on the relationship between growth and democracy: about one-fifth of the studies find a positive relationship, one-fifth a negative relationship, and the rest are inconclusive. The analysis of the determinants of growth summarized in Chapter 2 also did not find any statistically significant correlation between democracy and growth. And economic performance among developing countries classified as sustained democracies has varied considerably.

9.24 In many countries political transformation is accompanied by a transition from a planned to a market economy. As noted in Chapter 7, using the ballot box to punish or reward politicians for past performance (retrospective voting) could be a powerful way to ensure accountability and good policy outcomes. The road can be rocky, however. Indeed, governments' initial reaction to greater political contestability may add to the difficulty of improving institutions. Transitions to democracy are often associated with increased budget deficits and inflation. Sub-Saharan Africa has witnessed about twenty-seven new elections since 1990, of which twenty-one were in countries holding elections for the first time. Young democracies are not immune from the electoral cycle. Prior to Ghana's 1992 elections, the government increased outlays on rural development, raising capital expenditures from 2.6 percent of GDP in 1989-91 to 3.1 percent in 1992-94. In sub-Saharan Africa, the numbers of ministerial positions and legislative seats have increased by 22 percent during the political transition that began in 1989. The governments of Malawi, Cameroon, and Senegal have all more than thirty ministers each. A careful prioritization of policy issues (i.e., agenda control) is difficult to achieve in such an atmosphere. Bolivia, for instance, has responded by putting legal restrictions on the size of the cabinet: only two additional ministries may be created and those on a temporary basis. A capitalization ministry was created under this law. These experiences suggest that how skillfully states manage the political transition will be key to ensuring that the development agenda is not compromised by political expediency.

When and why do countries reform?

9.25 Insights about the circumstances under which reforms are likely to succeed are as useful as insights about the obstacles to reform. In fact, the two sets of issues are related. If circumstances are conducive to reform, the first step is to alter the dynamics that created the status quo. An external threat or an economic crisis—real or perceived— may override resistance to change. But even these extreme situations may not be enough to motivate reform.

External threat

9.26 A growing external military threat has often triggered bureaucratic reform. Until recently a country lagging technological and economic performance became evident only during wartime. In the 1700s and 1800s the leadership of Ottoman Empire reorganized the military and made broad reforms in education and governance, in response to battlefield losses to Europe. Similarly, the Meiji restoration in Japan in 1868 was motivated by a desire to strengthen the state against the encroachments of Western powers (Box 9.3).

Box 9.3 Reform under external threat: the Ottoman Empire and Japan

At the height of its power the Ottoman Empire controlled vast territories stretching into Central Europe. After the seventeenth century, however, the Ottoman military began suffering defeat in the hands of European powers. The first attempts at modernizing the empire came in the early eighteenth century, following the treaties of Carlowitz (1699) and Passarowitz (1718), which capped two humiliating defeats by Austria and its allies. The sultan sent an ambassador to Paris and asked him to report on "the means of civilization and education," particularly those that could be applied in Turkey. But for obvious reasons, reform of the military bureaucracy received the most sustained attention. Western experts were brought in to establish new training facilities and to introduce modern engineering, navigation, and artillery sciences into the military curriculum.

The annexation of Crimea by Russia in 1783 prompted new reforms, again focusing on improving military capabilities. New regulations in 1792-93, known as the New Order, covered provincial governorships, taxation, control of the grain trade, and other administrative and fiscal matters. The most significant reform, however, was a new regular infantry, to be trained and equipped along European lines. Military schools of engineering and medicine were also set up. Reforms continued in fits and starts throughout the 1800s and early 1900s, until the collapse of the Ottoman Empire after World War I.

The intrusion of Western powers into national commerce, rather than defeat on the battlefield, prompted reform in Japan. Japanese commerce. Starting in the 1840s, Japan was under increasing pressure from the Western to grant commercial and trade privileges. The Tokugawa leadership was aware that Japan's technological and military prowess lagged, and in 1854 Japan had little choice but to accede to Commodore Perry's demand that some ports be opened to American ships. Similar arrangements with other foreign governments followed. By 1865 Western powers had restricted Japan's ability to levy import tariffs, the highest rate was set at 5 percent. In 1868 a coalition of feudal lords overthrew the Tokugawa family, which had ruled Japan for more than two centuries, and replaced it with a leadership that would modernize Japan and transform it into a country better able to face up to foreign threat. This so-called Meiji restoration marked the beginning of modern Japan's economic growth.

Reforms following the restoration transformed the Japanese state and society. The class system was abolished, a new system of local and national government was set up, and conscription into the army and the navy was instituted. As the basis for a sound fiscal system, the government undertook a land survey, established titles, and implemented a land tax payable in cash. Education was gradually made compulsory, so that by the mid-1880s, almost half of school-age children were attending school. The Bank of Japan was created and bureaucratic reforms were undertaken, laying the ground for the recruitment of state officials based on merit, not patronage. Moreover, the new regime undertook initiatives that today would be called industrial policies: it established and operated

factories (silk, brick, glass, cement, textiles, shipyards), subsidized industries, imported technicians, and sent students abroad.

9.27 Today, military confrontation plays a smaller role in driving reforms. But the perception that a country is lagging behind its neighbors economically often leads to important demonstration effects. Chile's economic success inspired other countries in Latin America in the late 1980s, as did the success of Japan and later of the Republic of Korea's and Taiwan (China) in East and Southeast Asia. Economic reform in China can be explained by many factors. Among them the demonstration effect of neighbors and China's unwillingness to be left behind economically and militarily, and in terms of regional political influence. Thus, the Chinese leadership became convinced that modernization was essential in order to acquire the economic and military wherewithal to stand up to its neighbors.

Economic crisis

9.28 Economic crisis is the most important reason countries have introduced ambitious reforms since the early 1980s. As the failure of prevailing policies becomes widely recognized, popular demands for reform become more vocal, and politicians are more willing to risk radical departure from existing policies. Economic crisis—particularly hyperinflation and deep recession—preceded economic reform in, for example, Indonesia in 1961-64 and Peru in 1990. Many countries without suffering through crises, however, and others in dire economic straits have failed to take corrective measures. Economic crisis cannot be credited for stimulating reform in Colombia (1989), Australia (1983), or Portugal (1985).

9.29 Economic crisis and civil conflict often reinforce one another, leading to near disintegration of the state (for example in Liberia and Somalia). Such crises have immense social costs and offer little hope for quick resolution. State capability matters when it comes to turning crisis into an opportunity. But political leadership and political entrepreneurship are also important. Political leaders who can convert opportunities for economic gains into reality can capitalize on the benefits of successful reform. Consider Prime Minister Vaclav Klaus of the Czech Republic, Mahathir of Malaysia, and Fernando Henrique Cardoso's stabilization plan in Brazil. In each case courageous reforms were later rewarded at the polls.

9.30 A change in government in time of economic crisis (as in Peru and Poland in 1990) may provide an opportunity to undertake reforms that incumbents are more reluctant to embrace. Terrorism, hyperinflation, and the poor performance of traditional parties in Peru, gave the new president, room to maneuver. By contrast, the 1989 Colombian reform took place toward the end of the administration of Virgilio Barco and the economy was not in crisis. Thus honeymoon periods and economic crisis provide an opportunity, but not the only opportunity, for embarking on reform. More importantly, even in countries where economic crisis triggered reform, the depth of reform tends to be modest. Hyperinflation and economic decline led to stabilization and structural reform. In many areas, however, no significant improvements were made. Economic crisis may provide an opportunity to go beyond stabilization. Whether countries seize the opportunity depends on the redistributive effects of the crisis, the state's initial capability, and political leadership. But deep institutional reforms are unlikely to result from a reform agenda triggered and driven by crisis alone.

Implementing and sustaining reform

9.31 Reform of the state means not only reform of policies but an institutionalization of good rules of behavior for government agencies. Institutions must be created that help avoid heavy discounting of the benefits from reforms, paralysis from changed circumstances, and problems of social mistrust. A balance must be struck between clear rules that circumscribe the freedom of state officials to engage in opportunistic action, and the need for flexibility and responsiveness. An effective state operates with clear and transparent rules, yet is quick to exploit opportunities and to reverse course when circumstances demand it. Obstacles to building an effective state are not insurmountable. Change has a better chance of success when policymakers do three things: tactically design and sequence reforms, compensate losers, and build consensus.

9.32 We take up each of these in the following discussion. But in some cases institutions must be modified to make the state function better. It is not an issue of tactics but of fundamental reform. Nevertheless, one lesson is clear: all these changes are easier in those countries where political leaders have a clear vision of the future.

Tactical design and sequencing

9.33 Tactical design and sequencing of reform can improve chances of success by internalizing capacity constraints, diluting resistance to change, and strengthening a constituency in favor of reform.

9.34 *The umbrella principle: matching role to capability.* As emphasized throughout this report, this principle is key to ensuring the effectiveness of policies. A mismatch between capacity and reform could compromise sustainability and effectiveness even in the absence of political obstacles. Regulatory reform—whether of antitrust, environmental, or financial regulation should reflect institutional capabilities (see Figure 4.1). For instance, price-cap regulation in which the regulator sets the price adjustment factor is more suited to countries with relatively strong institutions. Similarly, mechanisms to improve the delivery of services have to take into account not only the characteristics of the service but also the capacity of the state (see Table 5.1). Within the core public sector (education, health care), using performance-based agencies and formal contracts requires institutional capacity that is lacking in many developing countries. Capacity constraint should also loom large in the choice of a decentralization strategy (see Table 7.4). Where capacity is low both in central and local government, a cautious decentralization strategy with pilot testing is recommended. But existing capacity should not be viewed as a permanent constraint, and the pay off from improving capacity is significant indeed.

9.35 *Enclaving as a first step to improve capability.* Where administrative capacity is weak, rather than attempting comprehensive reforms of all institutions countries, countries might do better selectively reform key functions and agencies and isolate them from political interference. Besides being consistent with fiscal and human resource constraints, this approach has two advantages. First, it allows reformers to learn from the unavoidable mistakes associated with institution building. Second, by beginning with the most promising agencies, reformers can

count on demonstration effects for the rest of the public sector. These two advantages increase the likelihood of achieving a series of success stories that will maintain political support of overall reform program.

9.36 Many countries, particularly in Latin America, have used this enclave approach. Candidates for early treatment typically include the ministry of finance, the central bank, and the tax collection agency. In both Peru and Ghana, for example, single-digit tax ratios forced the government to make swift changes in the tax collection agency. Sometimes the enclaved agency is peculiar to the country. In Colombia, for example, the National Coffee Fund, which manages a strategic commodity, is privately managed and insulated from political interference. To reduce the social cost of adjustment, some countries have bypassed line ministries and set up social funds as in Bolivia and autonomous contracting agencies such as the AGETIP in Africa.

9.37 Countries following an enclave strategy must ensure that the assignment of policy responsibilities among agencies and ministries takes into account where the relevant professional expertise is concentrated, and that mandates are broadly consonant with the public interest at large. For instance, a tariff regime that is managed out of the finance ministry is likely to emphasize revenue goals over revenue industry protection—the priorities would probably be reversed if the ministry of commerce were in charge. Transforming quantitative restrictions into tariffs would typically receive more support from the treasury (Table 9.1). In Kenya, the fact that the provident fund is under the joint responsibility of the ministries of labor and finance gives rise to conflicting objectives. The labor ministry views the provident fund more as a social assistance scheme than as a financial institution that should maximize the return on member contributions, and mobilize long term savings. The appropriate assignment of policy responsibilities can help sustain reform by influencing what gets approved and in what order.

9.38 The enclave strategy allows countries to adopt the first generation of reforms (Table 9.3). These reforms—mostly enacted through executive order—typically involve stabilization and selected structural reforms. Too narrow an approach to enclaving can, however, impede the deeper institutional changes that the second generation of reforms calls for. Moreover, progress in the social sectors has generally been modest. Ghana, for example, is one of the pioneer reformers in Sub-Saharan Africa, yet health expenditures there have become more regressive. Deep institutional reforms take time and are complex, and opposition to reform by interest groups (for example, the teachers union in Colombia) is often strong. For countries trapped in the first generation of reforms, sustainable long-term development will be elusive.

9.39 Countries can implement a strategy that enables them to escape the enclave trap. Such a strategy involves, above all, setting clear rules for the conditions under which agencies outside the original enclave will be brought within the reform program. These rules provide a bridge between the first and second generation reforms, while mitigating animosities from agencies outside the enclave. The Bolivian civil service reform has rightly moved in that direction. Embedded in the 1990 Financial Administration Act and associated agency-specific regulations are a series of rules governing which entities are eligible to recruit highly-paid civil servants, what conditions these entities have to meet in order to qualify, and what is expected from them once they have implemented the reform. Ecuador's experience with a similar reform

strategy, however, illustrates that without a firm commitment to the program these rules may not be implemented in practice. Two months after finalizing the rules governing administrative reform, the secretary in charge (SENDA) declared all central administration entities "restructured" and granted salary enhancement, although none had met the eligibility conditions. Rules are simply not a substitute for a commitment to reform.

Table 9.3 First and second generation reforms

	First generation	Second generation
Main objectives	Crisis management: reducing inflation and restoring growth	Improving social conditions and competitiveness, and maintaining macroeconomic stability
Instruments	Drastic budget cuts, tax reform, price liberalization, trade and foreign investment liberalization, deregulation, social funds, autonomous contracting agencies, some privatization	Civil service reform, labor reform, restructuring of social ministries, judicial reform, modernizing of the legislature, upgrading regulatory capacities, improving of tax collection, large-scale privatization, restructuring of central-local relationships.
Actors	Presidency, economic cabinet, central bank, multilateral financial institutions, private financial groups, foreign portfolio investors	Presidency and cabinet, congress, civil service, judiciary, unions, political parties, media, state and local governments, private sector, multilateral financial institutions
Main challenge	Macroeconomic management by an insulated technocratic elite	Institutional development highly dependent on middle management in the public sector

Source: Adapted from Moises Naim, 1996.

9.40 *Gradual phasing out.* Matching the state's role to its capacity and going beyond enclaving sometimes require replacing a public agency with a private one. This adjustment may require a two-stage strategy to circumvent political resistance. During the first phase an opting-out mechanism might be put in place that would allow people to switch to private providers if they wished. Phasing out public providers during the second phase is much easier once the benefits of better service are widely recognized. Sri Lanka's 1991 Telecommunications Act shows the benefits of such a strategy. This act created the regulatory agency and allowed private operators to compete with the state monopoly (SLT) in value-added telecommunication services. The legal and regulatory framework has contributed to making Sri Lanka one of the most liberalized telecommunications markets in Asia. By 1995 there were four mobile cellular operators, five paging companies, three data transmission service providers, and one Internet provider. At end of 1995, 20 percent of all telephone subscribers were connected to cellular services. Competition between the cellular operators has led to some of the lowest tariffs in the region, and these services are increasingly seen as a credible alternative to SLT's wired services. To reduce unsatisfied demand quickly, in early 1996 the SLTA licensed two fixed wireless private operators for basic telecommunications services. These impressive results have created pressure for better performance by the public telecommunications company. Consistent with a two-stage phasing-out strategy, the government has announced the sale of 34 percent of SLT's equity to a strategic investor.

9.41 New Zealand also followed a two-stage strategy in 1986 when reforming its public corporations. During the first stage of the reform, state-owned enterprises were exposed to competition and required to borrow on commercial markets without government guarantees. This put them on the same footing as private companies. In addition, line ministries were removed from the management of companies, which became under the responsibility of treasury and the ministry of state enterprises. Four years after the reform, performance had improved markedly in ten out of eleven companies examined. Despite this success, successive governments went on to privatize a number of these companies. This was done mostly to ensure the long run sustainability of reforms, and to prevent reversal of policies granting managerial autonomy, a very tempting route when the economy is no longer in crisis.

9.42 Peru's pension reform illustrates how gradual phasing out can be applied to social sectors as well. When the reform was launched in 1993, workers were allowed to choose between public and private pension providers. In 1996, disincentives for joining a private provider were removed, leading to a de facto phasing out of the public scheme. During the second stage a strong constituency in favor of the reform was formed, comprising workers who had already shifted to a private provider and pension fund managers. By contrast, the sequencing of the direct tax reform in Pakistan was ill designed by separating the tax reduction from the broadening of the tax base (Box 9.4).

Box 9.4 Why did tax reform fail in Pakistan

Pakistan has a direct tax system with high rates, many exemptions, and low rates of collection. Revenues from direct taxes are less than 2 percent of GDP, compared with 7 percent for other countries at a similar stage of development. Direct tax losses due to loopholes are estimated at 2.3 percent of GDP, more than actual collection. The agricultural feudal class is one group that benefits from these loopholes.

In 1991 the government attempted tax reform, starting with a reduction in rates that was supposed to be accompanied by a removal of tax holidays. The maximum personal income tax rate was lowered from 60 percent to 35 percent. The corporate income tax was also supposed to be reduced from a range of 44 to 66 percent to one 30 to 55 percent.

It proved a mistake to start reform with rate reductions. The powerful agricultural lobby blocked the lifting of exemptions., and an attempt in 1993 to introduce a tax on rich farmers was circumvented by raising the exemption ceiling tenfold. Although the failure of reform reflects the power of the feudal elite, particularly in areas such as Punjab and Sindh that are a political base for the ruling party, it also reflects poor implementation. Even a revenue-neutral tax rate reduction combined with a broadening of the tax base would have reduced distortions without creating losers. A back-of-the-envelope estimate of the reduction in distortions is 1.4 percent of GDP.

9.43 *Efficiency versus tactical sequencing*. The optimal sequencing from an efficiency standpoint may not be politically feasible. For example, efficiency considerations dictate setting up a credible and stable regulatory agency before privatizing telecommunications. This sequencing reduces the risk involved in the purchase, hence increasing the selling price of the company. Argentina, however, did not follow this sequence when privatizing telecommunications. Instead the telephone company was sold a year before a new regulatory agency was set up. This strategy was adopted to speed privatization and prevent opposition to the reform. Although the selling price may have been lower, political feasibility was enhanced, and the efficiency gains induced by the overall privatization program were significant (Table

9.2). Moreover, countries choosing to reverse the most efficient sequencing could mitigate the initial loss in the selling price by selling shares in stages, as the reform's credibility improves.

9.44 *Combining and packaging reforms*. Introducing the right mix of reforms could allow key constituencies to balance their gains and losses, hence reducing the political cost of the reform (see Box 9.1). This strategy was pursued by New Zealand's Labor government in the 1980s. Minister of Finance Roger Douglas persuaded agricultural groups that losing their subsidies was essential to the total reform package, which benefited farmers by cutting tariffs, lowering inflation, and addressing the bias against exports. Similarly in Bolivia, the broad reform package introduced in 1985 by the Paz Estenssoro government, in a context of hyperinflation, managed to circumvent labor opposition, which had vetoed previous reform plans. Although, support from the two main political parties helped, the speed and comprehensiveness of the reform prevented pressure groups from organizing to derail the reform.

9.45 When deep macroeconomic imbalances have to be corrected, packaging some reforms could increase their political feasibility. For example, trade liberalization is often easier to implement in conjunction with an adjustment program, because gains from macroeconomic policy can offset the distributive effects of liberalization (see Box 9.1). Broad and speedy reforms also may enhance credibility. Eastern Europe's transition supports the view that rapid liberalization leads to quicker economic recovery. Countries that have delayed liberalization, such as Bulgaria and Romania are growing less rapidly than radical liberalizers such as the Czech Republic and Poland. In 1990 the Polish government freed 90 percent of prices, eliminated most trade barriers, abolished state trading monopolies, and made its currency convertible for current account transactions. After an initial decline in output in 1990-91, Poland became the first country in the region to resume growth.

Compensation

9.46 *Severance packages*. Both matching state's role to its capacity and enhancing capacity require not only tactical design and sequencing but also the compensation of groups adversely affected by these reforms in order to secure their support. These groups are not always the poorest in society: they may, for example, include bureaucrats whose jobs are being eliminated, managers of privatized state enterprises, and business people used to operating behind high levels of trade protection. Bureaucrats might receive generous severance packages and state enterprise managers might be offered shares at a discount. Although compensation might be economically costly in the short run, to the extent that it eases opposition to reforms, it will pay off in the long run. A recent study of retrenchment programs found that, on average, the associated benefits in terms of productivity gains and wage bill savings offset the compensation cost after only 1.7 years. Three factors highlight the critical role of severance payment. First, political feasibility may require that retrenchment be done on a voluntary basis. Second, even where political constraints are not a factor, the law may preclude involuntary separation as in the case of the Central Bank of Ecuador. Third, most developing countries do not have an unemployment insurance scheme, and severance payment then becomes a close substitute.

9.47 Well-designed severance schemes can further reduce the cost of the retrenchment program. By designing severance schemes that take into account broader characteristics of workers, politically feasible retrenchment can be achieved at lower cost and with better targeting. One such mechanism would be to set ceilings on the number of departures by skill level. In Argentina, for instance, trained professionals from the National Institute of Agricultural Technology were made ineligible for voluntary retirement packages. It is also important when designing retrenchment programs to have built-in mechanisms that prevent rehiring, which would defeat the purpose.

9.48 *Equity incentives*. In some cases, compensation goes beyond generous severance payments: labor, management or the public at large may be given a share of privatized enterprises. Bolivia's capitalization program is a very innovative approach. At least three features of the capitalization program increased its political acceptance without compromising on efficiency gains:

- By distributing shares to employees and pensioners, the program circumvented the resistance to privatization that often occurs when assets are sold entirely to foreign companies, while fostering institutional investors.

- Tangible benefits accrue to citizens early in the process. Beginning in May 1997 each person over 65 will get an annuity from the capitalization program with an estimated value of US$200-225. Bolivia's per-capita income, for comparison, was US$770 in 1994.

- The concern often raised by opponents of privatization that it provides a venue for corruption (whether warranted or not) is somewhat mitigated since the state does not receive funds.

9.49 In Eastern Europe the former Soviet Union, privatization through vouchers has been widely used. In the Czech republic mass privatization led to the transfer of more than half of all assets of state-owned-enterprises into private hands. To induce concentrated ownership and more active corporate governance, pooling of vouchers through investment funds was allowed. The Czech experience indicates that the political obstacles to privatization can be overcome by a well-designed voucher program without jeopardizing efficiency gains and the development of capital markets. Ill-designed voucher scheme, however, can block rather than facilitate reform. Management and employee buyout schemes can lead to insider entrenchment and compromise the whole reform program. Insiders typically lack needed skills and new capital and can deter outsiders who have these from participating. In Russia, for instance, managers who benefited from buyouts have prohibited, often illegally, workers from selling their shares. The weakness of laws and institutions in Russia permitted this abuse, leading to some public resentment about the process. The Bolivian and Czech experiences show how a capitalization program and management-employee buyout can enhance the political feasibility and achieve sustainable efficiency gains, but ill-designed these strategies could backfire.

Building consensus

9.50 Reforming the state requires cooperation from all major groups in society. Deep-seated differences and mutual suspicions among groups can delay or kill reform. There are no quick fixes for reversing age-old enmities, but social pacts can help. In a social pact, business, labor, and agricultural interests negotiate the terms of a contract with government leaders, setting clearly defined responsibilities for each group. This approach proved successful in countries such as Spain with the Moncloa Pacts (Box 9.5) and Mexico with the Solidarity Pact (1987-88) and Benin with its National Economic Conference (1996). In Spain a minority government was able to impose wage restraint by bringing all political parties to the negotiating table and developing a common program. In Mexico business and labor agreed to restraint wage and price increases while the government froze the exchange rate and cut the fiscal deficit. Benin's second democratically elected government on taking office in May 1996 organized a consultation with political parties and civil society. Sector working groups were created and made specific recommendations about the role of the state. Whether this initiative translates into a consensus around an economic program remains to be seen.

Box 9.5 The Moncloa Pacts in Spain

Adolfo Suarez was named chief of government by Spain's King Juan Carlos in July 1976, early in the transition to democracy following Francisco Franco's death in November 1975. Suárez started by instituting political reforms: he recognized free trade unions and the right to strike, legalized all political parties (including the Communist Party), proclaimed a political amnesty, and passed a new electoral law. The first free elections since Spanish civil war were held on June 15, 1977. Suárez won the elections, but his newly-created party the Center Democratic Union held only 47 percent of the seats in parliamentary.

The elections took place as the economy was falling into a crisis. Inflation and unemployment were both on the rise, and the external balance was deteriorating rapidly. As part of its anti-inflationary drive and its policy of external liberalization, the Suárez government sought to reduce wage growth. But rather than confront the labor movement and trade unions, Suárez took a consensual approach to incomes policy. Peak business and labor associations were brought together in late summer 1977 to forge a common position. These attempts failed, however, because of deep divisions within business and labor. Labor, for example, was represented by officials from at least four distinct political leanings. No one wanted to appear to be making concessions.

Suárez then changed strategy and asked sought agreement among party rather than class leaders. The resulting agreements reached in October 1977 have come to be called the Moncloa Pacts. Agreement among the political parties proved easier to achieve because the party leaders were more moderate than the particular interest groups they represented, and because the far left (which had no parliamentary representation) could be excluded.

The pacts went far beyond wage restraint and encompassed provisions on monetary and fiscal policies and structural reforms as well. They promised a "new framework for labor relations" with increased labor market flexibility, a more progressive tax system, and the rationalization and decentralization of public enterprises. Importantly, the pacts contained measures to compensate workers for some of the costs that adjustment was expected to impose on them. Increased state spending on job creation and unemployment insurance, the progressive extension of unemployment insurance to all the unemployed, and some price controls were among the compensatory measures. Given that Spain already had the highest level of worker conflict in all of Europe, getting labor to go along with fundamental reforms without these concessions.

Although not all the promises made in the Moncloa Pacts were fulfilled (especially in the areas of labor market reform and public enterprises) were fulfilled, the pacts were successful in achieving their primary targets. Price and wage inflation was sharply reduced after 1977, and the current account gap was closed.

Political leadership and vision for the future

9.51 There is no universal blueprint for reform. Most major reforms in developing and transition economies are crafted by dynamic leaders who shepherd changes through complicated political terrain. Such leaders seize opportunities as they appear, but they also create them by identifying and reaching out to potential beneficiaries, reshaping institutions, and articulating a compelling and achievable vision for the future. Political leadership is particularly important in countries that lack trust and cohesion among different social groups. When business people mistrust bureaucrats, workers are wary of managers, and farmers are suspicious of everyone, sensible reforms can stall. Leaders must instill a sense of common purpose that minimizes polarization.

9.52 The purpose of reform is to enhance economic well-being. The consequences of reform are often measured using quantifiable yardsticks, such as national income, exports, or inflation. But an equally important aspect of reform is whether it succeeds in reshaping the values and norms of the state and the state's relationship to the economy. It is this transformation that ultimately legitimates reforms in the public eye. Thus political leaders must offer a compelling vision, beyond the dry realities of economic efficiency, about where their societies are headed. Such a vision can motivate and rally support for reforms.

9.53 For example, in some economies—such as the Czech Republic, Hungary, and Poland—transition was aided by the prospect of joining the European Union. The same desire motivated reform in Spain and Portugal in the early 1980s. In other instances a clear vision does not present itself so easily. Venezuelan's reforms under Carlos Andrés Pérez (1989-93) were a political failure because there was no coherent vision to help sell the reforms (Box 9.6). In Malaysia, by contrast, President Mahathir's policy initiatives in the 1990s were packaged in his Vision 2020 which set as its goal the raising of Malaysian living standards to industrial country levels by that year.

Box 9.6 Venezuela's 1989 reform program and its reversal

In the late 1980s the Venezuelan economy was experiencing a deep crisis with internal and external imbalances generated by an overextended state and a mismanaged economy.

In 1989 Carlos Andrés Pérez, who had served as president in the 1970s, was reelected. Candidate Pérez was critical of the International Monetary Fund (IMF). The economic reforms undertaken by his administration, however, were consistent with IMF and World Bank stabilization and adjustment strategies. The 1989 stabilization plan included a sharp devaluation of the bolívar, and a lifting of price and interest rate controls. The plan restored internal and external balance and was accompanied by structural reforms such as trade liberalization, privatization, and increased of central bank autonomy. Tax reform, however, was defeated.

These reforms were made possible by the broad executive powers of the Venezuelan presidency. The president's party had the largest minority in Congress—a few votes shy of a majority—although a majority of party delegates did not support the president on such key battles as tax reform. Eventually, however, the party began hindering the economic program. Two failed coup attempts in February 1992 and November 1993 precipitated a legitimacy crisis that ultimately led to the unseating of Perez on corruption charges in May 1993. A provisional administration took over in December 1993.

Under this interim administration, a value added tax and a tax on firms' assets were enacted. In new elections in February 1994 Caldera was elected president as leader of a coalition government. Traditional political parties lost, ending the political duopoly.

Caldera started by repudiating some of the reforms, eliminating the value added tax and returning to price and interest rate controls. Central bank autonomy was also compromised, prompting its bank's president to resign. Constrained by international agreements, the Caldera administration did not reverse trade liberalization, but instead relied on nontariff protection. The program's lack of coherence caused an erosion of confidence in the international investment community. Venezuela's bond rating dropped 20 percentage points below its 1991 level. In 1994 real GDP dropped by 3 percent and inflation soared to 71 percent.

In the second quarter of 1996 the Caldera administration began adopting more orthodox economic policies, supported by an arrangement with the IMF. These have been implemented with some success thus far. How far-reaching and sustainable this program will be remains to be seen.

Venezuela's experience highlights some important points about the sustainability of reform. Economic reform is more susceptible to reversal when it is supported by only a few technocrats, without backing from political parties or other groups. Reforms linked to stabilization are easier to implement than are structural reforms requiring congressional approval. Moreover, economic reforms are harder to implement in an environment prone to political risk. Introducing new taxes is contentious in an environment where state control over natural resources (in this case petroleum) gives the appearance of cost-free public services. A crisis may be sufficient to create the conditions for initiating reforms, but sustaining them requires much more. Long-term performance requires vision and unity of purpose.

Conclusion

9.54 This Report emphasizes the significant payoffs from adopting better policies and improving state institutions. This chapter has identified the main obstacles to reform and suggested mechanisms for circumventing them. Machiavelli rightly recognized that distributional conflicts lie at the heart of the difficulties of reforming the state. And reforms that involve large reshuffling of resources relative to their efficiency gains are even more difficult to implement. Institutional designs may exacerbate these difficulties. In particular, the presence of many veto points (formal and informal) in state institutions and the ease with which interest groups can capture these veto gates can stall reforms.

9.55 Distributional conflicts and constraints embedded in state institutions are not immutable. Change ultimately comes when the incentives to remain with the old policies and institutional arrangements are no longer beneficial to society. An economic crisis or an external threat may provide the impetus for initiating reforms. But its precise timing can be prolonged if those who control state power stick with outdated policies because it is in their (or their allies) interest that it be so. Sometimes the delays can be painfully long periods of time as in Haiti under Duvaliers, or in Zaire today.

9.56 This chapter has shown how windows of opportunity can open and how important it is to seize these opportunities to bring about change—through compensation of potential losers and through the skillful choice of tactics. As emphasized throughout this Report it is important to internalize state capacity when designing reforms. A mismatch could lead to failure even in the absence of political obstacles. A strategy for improving state capacity, however, is also critical. A more capable state can broaden the scope of policy options and significantly improve

economic performance. Enclaving is a good first step and is consistent with the budgetary and other constraints facing many developing countries. Early on, however, countries should design early a strategy for going beyond reforming a few agencies, and thus escaping the enclave trap. This involves defining clear rules under which agencies outside the original enclave will be brought in to the reform program. Rules and tactics, though, are no substitute for commitment and political leadership.

Chapter 10 The Agenda for Change

10.1 This Report has shown that the state has great sway over a country's development—economic and social—and whether that development is sustainable. Its capability to leverage, promote, and mediate change are unmatched. Yet if the state is so important, why have we not seen it become more effective? Or why do we see improvement in some parts of the world and not in others? Much of the answer lies in politics. But it is not simply a matter of democracy versus authoritarianism. We need to go beyond those broad concepts of political organization to understand the incentives that inspire state organizations to work better. We need to understand better how and when political and economic interests that favor development can be harnessed to bring about the institutional changes needed to make development happen.

- **Countries where the arbitrary exercise of unconstrained state power has led down a developmental dead end must build institutional arrangements that foster responsiveness and accountability.**

10.2 The task is difficult at two levels. First, it requires patience. It takes time for judiciaries to convince firms and citizens that they are impartial in their decisions. It takes time for national and provincial legislatures, political appointees, judges, civil servants, public-private deliberation councils, independent watchdogs, and NGOs—arrayed in unique relations to one another in different societies—to learn to respect the limits of one another's authority and to work together. It takes time to lay the foundations of a professional, rule-based bureaucracy. Still, it is possible to sequence reforms in a manner that yields some early payoffs. Such early measures can include strengthening the capacity of central government, raising upper-end salary scales to attract capable staff, inviting more inputs into policymaking and making deliberations more open, hiving off contestable and easily specified activities for private sector involvement, and seeking greater client feedback. In general, though, there are few quick fixes.

10.3 Second, the task is difficult because institutions capable of fostering credibility and accountability can also be constraining. The challenge is to devise institutional arrangements that provide flexibility within appropriate restraints.

10.4 In the end each country must strike its own balance. Countries with strong track records of following through on commitments, and whose state institutions have deep roots in society, are likely to have room to experiment and to respond flexibly to unanticipated events, with little cost to credibility or accountability. Countries emerging from long periods of arbitrary and dysfunctional government might be better off forswearing the short-term benefits of flexibility in favor of the long-term goal of building sustainable institutions.

10.5 Where prospects for reform are strong, this Report has suggested a two-part approach to improving the effectiveness of the state to make it accountable and responsive:

- matching role with capability, and
- reinvigorating state capability by subjecting the state to more rules and restraint, competitive pressures, and making it more transparent and open.

- **Focusing limited state capacity on a return to basics is a badly needed first step in a wide range of countries—especially in Africa, Central Asia, and parts of Latin America, the Middle East, and South Asia.**

10.6 Focusing role with capability must come first. In many parts of the world the state is not even performing its basic functions—safeguarding law and order, protecting property rights, managing the macroeconomy, providing basic social services, and protecting the destitute.

10.7 In some cases—especially in the Middle East and in South Asia—the state has been overregulating the economy, even though it lacks the capability to enforce regulations systematically. One consequence has been the spread of corruption, which corrodes capability even further—sometimes rendering the state incapable of delivering even basic services. Reasonably well-functioning bureaucracies have been weakened over the years and will now need considerable overhaul. Deregulating these economies is vital.

10.8 Reforms supported by the World Bank and other international organizations have tried to help countries design reforms to match the state's role to its capabilities. Many reforms over the last decade or so have tried to trim back the state's role in some areas of the economy and refocus the released resources on core functions. These are a start, but more is needed. This refocusing must be complemented by improvements in capability.

- **Improving state capability is not simply a matter of more technical assistance. It takes the right incentives.**

10.9 In many areas the state can improve its effectiveness only if it expands its partnerships with other organizations of civil society. In other instances it will become more effective only if its decisions and actions can be contested—if people and business have choices and if the state's monopoly is broken.

10.10 What needs to be done to improve state capability will vary, since so much of reform is institutional and institutions differs in some many dimensions. Before examining some of the opportunities and key challenges facing states across the developing regions, it is important to consider the most extreme case of institutional

dysfunction, that is, when for a period, the state itself, as a legitimate and functioning order is gone.

When states collapse

10.11 In recent years, a growing number of countries have seen virtually all of the functions and institutions of governance collapse, often in the context of civil war. When the state ceases to perform even its most basic functions, the associated crisis can be prolonged and severe. Structures that might normally mitigate the impact of the crisis and provide a vehicle for eventual recovery are frequently destroyed, hence the need to address issues of state collapse as separate from the generic issues of enhancing state capability that follow.

The causes of state collapse

10.12 State collapse is not a new phenomenon. It does, however, seem to have become more common in the 1980s and 1990s than in the earlier post-war years, and is subject of grave concern on the part of other states, individually and collectively. Failed states such as Afghanistan, Cambodia, Liberia and Somalia, have been the settings of some of the worst humanitarian disasters in recent years. These often spill over into neighboring countries in the form of violence, banditry and refugee flows. They also send countries into arrears, destroy economic assets and infrastructure and claim huge amounts of international assistance—and, of course, waste countless lives. Generally, three broad and overlapping pathologies of state collapse can be identified:

- states that have lost (or failed to establish) legitimacy in the eyes of most of the population notionally under its authority and are therefore unable to exercise that authority;
- states that have been run into the ground by leaders and officials who are corrupt, negligent and/or incompetent;
- states that have fragmented in civil war, and in which no party is capable of re-establishing central authority.

10.13 What all these states have in common is a fundamental loss of institutional and governance capacity. As outlined in Chapter 1 (see Table 1.1) at a minimum the state must perform the most basic functions of maintaining law and order, national defense and a framework for managing economic transactions. A collapsed state is not, therefore, one that failed to do the right things, but one that fails to do much of anything effectively—not even maintain repressive order. Collapse is not the same as a state defeated in war, or a state split apart into two or more states, where despite some incapacity, systems continue to function more or less effectively. Nor is a collapsed state the same thing as a "predatory" or repressive state. Successful repression of a whole population takes considerable organization capacity, as does genocide. Such acts may provoke the

replacement of one state structure or regime with another, as in Cambodia or Rwanda, but do not necessarily—or even probably—bring about its collapse. Neither war or anarchy constitutes state collapse, but each may actually predispose a state to collapse (Box 10.1).

Box: 10.1 State collapse and beyond in Somalia

Somalia is one of the most ethnically homogenous countries in Africa; one of the most common factors in state collapse— inter-ethnic conflict—played no part in its collapse. Rather, the dynamic of state collapse was set in motion during a long period (1969-91) of dictatorial rule and egregious economic mismanagement by Mohammed Siad Barre, followed by a fierce contest for power after he was violently deposed. Siad Barre played off Cold War superpowers against each other. His external support, first from the Soviet Union and then from the United States, unbalanced the fragile social ecology of Somalia's clan politics and introduced high levels of lethal weaponry. A north-south conflict inherited form the pre-independence era, an irredentist war to seize Ethiopia's Somali populated Ogaden region, and the suspension of economic and military aid in 1989 contributed to the erosion of state capacities.

Since 1991, continuous civil war between rival clans and factions has complete the ruin of the economy and left Somalia with no state institutional or public administration. Physical infrastructure and economic assets have bee destroyed, private businesses looted, agricultural and pastoral production drastically reduced. Professionals, technocrats and civil servants have fled. International intervention to halt a major war-induced famine brought a respite and some reconstruction from late 1992 to early 1995, but these gains were reversed as anarchy returned after U.N. forces withdrew.

Amid the chaos and violence, some elements of the private, informal market have shown extraordinary, if somewhat perverse, resilience. Merchants and entrepreneurs can operate only with clan protection; those who benefit from this protection and from their clan's control of economic assets such as ports, mineral deposits and agricultural lands, finance clan militias. With no government regulations or controls, the prices of goods and foreign currencies float freely. Transactions costs are high, but markets operate efficiently. The Somali shilling has value despite the absence of a central bank, although banknotes are physically wearing out. Remittances from abroad and handed quickly and reliably through clan networks.

Today, Somalia exemplifies a post-state economy. Productive capacity, private investment and employment are extremely low; risks are high and violence is the normal mechanism of competition and resolution of economic disputes. If a functioning state with legitimate institutions were able to restore law and order without reverting to the heavy-handed economic mismanagement of the Siad Barre regime, the private sector has shown its ability to weather high risk and respond to the challenges of the market.

Factors perpetuating the conflict

10.14 In most countries where the state has collapsed, there are forces that have an interest in perpetuating a state of anarchy, and whose unbridled pursuit of riches or power would be constrained by a state with the capacity to make rules, collect revenue, and enforce the law. The most troubling and intractable of collapsed states are those in which these forces are dominant. In Liberia, Angola and Somalia, for example, a self-sustaining economy of armed violence has emerged, based on looting, protection rackets, drugs and money laundering and the extraction of crude resources such as gems, minerals, tropical timber and others. While the wars have their roots in political or ethnic rivalries, these wars have gradually shifted character and are now centered around the control of economic assets, which provide the source of financing the war and private enrichment.

10.15 In such cases, factional warfare is the main system of resource allocation, and violence is the source of power. These economies operate independently of any state institutions, and indeed would likely be hindered by them. Strong economic forces are at work perpetuating the fighting. The role of economic factors as a driving cause of the war has been especially pronounced in the case of Liberia (Box 10.2) but also explain the prolongation of wars in Angola and Sierra Leone. Ordinary people pay a high price for their helpless proximity to these systems. Normal international economic transactions are disrupted or even corrupted by them.

Box 10.2 The economic underpinnings of conflict—the case of Liberia

Initially, the war in Liberia was fought largely for social and political motives with control over the central government as the central objective. Foreign support helped finance the launching of the war. Gradually control over Liberia's rich natural resources and other assets, in addition to being a means of ensuring funding for the war, has become an end in itself for the fighting factions.

The factions depend on steady supply of income from the export of rubber, timber, iron ore, gold and diamonds to finance the fighting. During periods of intense conflict, much of the income is used to purchase arms and ammunition. However, during periods when no fighting takes place, a revenue 'surplus' is created which provides for potential personal enrichment for leaders, and for financing payoffs to keep faction members loyal. This, and the uncertainty that faction members face regarding their economic prospects after the war, creates strong pressures down the ranks to share in the surplus. However, lower rank fighters rarely receive direct payments, instead they rely on looting and pillaging to sustain their livelihoods.

Because fighting actually runs down the 'surplus', as long as the prospects for private enrichment remain high, there are strong incentives for factions to maintain a 'no war-no peace' equilibrium, a situation that helps explain the difficulties in reaching a lasting peace agreement in Liberia.

To actually restore peace, therefore, interventions must include actions that both make the 'surplus' accruing to the fighting organizations zero or negative, simultaneously with actions to eliminate individual figherts risk-adjusted income from looting. Such actions range from economic sanctions on the export of timber and rubber exports, to measure that increase the costs of arms through international agreements. In addition, incentives to individual combatants to continue the war must come to an end, through a combination of carefully planned demobilization and enforcement of criminal laws.

10.16 While the diminishing returns of conflict and resource extraction imply that wars eventually fade away without international intervention, this point is reached only after nearly all the assets of a country have been destroyed. For the international system this is untenable. Consequently, for other states, and for intergovernmental organizations, two urgent questions arise. How can state collapse be prevented? How can a functioning state be resurrected from the ashes of a collapsed one?

Preventing state collapse

10.17 Collapsed states take tremendous toll on stability, productive capacity and human life. Peacekeeping and humanitarian relief operations have absorbed billions of dollars a year in the 1990s. The opportunity costs of lost economic activity are incalculable. The enormous toll has naturally turned attention to prevention as a preferable and potentially less costly course of action.

10.18 There are no short-cuts to prevention however. At its most fundamental it involves the whole gamut of institutions and policies that affect social , political and economic relations within a society. Nevertheless, two interrelated approaches have emerged as ways of reducing the likelihood that political conflict will spiral down into a comprehensive collapse of the state. One emphasizes the reinforcement of civil society as away of increasing the resilience of social institutions that may be able to fend off anarchy even if the state is very weak. A rich associational life may enable communities to maintain local law and order, support a safety net and resist official corruption of exploitation. A second approach, drawn from the East Asian experience, points to the need to build bureaucratic structures that are insulated from political interference and the need to embed bureaucratic decision-making within appropriate restraints. The integrity and professionalism of the civil service is an important element in this.

- **An active civil society and a competent and professional bureaucracy are twin pillars of a constructive relationship between state and society that may reduce the likelihood of comprehensive collapse of the state.**

The challenge of reconstruction

10.19 Once the spiral into failure has occurred, there are no 'quick fixes'. Most collapsed states are immersed in, or just emerging from, bitter internecine conflicts. Politics is often highly charged with suspicion of complicity; mistrust is widespread. Cooperation among former rivals is difficult to achieve, while the desire for justice on the part of some may look like vengeance seeking to others. There may be little confidence that peace will be sustained, or policies maintained, and social and human capital have often been severely damaged.

10.20 External actors face unusual difficulties when they determine to become engaged in a country without a functioning state. The question arises, how and with whom should external actors work? One strategy involves choosing among local factions or leaders and attempting to reinforce their position. This strategy is risky. The chosen partner may be unreliable, or may abuse the position of leadership. There is also the risk that another external actor will pick an alternative winner, prolonging the conflict as occurred in Mozambique and Angola. Alternatively, external actors can choose to work with local authorities and institutions that often retain legitimacy and capability long after central institutions collapse. Working with them can help rebuild local confidence and strengthen local decision-making capacity. But, unless accompanied by a strategy for rebuilding central governance authority, such as strategy can prolong the period of state fragmentation, as has happened in Somalia.

10.21 In many instances external actors focus on mitigating the human costs of state collapse, through relief and rehabilitation programs, rather than intervene directly in civil/political reconstruction. Recent experience suggests, however, that after some time these programs can lead to dependency amongst the population, and even undermine the rebuilding of state-capacity by detracting attention away from minimal state functions.

By contrast more comprehensive peace approaches, as adopted in Angola, Cambodia and Mozambique, place far-reaching authority in the hands of international organizations to formally oversee peace agreements, deliver public services and facilitate refugee repatriation, with a view to handing over to an indigenous authority after elections have been held. The international operations in Cambodia and Mozambique are generally considered to have been successful in this regard, but both were enormously costly in financial terms, and beg the question of whether in replacing 'absent' state capacity, these arrangements simply prolong the task of restoring a credible, indigenous central authority.

10.22 The choice of strategy for external actors will differ according to the particular pathology of state collapse in each case. As the discussion in Chapter 8 suggests, there is an increasing awareness of the role that external donors and agencies may need to play in the future to allow for the long process of reconstruction and rehabilitation. Some of the challenges facing external actors are mentioned below.

10.23 *Reestablishing security.* The end of a civil war does not lead automatically to the end of insecurity. Fear of personal violence or theft may actually increase after the war, and unless there are measures to increase the opportunity cost of warfare for individual combatants, the end of the war may signal increased opportunities for criminal activity. Well-designed demobilization programs that assure combatants of their reintegration into civil society after the end of the war, giving them a legitimate exit strategy from the war, are therefore a priority (Uganda, Angola). Simultaneous measures to create strong deterrents against the practice of 'living by the gun' are also essential, including strengthening local police forces, strict enforcement of criminal laws and other measures to increase the risks of banditry and criminal enterprise. The long term response, however, should be to address the socioeconomic root causes of these types of conflicts.

10.24 *Economic recovery.* While the elements of a postconflict stabilization and recovery program may differ little from a nonconflict program, there are grounds for caution and for examining the components of the standard policy package in light of the conditions and distortions peculiar to the postconflict environment. Civil conflict erodes social capital that has been developed to facilitate trust and investment. Consequently private agent 'fear' may be a bigger obstacle to investment revival than the physical damage to infrastructure. Thus a policy environment conducive to private recovery should avoid overly aggressive increases in taxation and should stress the early sequencing of investment-sensitive reforms, including the preservation of low inflation by direct targeting of the price level, the sale of expropriated housing stock and restraint in revenue collection. Avoiding aggressive revenue collection does not imply, however, that overly generous tax incentives for private foreign investment are to be preferred. As the case of Cambodia now attests, these may be counterproductive, depriving the government of substantial revenue for many years and distancing government from the all important task of reviving domestic investment.

10.25 *Promoting fundamental socio-political reconciliation.* Economic policy and sectoral projects need to be tailored to take account of special problems of traumatized populations and societies with heavily damaged social capital. The sequencing of standard economic policy reform and of governance measures also needs to be tailored to avoid negative effects on the sustainability of peace agreements and to take account of the typically severe distortions in economic conditions.

10.26 *Capacity building.* The problem of capacity strikes at the heart of the problem of sustaining recovery and reconstruction in postconflict situations. Yet, even where effective macroeconomic and political reforms have been undertaken, improvements in bureaucratic capacity have often lagged well behind (Uganda). Faced with the unusual urgency for capacity building, various options have been tried to jump-start the process, including drawing on a diaspora of professionals to occupy positions within the new government (Cambodia, Lebanon, Haiti) and providing cadres of foreign experts to work as advisers to local counterparts. As the strategy for enhancing state capability implies, conventional technical assistance is rarely effective if applied in settings where the minimum of rules and restraints on arbitrary action are not in place. The absence of such rules is a defining feature of a failed state. Consequently, in addition to imported technical assistance it is critical that simultaneous attention be given to implementing and enforcing even the most basic rules of accountability and restraint within government, as a vehicle for strengthening capacity and rebuilding some of the credibility lost during the conflict.

10.27 Instances of state collapse are both extreme and unique. There are no simple generalizations about their causes or effects, each instance produces its own challenges for individual nations and for the international system as a whole. The consequences are, however, almost uniformly borne by ordinary people, illustrating once again how fundamental an effective, responsive state is to the long term health and wealth of society.

Some regional steps—and missteps

10.28 Moving beyond the extreme case of state collapse, we now shift the focus onto improving state effectiveness, and inevitably the specific elements of any reform strategy will differ by institutional and political setting. The key features and challenges of improving the effectiveness of the state in the various developing regions are summarized below. These are of necessity broad generalizations, and each region includes several countries with experiences entirely different from those sketched out below.

10.29 In *Africa*, with few exceptions (one of which is Botswana), the deterioration of state effectiveness has perhaps been most severe, resulting from the erosion of civil service wages, dependence on aid, and patrimonial politics. The first step toward reform is to pledge that the state will henceforth be on balance beneficial rather than harmful. High military spending and the dysfunctional behavior of military

personnel are related impediments in many countries. Thus reforming the state and strengthening its capacity to help and facilitate, rather than repress and hinder, are structurally complex and politically problematic issues—as daunting as they are essential. In recent years repressive governments in many parts of Africa have given way to emerging democracies. But the legacy of the past is one of weak institutions, which now need to be reformed and strengthened. Multiethnic societies will need to give careful thought to the management of ethnic differences. Malaysia and Mauritius have shown that this can be done, and that the payoffs are far-reaching.

- **In many parts of Africa an immediate need is to rebuild the rule of law through fortified and more independent judicial systems.**

10.30 Strengthening the capability for legislative oversight of the executive would help enormously. But strengthening the executive—particularly the central government's capacity to formulate macroeconomic and strategic policy, and its incentives to deliver core public goods efficiently—is also a key priority. Generally government in Sub-Saharan Africa operates at the lowest levels of capability and efficiency of any developing region. The clear need in most African countries is for a thorough overhaul of the machinery of the state, so that it can deliver quality public services and facilitate private activity rather than impede both. Disappointingly, with some promising exceptions (Uganda is one), improving the effectiveness of the state in Africa has generally been limited to tinkering around the edges and to promulgating reforms on paper. Cost containment has been the entire story.

10.31 A major constraint to systemic institutional reform of the state in Africa is its cost, but resources can be found if the priorities are clear. Most countries will need to redirect resources that are available now but are misallocated: to raise real public wages (more than proportionally to whatever retrenchment is still possible), to increase spending on the social safety net, and to undertake vast investments in personnel management, retraining, and accountability. This major rebuilding of state capability cannot happen without international adjustment assistance. But the modalities of international assistance and the incentives such assistance generates also need to be reexamined, to ensure that it supports coherent and well-contested policies rather than fragmented and conflicting projects, and that it strengthens overall framework of incentives both within and outside the state, rather than isolated enclaves.

- **Where the links between the state and civil society are fragile and underdeveloped, improving the delivery of public and collective services will require closer partnerships with the private sector and civil society.**

10.32 A hopeful recent development is a growing array of self-help community initiatives, particularly in elementary education, basic health care and local services such as waste disposal. These initiatives have often sprung from the state's own failure to provide such services effectively. Although they can seldom fully substitute for a well-functioning government administration, they offer a partial escape from the current

morass and serve as models in efforts to improve the role of the state. The emerging partnership between international donor organizations (including the World Bank) and the NGO community, although not without its growing pains, is a constructive example.

10.33 However, it is difficult to imagine how reform of the role of the state and improvement in its capability can be meaningful in most African countries without the stronger incentives that this Report also recommends: increasing competitive pressure, greater voice and transparency, and the rule of law.

- **Clearly the capability of the state in most East Asian countries cannot be considered a problem; indeed, it is an important part of the solution to their other problems.**

10.34 The situation in *Asia* is different. In the newly industrializing countries of *East Asia*, the state is generally viewed as capable, engaged in a productive partnership with the private sector. Whereas ineffective authoritarian states have been directly responsible for economic decline in Africa, many East Asian countries have experienced remarkable growth (with some improvement in equity) under authoritarian regimes. As the previous chapter implied, the link between authoritarianism and economic decline, so evident in Africa, has been inoperative in Asian countries largely because of their strong administrative capability and institutionalized links with stakeholders such as private firms; as well as their ability to deliver on the economic and social fundamentals—sound economic management, basic education and health care, and infrastructure.

10.35 This does not mean that reform of state institutions is not needed. In several East Asian and Pacific countries, especially in parts of Indochina and some Pacific island countries, more effective government is badly needed. And even in countries like Korea that have performed well, their earlier success on the economic front has raised calls for government reform.

- **The situation is different in South Asia, where in many countries state inefficiency and corruption have coexisted with a relatively competent and efficient civil service, albeit one whose quality has suffered noticeable decline.**

10.36 The main flaw in South Asia is overregulation, both a cause and an effect of bloated public employment and the surest route to corruption. Regulatory simplification and public enterprise reform, and the resulting contraction of the role of the state, will be complex and politically difficult. But they can boost economic efficiency, increase competitive pressures, reduce corruption, and—unlike in Africa—produce substantial fiscal savings. Another key imperative is to build stronger partnerships with and listening more effectively to private business and civil society, to improve feedback and supplement the state's capability.

10.37 Pervasive political interference is a second major impediment to state efficiency and effectiveness in many countries of the region. India is a major case in point. As discussed in Box 1.4, not only is India's administrative red tape legendary, but

the autonomy of its highly qualified civil servants is severely circumscribed in practice (despite statutory protection from interference in their individual actions) by frequent transfers of personnel and other arrangements. In Pakistan the machinery of the state has come increasingly under pressure from powerful business and feudal interest groups. More recently, from the resulting erosion of state authority and effectiveness has sprung an attempt to reform the very machinery of the state. Here, too, a competent civil service, allied with an activist judiciary, offers grounds for optimism that reform is not only possible, but will happen. And in Bangladesh, recent political developments have created conditions for beginning to address the decline of the state's authority and effectiveness, using the pillars of strong top-level political commitment, popular participation, and decentralization, buttressed by competent and professional elements of the civil service. Similar possibilities for improving governance and streamlining public administration are emerging elsewhere in the region.

10.38 As noted earlier, substantial differences exist among countries in all regions, and regional generalizations are useful only as a first approximation. This is particularly true of the countries of *Central and Eastern Europe* (CEE) and the *Commonwealth of Independent States* (CIS), now in transition from socialism. In addition, broad differences exist between the CEE countries as a group and the CIS countries. While both sets of countries face a common challenge of economic and political transformation—and hence of a fundamental reorientation of state structures—the CIS countries (except Russia) face the gigantic, and historically unique, double challenge of economic transformation *and* state building: they have had no central government within living memory, nor have they constituted for centuries (most never) independent political entities within their present boundaries.

- **The job of reorienting the state toward the task of "steering, not rowing" is far from complete in Eastern Europe. But most countries have made progress and are on the way to improving capability and accountability.**

10.39 It is no surprise, then, that improvements in the effectiveness of the state have been more noticeable in CEE—especially in countries such as the Czech Republic, Hungary, and Poland. (Indeed, the Czech Republic is now a model of administrative best practice in many fields. The sustainability of its economic reforms and its administrative institutions and structures owe much to the early recognition, largely to be credited to President Václav Havel, of the need to clarify and respect property rights, and not trample on them for the sake of quick but ephemeral reform "successes.") However, progress in Southeastern Europe has generally been much less significant—both in terms of policy reform and on the public administration front.

10.40 In particular, many CEE countries have made advances toward setting up competitive systems for service delivery and toward relying much more on the private sector (including, in part, for education and health care). In these countries, too, autonomous professional associations are beginning to arise, with healthy potential implications for capacity outside the government (capacity that is needed to help

implement the reforms) and for the rebuilding of social capital. And substantial regulatory reform and simplification has occurred, with support from the European Union. Again, in Southeastern Europe progress toward greater contestability, private participation in service delivery, and regulatory simplification has been much slower. The difficulty is not so much a lack of consensus on the desirability of these reforms, but a severe lack of capability at the core of government to formulate and guide them—compounded, in some countries, by a fluid political situation.

- **Low state capability in the former Soviet republics is a serious and mounting obstacle to further progress in most areas of economic and social policy.**

10.41 In the CIS, the process of reorienting the state is still at an early stage, and a host of severe problems have emerged from general lack of accountability and transparency. A first and fundamental problem is the weak accountability of the executive to the legislature in most CIS countries. In the very early 1990s, parliaments in most of the new countries were the only repository of whatever political legitimacy existed after the collapse of the Soviet Union. There were even instances of excessive interference by the legislature in routine executive functions (which remains a problem in Ukraine). In contrast, the situation in most countries today is one of a dominant executive and weak legislative oversight.

10.42 Beyond the issue of executive accountability to the legislature, four major sets of problems confront most CIS countries. Together these give rise not only to enormous economic cost, but also to the pervasive corruption that is rightly decried almost everywhere in the region—as a survey conducted for this Report reveals in all its alarming aspects. First, the weakness and slowness of judicial systems have severely handicapped both reform and economic activity. Second, fuzzy boundaries between private and public property rights have generated massive rent seeking, with officials often exploiting public assets, including those of state-owned enterprises, for private profit. Third, the opaqueness and still vast complexity of the regulatory framework have contributed to corruption across the entire interface between the public and the private sectors. Finally, as is well known, weak law enforcement and judicial processes have permitted the unprecedented rise of organized crime. Consequently, outside assistance and encouragement—to tighten accountability of executives to legislatures, to strengthen legislative oversight capacity, to streamline and reinforce judicial systems, to clarify property rights and provide for accountable management and oversight of public assets, to radically simplify the regulatory framework and move rapidly toward rules and away from discretion, and, not least, to bring criminal activities under control and sever their links to the public sector—are clearly essential to improve the functioning of the state and promoting economic recovery in general.

10.43 Concerning public administration in particular, except for slight improvements in the autonomy of government employees, genuine administrative reform is conspicuous by its absence in most of the former Soviet Union. The central government work force is typically small, and although these workers are often highly

educated and technically knowledgeable, they lack the skills needed for administration in a noncommand economy. They are, moreover, unaccustomed to personal initiative, deprived of basic supplies and resources, and very badly paid. It is unsurprising that, during the first stage of the economic transformation, attention and financial resources were devoted to the urgent tasks of privatization, reforming the price and exchange system, and establishing some measure of fiscal and monetary control. But it is equally unsurprising that the next stage of the transformation—that dealing with reforms requiring "affirmative administrative action"—is now severely hampered by the absence of the mechanisms, government personnel, and resources necessary to implement them.

10.44 The role of the state in *Latin America and the Caribbean* has been undergoing profound change over the past decade, fueled by fiscal crises and rising expectations with the return of democracy and the emergence of civil society. Globalization of markets, through greater cost and technology competitiveness, has put increasing pressure on government to privatize or to contract out activities in which it lacks comparative advantage, and to improve its efficiency and effectiveness in producing public goods.

10.45 But while some reforms have been implemented successfully in a number of countries in the region, progress has lagged in such areas as civil service reform, held back by political constraints and vested interests. Such reforms (recently begun in Argentina and a few other countries) cannot be undertaken in isolation, but must be part of a broader decentralization of political administration and financial management.

10.46 Especially notable has been an emphasis over the past decade on decentralization, particularly to improve service delivery, in both federal and unitary states. Authority and responsibility for both revenue and spending have been transferred, although often these have been mismatched at first. Strengthening institutional capacity at the provincial and the local level is a major challenge in countries with federal systems, such as Argentina and Brazil, which have a legacy of overly indebted local governments and weak state or provincial banks. Nevertheless, examples are abundant of successful local government reforms (for example, through public-private partnerships) emerging in time of crisis, where dynamic local leaders have been able to foster reforms on a manageable scale.

- **Decentralization of power and of spending, coupled with democratization, has dramatically transformed the local political landscape, in what some have called a "quiet revolution." A new model of governance is emerging in Latin America.**

10.47 The first stages of local reform in Latin America (covering roughly the period 1983-90) created an institutional environment that nurtured a fresh generation of office seekers, more professional and more reformist than their predecessors. Leaders in scores of cities were drawn by the ineluctable logic of popular participation as a natural means of sounding out the wishes of voters. This same logic led to a strengthening of the fiscal linkage between government and governed, making more obvious the connection

between the public works and service improvements neighborhood residents say they want, and the payment burdens authorities say residents must bear to achieve cost recovery. For instance, many local governments tie improvements to user fees or betterment levies or rely on referendums. Traditional fiscal models of government take as axiomatic that this exchange—payments for goods and services rendered—will take place. But four decades of centralized systems in Latin America and the Caribbean have broken this unspoken bargain of trust, and poor cost recovery and low tax revenues are just two of the consequences. The outstanding feature of the new style of governance, and one bright prospect for the future, is the restoration of this critical fiscal connection at the local level.

10.48 Governments are also moving to create more open administrations, reflecting the emergence of a more forceful civil society (media, private think tanks, NGOs) demanding greater access to decisionmaking, particularly in the Commonwealth Caribbean through citizens' charters (for example, in Jamaica). Efforts are under way (for example, Colombia) to develop performance indicators (of economy, efficiency, effectiveness, service quality, and financial performance) that will provide accountability for public sector managers and politicians.

- **Court systems in most Latin American countries have suffered from major inefficiencies, widespread corruption, and political interference.**

10.49 For the new legislative and institutional structures to work effectively the judicial system must work well and fairly. Needed reforms, which are under way in a number of countries (including Bolivia, Ecuador, Trinidad and Tobago, and Venezuela) include legal education, better court administration and case flow management, and procedural reform, including the development of alternative dispute resolution systems outside the courts. Efforts are also needed to strengthen the criminal justice system, to address the growing problem of crime and violence, partly related to drug trafficking in the region.

10.50 Governments in the region are also rethinking their approach to poverty alleviation, particularly important in a region with highly skewed income distributions. A number of countries, having launched major economic and structural reforms, have created social investment funds for the poorer segments of society. At a broader level, governments in the region have been faced with the bankruptcy of highly inequitable, state-run, pay-as-you-go pension systems. Chile privatized its system in 1981, reducing the role of government to that of regulator; other countries (Argentina and Colombia, for example) have pursued dual systems, and a third group of countries is just beginning to contemplate pension reform.

- **In the Middle East and North Africa, unemployment is by far the single greatest economic and social problem and makes government downsizing especially difficult.**

10.51 Counties in the *Middle East and North Africa* assigned Vast economic responsibilities to the state in the 1960s and 1970s. More recently, governments have trimmed back their roles, but there has been no proportionate slimming of the large civil services built up to execute the wide range of state responsibilities in those earlier years (and to provide employment to college graduates). With a few exceptions (Tunisia is one), states in this region share some of the undesirable characteristics of the state in both Africa and South Asia. As in Africa, there are problems with skills and with inadequate public service delivery; as in South Asia, overregulation has produced a bloated work force, pervasive interference in private economic activity, and widespread corruption. Little effort has been devoted to streamlining agencies and improving state efficiency. In addition, the system's capacity to change has atrophied. Regional conflict has also distracted attention from state reform, but with the end of the Cold War, the conclusion of the Gulf War, and the change in attitudes brought about by the Arab-Israeli peace process, governments in the region are beginning to turn their attention to the issue.

- **Because the political and social difficulties of reform are probably greater in the Middle East and North Africa than in any other region, a promising approach might be to follow Latin America's decentralizing strategy.**

10.52 The challenge of reforming the machinery of the state is further complicated by difficult issues of national unity and governance and is intertwined with the debate on the appropriate interaction between religion and society. In their most acute form, these issues were at the root of the fifteen-year civil war in Lebanon. Yet even under that country's extreme circumstances, the reestablishment of peace has made possible the beginning of state rebuilding, based on a consensus to insulate a professional civil service (except at its top levels) from religious considerations. In any event, the first step in most countries of this region must be to prevent any further growth in central government employment.

10.53 In the *OECD countries,* where the overall effectiveness of the state is high, efforts to improve it nevertheless continue. Some of the most comprehensive reforms seen anywhere have occurred in these countries, driven primarily by the rising cost of government and from citizens' demands for more value for money. Except in a few cases, it is difficult thus far to judge the outcomes in any definitive manner. Still, the depth of dissatisfaction with the effectiveness of the state in these countries suggests that the search for better government, for better public services at lower cost, continues.

- **Even small steps can make a big difference in the state's effectiveness, leading to better standards of living and opening opportunities for more reforms. The challenge is to take those small steps that can open the way to virtuous cycles.**

10.54 The two-part strategy laid out in this report is only a broad guide for the many different agendas of reform being pursued throughout the world. Likewise, international assistance for state reform must go beyond a one-size-fits-all approach, or one based on the preferences of donors rather than the needs of recipients, to a better

diagnosis of individual cases and of how reforms fit into broader political and social changes in each country.

10.55 An important component of the reforms discussed in this Report is institutional—and so will take time. Quick-fix capacity-building solutions have been attempted over the past twenty years, with limited impact. These efforts have focused largely on training, on building skills, and on importing technical systems. They have not focused on incentives, which come from contestability, partnership, and listening, and from rule-based systems. Reforms that are pushed forward too rapidly can produce new risks as well. Reforms will be blocked by those likely to lose from change. An added risk is that the reforms could lead to fragmentation and produce an institutional vacuum.

10.56 International cooperation and decentralization are creating opportunities for multiple levels of governance. This is a potentially positive trend since it creates the opportunity to improve international collective action and the delivery of local public goods. The two trends, in fact, reinforce each other. But the gains will be realized only if the pitfalls are avoided. International cooperation will yield gains only if countries believe that they will benefit from international integration. This can happen only if the risks and uncertainties of globalization—for households, workers, the poor, and the vulnerable—are skillfully handled. The dangers of decentralization—from loss of macroeconomic control to rising regional inequalities—need to be managed as well.

10.57 The approach of the twenty-first century brings enormous promise of change and reason for hope. In a world of dizzying changes in markets, civil societies, and global forces, the state is under pressure to become more effective, but is not yet changing rapidly enough to keep pace. Not surprisingly, there is no unique model for change, and reforms will often come slowly because they involve fundamental alterations in the roles of institutions and in interactions between citizens and government. Reform of state institutions is long, difficult, and politically sensitive. But the issues raised in this Report are now an integral part of the thinking and rethinking of the state in many parts of the world and are on the agenda of the international organizations that assist them.