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Thanks, Lynette.

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Managing Development:
The Governance Dimension

A
Discussion
Paper

August 29, 1991

The World Bank
Washington, D.C.

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

August 29, 1991

MEMORANDUM TO BANK MANAGERS

Subject: Managing Development: The Governance Dimension

Attached is a discussion paper, entitled: "Managing Development: The Governance Dimension". The paper was prepared by a Bank-wide Task Force. It follows on the General Counsel's Legal Memorandum on "Issues of Governance in Borrowing Members" dated December 21, 1990. The paper was discussed by Executive Directors meeting as a Committee of the Whole on July 16, 1991.

The paper discusses approaches to the governance issue which promote the Bank's work and protect its reputation for technical excellence, professionalism and objectivity. I fully endorse the main messages of the paper.

I want to emphasize that this is not a policy paper or a call for a new initiative. It establishes a coherent framework for efforts going on in different parts of the Bank, and reaffirms certain basic propositions: that efficient and accountable public sector management and a predictable and transparent framework for economic activity are critical to the efficiency of both markets and government interventions -- and hence to economic development. A similar message is contained in the 1991 World Development Report.

The discussion of the paper in the Committee of the Whole was both lively and thoughtful. Governance is an emotive word, and more importantly, a potentially contentious issue internationally and within many of our member countries. It is not surprising that there were divergent views expressed by Executive Directors on the subject. Despite these differences, the approach taken in the paper received widespread support. In particular, several Executive Directors emphasized the following messages of the paper:

- Problems of governance are universal and are not particular to one Region, or only to the developing world. Each country is different, and a thorough understanding of the historical, social and cultural traditions of each country should underpin the Bank's response to such problems.

- There is a need to take a long-term approach to issues of governance.

- The Bank should be selective in its work on governance, recognizing the efforts of Bank and external donors cannot substitute for the domestic political commitment needed to undertake successful reforms.

There remains some apprehension among our borrowing members that our staff might exceed the Bank's mandate in ways which could be interpreted as interfering in the political affairs of our borrowers. This concern, given the difficulty of drawing neat lines in this area, is understandable. I am confident that you will respect the sensitivities and concerns of borrowers while not shying away from issues relevant to development performance when these need to be raised.

Until our borrowing members achieve a greater level of comfort with dialogue on governance matters and our own experience with it matures further, it is advisable that delicate policy issues are discussed only by senior managers (Directors and above). Technical issues, of course, can continue to be handled at staff level.

I want to thank the Task Force on Governance chaired by Sarwar Lateef for doing a good job on a difficult, nebulous subject. This group, now chaired by Mary Shirley, could assist you in the dissemination of this paper.

Barber B. Conable

Barber B. Conable

MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION*

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* *This paper was prepared by a Task Force with participation from the Operations; Policy, Research and External Affairs; Legal; Corporate Planning and Budget; and Finance Complexes (see Annex II).*

MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION
A DISCUSSION PAPER

EXECUTIVE SUMMARY

(i) This discussion paper is a review of issues of governance that lie within the Bank's mandate. Such an analysis was anticipated in Mr. Shihata's Legal Memorandum of December 21, 1990, discussed at a Board Seminar on April 11, 1991, which set out "a legal framework for the Bank's dealing with this issue". For purposes of this paper, governance is defined as the manner in which power is exercised in the management of a country's economic and social resources for development. The Bank's concern with sound development management extends beyond the capacity of public sector management to the rules and institutions which create a predictable and transparent framework for the conduct of public and private business, and also to accountability for economic and financial performance. Given the limited nature of the Bank's direct operational experience in this area other than that covered under public sector management, this paper defines major concepts, and surveys Bank experience to date. It also highlights some of the issues that have emerged as the Bank addresses a wider range of concerns in this area.

(ii) The Bank's interest in governance arises from its concern for the effectiveness of the development efforts it supports. From this perspective, sound development management, in the broadest sense of the word, is critical to ensuring adequate returns and the efficacy of programs and projects that the Bank finances, and so to the underlying Bank objectives of helping countries reduce poverty and increase sustainable growth. The Bank has a long record of helping countries build the institutions and practices essential to an efficient modern economy, and must continue to set high standards for itself and its borrowers. Its experience provides a number of examples of best practice (some of which are described in this paper, and some in the accompanying review of work on public sector management) that have been seen to have a demonstrable positive impact on development management in its borrowers.

(iii) The Bank's experience has also shown that when programs and projects appear technically sound but fail to deliver results, the reasons are sometimes attributable to weak institutions, lack of an adequate legal framework, damaging discretionary interventions, uncertain and variable policy frameworks and a closed decision-making process which increases risks of corruption and waste. Much needed legal reforms may come to naught, if laws are not enforced or there are severe delays in the settlement of cases. Privatization efforts may not succeed or be politically sustainable and the supply response to improved pricing policies may not occur unless clear rules and institutions contain transaction costs (i.e. the cost of arranging, monitoring and enforcing contracts). Sophisticated public expenditure reforms may founder if accounting systems are so weak that budgetary policies cannot be implemented or monitored, or when lax procurement encourages corruption which distorts public investment priorities. Public investments may waste resources unless those who will use, and often pay for, the resulting services are involved in their design and operations.

(iv) These examples illustrate a broader point: good governance is central to creating

and sustaining an environment which fosters strong and equitable development, and is an essential complement to sound economic policies. Governments play a key role in providing two sets of public goods: the rules to make markets work efficiently, and, more problematically, correcting for market failure. In order to play this role, they need revenues, and "agents" to collect revenues and produce the public goods. This in turn requires systems of accountability, adequate and reliable information, and efficiency in resource management.

(v) Productive institutional arrangements will vary between countries based on their cultural traditions and historic relationships. And they will continue to evolve as the economy grows, becomes more complex and more integrated with international markets. Mature institutional frameworks take a great deal of time, but there is no guarantee that arrangements which are supportive of economic growth and poverty alleviation will, in fact, emerge. The state may behave in a predatory manner or pursue strategies that hinder the development of efficient property rights. Or its agents may behave in an opportunistic manner and indulge in rent-seeking. Good governance is a continuum, and not necessarily unidirectional: it does not automatically improve over time. It is a plant that needs constant tending.

(vi) Recognizing the importance of sound development management, the Bank's emphasis in recent years has shifted rapidly from its own interventions to the overall country context within which those interventions are taking place. In the area of public sector management, attention has shifted from improving management of project-related agencies to more general reform of the civil service and public enterprises, and to the central economic agencies that are responsible for macro-economic policy. A similar broadening of focus is now taking place in such "areas" as accountability and the legal framework.

(vii) *Public sector management* (PSM) issues are addressed in an accompanying paper which reviews experience in selected areas. The primary focus of the Bank's work has been in public expenditure management, civil service reform and parastatal reform. The initial results have been positive, but often in trying circumstances. The effort has been long and arduous, reflecting obstacles of a socio-political nature.

(viii) This paper focusses on three other key dimensions: accountability, the legal framework for development, and information and transparency:

(ix) *Accountability* at its simplest means holding public officials responsible for their actions. Economic objectives of public accountability include congruence between public policy and actual implementation, and the efficient allocation and use of resources. This not only requires systems of financial accountability but also the capacity and willingness to monitor the overall economic performance of the government. At the micro level, the primary concern is with efficiency in the production and delivery of goods and services in the public sector. The Bank has addressed issues of both economic and financial accountability. Its public expenditure work has assisted governments address a range of public resource management issues, and has supported reforms of sector-wide institutions to improve accountability in service delivery. In terms of financial accountability, to improve compliance with accounting and audit covenants, the Bank is assisting some borrowers address country-wide constraints to accounting and auditing through assessments and technical assistance projects. The Bank is also assisting governments establish adequate oversight and administrative capacity at central and provincial/local levels as they move to

decentralize key economic functions of government.

(x) Macro-level accountability can be reinforced at the micro-level both through competition and by enhancing opportunities for participation or other means of articulating the interests of the affected public. The Bank does a great deal to encourage competition through deregulation and contracting out of services, and generally by assisting governments to break up monopolies and barriers to entry. Participation can be encouraged through dissemination of information on services, complaints procedures, and public hearings. The use of local NGOs and the encouragement of beneficiary participation in project design and implementation is encouraged in Bank projects, where appropriate.

(xi) *Predictability and the legal framework for development:* Predictability implies that rules and regulations are clear and applied even-handedly, and that lines of authority are clear. An efficient civil service helps provide continuity and predictability; Bank PSM work is intended to support these goals. The rule of law is a key element of predictability and stability where business risks may be rationally assessed, transaction costs lowered, and governmental arbitrariness reduced. It is this connection of the rule of law with the more efficient use of resources that justifies its consideration by the Bank. Five basic elements of the rule of law have been identified as relevant to sound economic development and, therefore, to the Bank: (a) there must be a set of rules known in advance; (b) these rules must be actually in force; (c) there must be mechanisms to ensure application of the rules; (d) conflicts must be resolved through binding decisions of an independent judicial body or through arbitration, and (e) there are known procedures for amending the rules when they no longer serve their purpose.

(xii) The Bank has, in recent years, assisted borrowers in ensuring coherence of rules and improved communication; in helping to improve the efficiency of institutions which administer laws of significance to the economy; in the training of judges in commercial law; in encouraging extra-judicial means of settling disputes (e.g. commercial arbitration); and in developing capacity to put in place appropriate procedural rules for enacting and repealing laws. Effective legal reforms require careful preparation, and a thorough understanding of local conditions and the cultural and historical context. With this in view, the Bank has, in a few cases, been carrying out comprehensive reviews of legal systems as they relate to development activity.

(xiii) Adequate and reliable *information* is a precondition for both accountability and the rule of law, and refers to the availability of and access to information from public and private sources, and transparency of decision-making processes. The availability of accurate information about the economy, in general, about market conditions and about the intentions of government critically affects the efficiency and competitiveness of the private sector. Yet, information flows are grossly inadequate in many countries and transparency of decision making low. The Bank has been assisting borrowers improve economic information flows, transparency in budgetary and monetary accounts, and procurement procedures. These measures help to increase the effectiveness of resource use and to reduce corruption and waste.

(xiv) Much of the work described under accountability, the legal framework for development, and information and transparency represents a natural extension of the Bank's work on public sector management. It is technical in nature and complements other efforts undertaken in economic reforms, such as the elimination of monopolies or removal of controls which help reduce rent-seeking.

Indeed, there is much that the Bank routinely does which indirectly contributes to improving development management.

(xv) However, in undertaking this work, the Bank's role itself is subject to a number of limitations. As an *external* agency, it cannot substitute for the political commitment that governments must bring to reforms in governance. Full ownership is as important in this area as it is in economic policy reforms. The Bank's *legal* mandate provides clear limits to its role, although the legal restrictions help to protect the Bank's reputation for objectivity and technical excellence and its status as an international institution guided solely by concern for economic development and not by any political agenda. The Bank's *past experience* with complex institution building efforts has been mixed, and suggests that it move with caution and absorb the lessons from those experiences. A further limitation arises from *resource constraints*. Work on governance is expensive and time consuming, and is limited by skill availability. However, such work will be handled like all other claims on resources through a determination of priorities within country programs based on need, borrower receptivity, cost, etc. The Bank should, of course, not attempt to take too much on itself, and needs to collaborate with other UN agencies and donors, where possible.

(xvi) Given these constraints, a measured and selective approach is called for. The main elements of this approach are: First, the Bank, through its interventions, needs to continue to exploit opportunities for improving development management, whenever appropriate, through a variety of means including assisting borrowers break up monopolies, removal of controls and other avenues for corruption, beneficiary participation in projects, etc.

(xvii) Second, selectivity is called for in allocating resources and developing work programs. The selectivity needs to be in terms of the choice of countries for specific work on the dimensions of development management outlined above, and in terms of the range of activities the Bank can take on and support at any given time. Such work should only be embarked upon in countries where there is a clear commitment to and need for improving development management along these dimensions. Many of the Bank's borrowers may neither want the Bank to be so involved nor require such assistance. Where there is need but no commitment, such work would waste resources. Similarly, the dimensions of development management the Bank chooses to assist should reflect both the chances of success as well as the Bank's own ability in terms of skills and resources to assist effectively.

(xviii) Third, in countries where the Bank is active in improving development management, it needs to assist in the design of highly differentiated responses, taking account of the country's institutional needs, its political economy, its society, and history. The objective in each case must continue to be to help strengthen the enabling environment for sustainable and equitable development. This requires high quality Economic and Sector Work.

(xix) The emphasis above is on the technical issues of development management. It is important to be aware, however, that a strong emphasis by the Bank on prudent financial management and attention to auditing and accounting or a legal framework suitable for development will tend to bring deeper and more general problems of governance into sharper relief. Thus, for example, sophisticated systems of financial accounting and auditing may be established but the government may not absorb or use the results to good effect. A legal framework could be

created, but arbitrariness or corruption in its implementation could undermine its value. This has already been the experience with sensitive issues of PSM such as civil service reform where political constraints to the success of such work have emerged. Where lack of progress is due not to weaknesses in capacity but to lack of government commitment, the Bank then faces a problem which needs to be reflected in its country strategy and dialogue.

(xx) When political commitment to sound development management is weak, the Bank normally takes up these issues in its dialogue with borrowers while remaining proactive in seeking ways to help the country improve performance in the key areas of concern. This dialogue is supported by economic and sector work, where appropriate. In such a dialogue, governance issues are not discussed in isolation but as an integral part of a government's overall development program. In conducting this dialogue, the level at which issues are discussed is a function of their sensitivity and requires the judgements of senior managers. Technical issues are handled at staff levels, but highly sensitive issues are handled at an appropriately high level (Country Director and above). Donor concerns regarding such lack of political commitment to sound development management are also surfacing increasingly at consultative group meetings. As Chair of these meetings, the Bank would normally inform the country of widely-held donor concerns, particularly when these are likely to affect Bank-assisted programs.

(xxi) When dialogue fails, the Bank's own lending to the country is likely to be affected. Lending levels have long been responsive to issues of development management and performance, and will continue to be so. Judgements of performance are already routinely made for purposes of IDA allocation and in assessing creditworthiness: there is no need for additional criteria to reflect concerns with governance: merely the effective and consistent application of existing criteria based on a greater awareness of the importance of issues of governance for development performance.

(xxii) Given absorptive capacity constraints, and the long-term nature of the development of appropriate institutions and economic decision-making processes, development management concerns need to be integrated into a long-term perspective of a country's development strategy and prospects. As a follow-up to the Long-Term Perspective Study on Sub-Saharan Africa, and the Maastricht conference at which it was discussed, the UNDP and the Bank are assisting interested African countries develop such perspectives. This also implies that some aspects of this work should be supported by investment operations rather than adjustment lending and that long-term capacity building technical assistance is called for.

(xxiii) Such a long-term approach needs to be supplemented by other measures to strengthen implementation capacity. This implies greater efforts at helping build ownership of adjustment programs, a more conscious effort to understand the political and social structure and the customs and laws of its borrowers, the need to foster an "implementation culture" within the Bank and to sensitize staff to the need to handle issues in this area with humility, sensitivity and caution, and the need to encourage participation by beneficiaries, where appropriate, in Bank projects.

(xxiv) Management proposes to disseminate to staff the key messages for the Bank in this paper together with the Board's guidance. A broad-based dialogue with borrowers, interested academics and others has been initiated in the Africa Region and depending upon this experience, could be extended elsewhere. The Bank's research program in

this area needs to develop further. A progress report on the Bank's unfolding experience with governance would be appropriate in two years' time.

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MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION
A DISCUSSION PAPER

I. INTRODUCTION

Definition and Purpose

1. The Bank's interest in governance arises from its concern for the effectiveness of the development efforts it supports. A general definition of governance is the "exercise of authority, control, management, power of government."[1] A more relevant definition for Bank purposes is "the manner in which power is exercised in the management of a country's economic and social resources for development."[2] The Bank's concern with sound development management thus extends beyond the capacity of public sector management to the rules and institutions which create a predictable and transparent framework for the conduct of public and private business and to accountability for economic and financial performance.

2. Public sector capacity issues are discussed in detail in the accompanying paper, *The Reform of Public Sector Management: Lessons of Experience* (PSM paper) (World Bank, 1991b), and will be referred to only briefly in this paper. The major focus here is on the overall management of resources for development -- with a special emphasis on accountability, the legal framework for development, and information and transparency.

3. In his legal memorandum of December 21, 1990, discussed in a Board seminar on April 11, 1991, the General Counsel set out "a legal framework for the Bank's dealing with this issue as a prelude to any future analysis of the manner in which the Bank may take it on operationally" (Shihata, 1991). Given the limited nature of the Bank's direct operational experience outside the public sector management area, this initial review defines major concepts and surveys Bank experience to date. The paper also cites best practice and highlights issues that have emerged as the Bank addresses a wider range of concerns in this area.

Relevance for the Bank

4. Governance issues are not new to the Bank. As a development institution, the Bank has grappled with these issues from its inception. However, the relatively good growth performance of developing countries between 1965 and 1980 helped conceal the deep-seated problems of governance which affected the efficient use of resources and retarded adjustment efforts to respond to a changing external environment. By the beginning of the 1980s, as growth decelerated sharply and the developing world was adversely affected by a severe worsening in the terms of trade, the emergence of a climate of relative scarcity began to expose governance issues in many countries. At the same time, it was becoming increasingly clear that investment lending could not achieve its objectives in the absence of an appropriate policy environment.

5. Structural adjustment lending and related public sector management (PSM) reforms aimed at creating an enabling environment for growth. Their focus was on reducing the area of government intervention in incentive policies, on the more efficient use of public resources and on reducing fiscal deficits, thereby indirectly addressing those governance issues which affected the management of resources. Despite some

encouraging success with adjustment lending and public sector reforms, the enabling environment is still deficient in many cases. Improvement in the efficacy of Bank-supported investments and policy reforms thus depends in such cases, on further improvements in the institutional framework for development management.

6. For some of the Bank's borrowers, the effectiveness of both adjustment and investment operations is impeded by factors which contribute to poor development management. These include weak institutions, lack of an adequate legal framework, weak financial accounting and auditing systems, damaging discretionary interventions, uncertain and variable policy frameworks and closed decision- making which increases risks of corruption and waste. There are examples of countries where corruption has adversely affected development. In those countries, pervasive patronage in government has perverted public investment choices to finance white elephants, usually by contracting excessive foreign debt. Monopolies were sanctioned and allocated to friends of those in power, at great economic cost to the nation. There are also examples where good progress in policy reforms has been offset by uncertainties in the investment climate. In some countries which have made good progress in establishing realistic relative prices, the expected private sector response has been inhibited by inconsistent behavior towards business by some government agencies, by inconsistencies between new government policies and the existing legal framework, or by discrimination against certain ethnic groups with strong business communities. In Eastern Europe, the lack of a legal framework conducive to private sector development is a severe impediment to privatization and new investment. In some Latin American countries, rapid decentralization has outstripped systems of accountability and civil service institutions at provincial and local government level, fuelling already unsustainable fiscal deficits.

7. The Africa Region was the first to articulate the Bank's concerns in its Long-Term Perspective Study on Sub-Saharan Africa (LTPS) (World Bank, 1989) in a frank discussion of the "crisis of governance".[3] The LTPS proved a stimulus to the debate now underway in both developing and developed countries on issues of governance in general, and in the Bank, as it relates to economic development. Another stimulus has been the rapid political changes in Eastern Europe, Latin America and parts of Asia and Africa. These changes have been accompanied by changes in the role of the state to reflect a greater preoccupation with the creation of an enabling environment for development, larger responsibilities for the private sector, a reduction in direct government involvement in production and commercial activity and the devolution of power from the center to lower levels of government. These changes have usually been associated with difficult economic reforms and macro-economic adjustment requiring considerable skill on the part of governments in developing a political consensus around these reforms. By its function, the Bank is intimately involved in this broad reform process and governments are increasingly turning to it to address a much broader range of economic management issues, including the legal framework and systems of procurement and financial accountability.

8. Bilateral donors have been increasingly sensitive to public criticism of concessional aid flows to governments which lack democracy, have a poor human rights record, or are seen to be corrupt, and have been pursuing a broader governance agenda through political channels.

9. The Bank's mandate, as laid down in its Articles of Agreement as applied in

practice, is the promotion of sustainable economic and social development. Its concern for governance must be driven by that mandate. The General Counsel's memorandum identified five aspects of governance that are beyond the Bank's mandate: the Bank cannot be influenced by the political character of a member; it cannot interfere in the partisan politics of the member; it must not act on behalf of donor countries in influencing the member's political orientation or behavior; it cannot be influenced in its decisions by political factors that do not have a preponderant economic effect; and its staff should not build their judgments on the possible reactions of a particular Bank member or members. This memorandum then suggested that governance may be relevant to the Bank's work if it is addressed in terms of having good order and discipline in the management of a country's resources. In this respect, the General Counsel considered the need for rules and institutions and mentioned, by way of illustration, a number of areas that may fall within the Bank's mandate such as civil service reform, legal reform, accountability for public funds and budget discipline (Shihata, 1991: 47-54).

10. Section II of this paper describes the nature of the governance problem from the Bank's perspective. Section III summarizes key dimensions of governance and the Bank's experience with each dimension. (Three of these dimensions -- accountability, the legal framework for development, and information and transparency -- are discussed in greater detail in Annex I.) Section IV discusses the role of the Bank. Section V discusses implications for Bank practice; and Section VI outlines next steps.

II. THE NATURE OF THE PROBLEM

The Role of Governments

11. Even in societies that are highly market-oriented, only governments can provide two sorts of public goods: rules to make markets work efficiently, and in some cases, corrective interventions where there are market failures (McLean, 1987: 19-21). With respect to rules, without the institutions and supportive framework of the State to create and enforce the rules, to establish law and order, and to ensure property rights, production and investment will be deterred and development hindered (Eggertson, 1990). This is because high "transaction costs" (i.e., the cost of arranging, monitoring and enforcing contracts) would inhibit such activities. Compensation for market failure is more problematic. Governments in the 1970s relied on this rationale to rush into unwise policies and investments, although often their own policy interventions were responsible for market failures and the investments did not yield adequate returns. Governments now increasingly recognize the need for more restraint and for taking "market-friendly" steps to deal with problems. In addition, the State must play a key role in ensuring the provision of services such as education, health, and essential infrastructure, particularly when such services are directed at the poor and are not forthcoming from the private sector. A well-educated labor force and adequate infrastructure are fundamental to the quality of private investment.

12. However, to finance such expenditures, the state needs revenues. The state also needs "agents" who will collect taxes from the public and produce and deliver essential services (such as education and health, and a legal framework).[4] This, in turn, requires systems of accountability --

accountability within government and from the government to those to whom it delivers services. For the system to work, adequate and reliable information flows are essential. Without it, the rules are not known, accountability is low, and uncertainties excessive. Thus, accountability, publicly known rules, information and transparency are all key elements of sound development management. Moreover, the institutional framework needed to provide these public goods must be managed efficiently.

13. Productive institutional arrangements will vary between countries, based on their cultural traditions and historic relationships. And they will continue to evolve as the economy grows and becomes more complex and more integrated with international markets. Mature institutional frameworks take a great deal of time to develop, but there is no guarantee that arrangements which are supportive of economic growth and poverty alleviation will, in fact, emerge. The state may behave in a predatory manner or pursue strategies that hinder property rights. Its agents may behave in an opportunistic manner and indulge in "rent-seeking". Why do some states behave differently from others? What are the conditions that permit success? The historical evidence is far from clear. However, institutional economists, like Douglass North, argue that institutions, defined as "the rules of the game in a society" (North, 1990: 3),[5] determine the performance of economies. Efficient institutions emerge when there are built-in incentives to create and enforce property rights, defined in the broadest sense. The example most often cited is that of the contrasting paths pursued by England and Spain in the seventeenth century, when both countries faced severe fiscal crises. The path pursued by England led to a burst of innovative activity; that of Spain led to a decline of such activity. Thus, to quote North:

> "In England, Parliament created the Bank of England and a fiscal system in which expenditures were tied to tax revenues. The consequent financial revolution not only finally put the government on a sound financial basis, but laid the ground for the development of the private capital market. More secure property rights, the decline of mercantilist restrictions, and the escape of textile firms from urban guild restrictions combined to provide expanding opportunities for firms in domestic and international markets. Both the growing markets and the patent law encouraged the growth of innovative activity....
>
> In Spain, repeated bankruptcies between 1557 and 1647 were coupled with desperate measures to stave off disaster. War, the church, and administering the complex bureaucratic system provided the major organizational opportunities in Spain and in consequence the military, priesthood, and the judiciary were rewarding occupations. The expulsion of the Moors and Jews, rent ceilings on land and price ceilings on wheat, confiscations of silver remittances to merchants in Seville (who were compensated with relatively worthless bonds called juros) were symptomatic of the disincentives to productive activity" (North, 1990: 114-115).

14. Such historical contrasts illustrate the importance to development of the "underlying institutional characteristics" of societies. Institutional economists point out that in order to understand better why these characteristics are different in different societies, we need to know more about the interaction between culture and formal rules and institutions.

15. The role of culture in shaping institutions and rules is an area of some contention in academic circles. Some argue that the importance of cultural divergences diminishes as the market economy progressively transforms society. Others, citing Japan, stress that norms and values of consensus and reciprocity may soften the impersonal nature of the market, and that national cultures impart a long-term, culturally specific shape to the legal and other institutions that support the functioning of the market. These two views are not necessarily inconsistent; the issue is one of degree.

16. The current debate on governance, therefore, needs to take account of cultural differences.[6] The concepts that are discussed in this paper mean different things to different cultures. The concept of "contract", which is at the heart of accountability and the rule of law, carries implicit the notion that rights and obligations incurred at a given point of time through an abstract legal device -the contract - will be honored at a later point of time by all parties concerned. Some cultures may have different conceptions of the relative importance of contractual agreements in relation to other rights and obligations. These may include, for example, strong and binding ethnic or kinship ties. Social norms may affect, for example, attitudes towards evading taxes or what constitutes conflict of interest.

17. The spread of political and legal systems modelled on Western traditions may lead to the simultaneous existence of two sets of norms and institutions for dealing with broadly defined rights and obligations, with Western notions of the rule of law, private property rights and contracts superimposed on ideas such as "consensus", "communal property" and "reciprocity", which have evolved over long periods of time in many non-Western cultural settings. While these different ways of anchoring social rights and obligations may or may not hamper the functioning of modern economic institutions, such as the market, it is important to be aware of them when pursuing policy reforms and institution building.

When Governance Fails

18. The institutional characteristics for managing development, thus, vary widely among countries and do not permit easy generalization. Nor is it practical to attempt a taxonomy, classifying states, say, by different governance characteristics. This complexity arises from the unique imprint of history, geography and culture on each country's institutions and rules, and the multidimensional nature of governance as a concept. Thus, each country is at a different level of political, economic and social development reflecting a wide array of historical, geographic and cultural factors. A number of the Bank's borrowers have been relatively successful in creating the institutions and rules that promote broad-based economic development. Some others are on their way to doing so, while yet others still labor under severe political, institutional and economic constraints on better government performance. What is said in this paper about government performance must be applied to individual countries in their context.

19. But poor governance is readily recognizable. The key symptoms are, inter alia:

- failure to make a clear separation between what is public and what is private, hence, a tendency to direct public resources for private gain;

- failure to establish a predictable framework of law and government behavior conducive to development, or arbitrariness in the application of rules and laws;

- the existence of excessive rules, regulations, licensing requirements, etc., which impede the functioning of markets and encourage rent-seeking;
- priorities inconsistent with development, resulting in a misallocation of resources;
- excessively narrowly-based or non-transparent decision making.

20. Such "problems" may be due to lack of capacity or to volition, or both, and may be of varying severity. However, it is when they are sufficiently severe and act in tandem that they create an environment that is hostile to development. In such circumstances, the authority of governments over their peoples tends to be progressively eroded. This reduces compliance with decisions and regulations. Governments then tend to respond through populist measures or, as in some authoritarian regimes, they resort to coercion. Either way, the economic cost can be high, including a diversion of resources to internal security, and escalating corruption. Poor development performance can in turn contribute to poor governance by further eroding the confidence of citizens in their governments, and causing governments to behave insecurely.

21. The absence of good governance has proved to be particularly damaging to the "corrective intervention" role of government. Programs for poverty alleviation and environmental protection, for example, can be totally undermined by a lack of public accountability, corruption and the "capture" of public services by elites. Funds intended for the poor may be directed to the benefit of special interest groups, and the poor may have inadequate access to legal remedies. Similarly, the enforcement of environmental standards, which benefit the population as a whole but which may be costly to powerful industrial and commercial groups, can be emasculated by poor governance. Industrial emissions standards, forest protection policies and guidelines for the incorporation of environmental concerns into public expenditure decisions may be worth little more than the paper they are written on unless rules are clear, information is available to the public, and government officials are accountable. In the case of the environment, problems are magnified by difficulties of monitoring and enforcement, which enable official government policies to be ignored.

22. Among the underlying causes of poor development management is the level of economic, human and institutional development. Lack of an educated and trained manpower and weak institutions can substantially reduce the capacity of countries to provide sound development management. Poverty and illiteracy make poor governance more possible. This is not, though, to suggest that development automatically brings good governance; nor to imply that sound economic management is not possible in poor countries. There are a number of Asian counter-examples, both authoritarian and democratic. It is simply that poverty, illiteracy and weak institutions make the task of good development management much more complicated and problematic.

23. Pervasive corruption is particularly damaging to development. Corruption occurs in all countries and in many different forms. It tends to thrive when resources are scarce, and governments, rather than markets, allocate them; when civil servants are underpaid; when rules are unreasonable or unclear; when controls are pervasive and regulations excessive; and when disclosure and punishment are unlikely. Although there have been isolated instances of governments being both corrupt and successful at promoting development, in general, corruption weakens the ability of governments to carry out their

functions efficiently. "Bribery, nepotism, venality and lack of dedication to duty," notes the 1991 WDR, "can cripple administration and dilute equity from the provision of government services, and thus also undermine social cohesiveness" (World Bank, 1991a). Graft on a large scale is not possible without collusion with private companies or foreign suppliers, with officials of foreign governments sometimes turning a blind eye, -- a problem of international governance.

24. Other causes of poor development management are a high degree of concentration of political power and the colonial inheritance. On the positive side, many former colonies inherited systems of financial accountability, an independent civil service, and a legal framework. However, since these were imported from outside, they have not always taken root. Colonial rule implied accountability to the colonial power, rather than to citizens; it thus sometimes destroyed indigenous systems of accountability.

25. Colonial rule has sometimes bequeathed standing armies, thus, diverting resources away from development and making fragile civilian governments prone to military coups and related political instability. The 1991 WDR estimates that since 1948, there has, on average, been one coup attempt per developing country every five years (World Bank, 1991a: 7.2). Colonially imposed frontiers have sometimes led to border disputes and ethnic strife. During the Cold War, such strife has, on occasion, been fuelled by arms exports to the rival factions/states.

26. These symptoms and causes of poor governance are not unique to any particular form of government. The 1991 WDR examined the evidence on the relative performance records of democracies and authoritarian regimes and noted that the democratic-authoritarian distinction itself "fails to explain whether or not countries initiate reform, implement it effectively, or survive its political fall-out" (World Bank, 1991a: 7.11). Authoritarian regimes were just as likely to yield to the interests of narrow constituencies. The report concluded that "there was no evidence to support the view that authoritarian governments, on average, show greater promise for achieving rapid growth" (p.16). Moving beyond growth to social development, the report notes that some studies suggest that for a given level of income, "improvements in social indicators are associated with freedom and liberty" (7.11).

27. In sum, governance is a continuum, and not necessarily unidirectional: it does not automatically improve over time. It is a plant that needs constant tending. Citizens need to demand good governance. Their ability to do so is enhanced by literacy, education and employment opportunities. Governments need to prove responsive to those demands. Neither of these can be taken for granted. Change occurs sometimes in response to external or internal threats. It also occurs through pressures from different interest groups, some of which may be in the form of populist demands. While donors and outsiders can contribute resources and ideas to improve governance, for change to be effective, it must be rooted firmly in the societies concerned, and cannot be imposed from outside.

III. DIMENSIONS OF GOVERNANCE

28. As indicated in the foregoing discussion, there are four key dimensions of governance that are of relevance to the Bank's work: capacity and efficiency issues in public sector management, accountability, predictability and the legal framework for development, and information. These are now discussed in turn (See Annex I for a more detailed discussion of accountability, the legal

framework for development, and information and transparency).

(a) Improving Public Sector Management

29. When the capacity of the public sector to manage the economy and deliver public services is weak, the prospects for development are poor. The public sector in many developing countries has been characterized by uneven revenue collection, poor expenditure control and management, a bloated and underpaid civil service, a large parastatal sector that provides poor returns on the scarce public funds invested in it and weaknesses in the capacity of core economic agencies to design and implement policies that would address these problems. Not only does this state of affairs contribute to large fiscal deficits requiring adjustment measures, but it also progressively erodes the capacity of the state to provide economic and social services.

30. The Bank's involvement in this area, till the 1980s, was overwhelmingly in the institutional development of the agencies implementing Bank-financed projects. With the introduction of adjustment lending, the Bank began to focus on improvements in overall public sector management, and the improvement of sector-wide institutions and service delivery. Within this dimension, three areas have received primary attention in the 1980s: public expenditure management, civil service reform, and parastatal reform. Within public expenditure management, the emphasis has been on assisting borrowers improve public investment programming and the budget process. Less advanced have been efforts to improve the execution and monitoring of public expenditure programs. Under civil service reform, in the short term, the emphasis has been on cost-containment measures; in the medium term, on strengthening personnel management and the effectiveness and efficiency of public agencies. In the management of public enterprises, the Bank has been assisting borrowers rationalize the size of the public enterprise sector, privatize, restructure, or liquidate public companies, as appropriate, improve the competitiveness of the policy environment, and clarify the relationship between the central government and public enterprises with a view to increasing the returns on the government's investment in the sector. The core agencies for key sectors and for national economic management have been assisted to strengthen management of these reform programs and to give greater priority to and to increase efficiency in the delivery of social services. Decentralization and tax reform are other areas where the Bank has supported government efforts to improve public sector efficiency (as noted in the Tax Reform Policy Paper).

31. The accompanying PSM paper provides a review of selected issues and concludes that initial results have been positive, often in trying circumstances. The effort has been long and arduous, reflecting obstacles of a socio-political nature. In public expenditure management, imperfect accountability has gone hand in hand with weak institutional capacity. In civil service reform, there is a shift in emphasis to improved personnel management. In all cases, the need for strong political commitment is noted. It is particularly difficult to ensure commitment to reforms over time. Tensions between economic benefits and political costs are typical of reforms in this area.

(b) Accountability

32. Accountability, at its simplest, means holding public officials responsible for their actions. How this happens varies widely from country to country, depending upon cultural traditions, history, political institutions, administrative capacities and the public's access to and use of information. For the Bank, accountability must be seen from the

viewpoint of development management. At a broad level, economic objectives of public accountability include congruence between public policy and actual implementation, and the efficient allocation and use of public resources. This not only requires systems of financial accountability, but also the capacity and willingness to monitor the overall economic performance of the government. At the micro level, the primary concern is comparable efficiency in investment and in the production and delivery of goods and services in the public sector.

33. The Bank has addressed issues of both economic and financial accountability. As noted above, public expenditure reviews have focussed on the efficiency of resource use in public investment programs, in the parastatals sector, in the social sectors, and more recently, in employment and wage issues in civil services. This has led frequently to the identification of reforms including the removal of white elephants from public investment programs, privatization, restructuring and closure of state enterprises, reallocation of resources in favor of primary health and primary education, and the removal of "ghost workers" and rationalization of employment levels in the public sector. Through sector adjustment or investment loans, the Bank also assists reforms of sector-wide institutions, with a view to improving the efficiency and accountability of institutions responsible for service delivery. In the area of overall economic performance monitoring, the Bank's Operations Evaluation Department (OED) has for long advised planning and performance ministries on monitoring and evaluation functions. Greater attention to this issue is also being paid under PSM projects.

34. In the area of financial accountability, the Bank has tended to focus on project implementation agencies. However, compliance with accounting and audit covenants has often been disappointing, reflecting weaknesses in country-wide accountability mechanisms. To address this problem, the Bank has been pursuing a three-pronged strategy: (i) improving borrower incentives to comply with accounting and audit covenants; (ii) encouraging a more systematic review of auditing and accounting issues during project preparation; and (iii) strengthening borrower capacity through country-wide reviews of accounting and auditing. For example, accounting and auditing functions are being strengthened in Ghana, Madagascar, Mauritania and Indonesia. The LAC Region has been actively helping governments strengthen agencies critical to accountability and transparency, such as tax and customs officers, Central Banks and the offices of Controller-Generals. Accountability assessments are also underway in some countries. To be effective, such reviews need to focus on the processes by which audited reports are reviewed and action taken to deal with the corruption and waste identified.

35. Decentralization is sometimes seen as the means of reducing an overload of central government responsibilities by relying on local decision making, micro-level accountability and through participation of beneficiaries in the design and monitoring of service deliveries. However, decentralization must be managed with care if it is not to result in fiscal imbalances, wastage and corruption due to a lack of adequate oversight from national authorities, weak administrative capacity at local levels and the risk of capture of institutions by local elites. Both in Latin America and Eastern Europe, the Bank has been active in assisting with the rapid decentralization proceeding in those regions, mainly through technical assistance for the strengthening of local governments and for ensuring fiscal and financial accountability. In Mauritania, an institutional framework for the creation of municipalities is being established.

36. Micro-level accountability can sometimes reinforce macro-level accountability through competition or the provision of alternatives, that is, opportunities for "exit", or by enhancing opportunities for participation, public comment or complaint, or other forms of "voice".[7] Exit mechanisms include deregulation, contracting out, public-public and public-private competition. The Bank has encouraged exit through deregulation and contracting out of services in various projects and generally by encouraging break-up of local or national monopolies. Voice can be encouraged through dissemination of information on services, complaint procedures, public hearings, public feedback on development activities and services, representation on boards, participation by beneficiaries in the design of projects, and the encouragement of local NGOs which are able to reach poor or marginal groups who would otherwise be voiceless. Popular participation in project design and implementation has been shown to have a significant positive effect on the efficacy of projects. Inevitably, however, there are some attendant risks that need to be factored in when pursuing these means (see paras. 19, 25 and 26 in Annex I). NGOs were involved in 50 Bank-financed projects in each of the past two fiscal years, compared to 15 projects in FY88. Some 20 projects, with exceptionally participatory approaches, are being studied by an Operations-PRE learning group in an exercise designed to draw lessons from Bank experience with popular participation. The Philippines Communal Irrigation Project remains a particularly good example of successful beneficiary participation on a large scale producing consistently good results. Best practice consists of a systematic effort during project preparation to explore, where appropriate, opportunities to enhance competition and participation.

(c) Predictability and the Legal Framework for Development

37. Predictability implies "standard operating procedures, institutionalized rules, non-personalized decision making and modest levels of discretion and regularized procedures for establishing and implementing policies" (Brautigam, 1991). In systems with high predictability, rules and regulations are clearly promulgated and generally and consistently applied, and lines of authority are clear. The civil service provides a measure of continuity. In most countries, predictability is imperfect. The Bank's concern is to support the continued evolution towards ensuring at least a minimum level of predictability. The Bank is increasingly involved in assisting its borrowers to improve the quality and efficiency of the civil service which, when successful, will help enhance predictability (see the PSM paper).

38. A sound legal framework for development, a further key element of predictability, is an area of focus in this paper. The General Counsel defined the rule of law in terms of a "system based on objective rules, which are actually applied, and on functioning institutions, which ensure the appropriate application of such rules." Reforms proposed by the Bank, he argued, "cannot be effective in the absence of a system which translates them into workable rules and makes sure they are complied with" (Shihata, 1991: 42-43). Such a system is needed to create a climate of stability and predictability, where business risks may be rationally assessed, transaction costs lowered, and governmental arbitrariness reduced. It is this connection of the rule of law with the more efficient use of resources that justifies its consideration by the Bank as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself; it is only to the extent that it establishes a set of preconditions for development that it comes within the purview

of the Bank. The elements of the rule of law are varied. Not all have the same bearing on the purposes of the Bank. The following basic elements have been identified by the General Counsel:

39. ***There must be a set of consistent rules known in advance.*** The Bank is assisting former socialist economies and others to ensure that new economic measures are not in conflict with existing laws or constitutional provisions. More can be done by most governments to communicate laws effectively and to explain to citizens the content of legislation. The Bank is assisting some borrowers in this area.

40. ***These rules must actually be in force.*** Laws are frequently ineffective or are not applied because they are perceived as obsolete or irrelevant, or because enforcement capacity is inadequate. The underlying reasons for non-compliance with the rules are manifold; some borrowers (with Bank assistance) are analyzing the causes and improving the efficiency and competence of the institutions which administer the laws.

41. The ***application of the rules*** requires flexibility and executive branch discretion to deal with diverse situations. To avoid abuse of that discretion requires systems of review. Some countries have independent or specialized courts or ombudsmen; civil service reform will also address the underlying causes of abuse. Rationalization of obsolete rules and regulations, by updating and simplifying legal systems, is being attempted with Bank assistance.

42. To assure a business environment conducive to investment and commercial activity, ***conflicts must be resolved through binding decisions of an independent judicial body or through arbitration.*** Confidence in the enforceability of agreements and commitments is critical to the proper functioning of an economy. The Bank is beginning to be active in this area with several operations under preparation that will assist borrowers train judges in economic and business fields and handle commercial matters in specialized courts. Other dispute settlement measures such as commercial arbitration can also be useful.

43. Finally, ***there should exist known procedures for amending the rules when they no longer serve their purpose.*** When laws are changed arbitrarily and subjectively without recourse to established procedures, they lack acceptance and invite evasion. While it is outside the Bank's mandate to determine what legislative process should be in place to amend laws, the Bank is assisting in a modest way in training and technical assistance for the offices of the Attorney General, Ministry of Justice, etc. in areas relating to development management.

44. The Bank's experience shows that effective legal reforms require careful preparation and a thorough knowledge of local conditions, and the cultural and historical context. Legal sectoral reviews in Indonesia and Cote d'Ivoire, and reviews of the legal frameworks for financial operations in the Philippines, Guinea and Senegal have enabled the Bank to assist borrowers tailor rules and the strengthening of institutions to country circumstances. It is also important to recognize, as noted in para. 16, that attention must be paid to local circumstances and traditions.[8]

(d) Information and Transparency

45. Adequate and reliable information refers to the availability of and access to information from public and private sources, and the transparency of decision-making processes. These are vital to both accountability and the rule of law. Their absence provides opportunities for deception,

unfair or inequitable treatment and corruption. The Bank's interest in information is once again derived from and limited to their impact on development management.

46. The availability of accurate information critically affects the efficiency and competitiveness of the private sector: information about the economy, in general, about conditions in particular markets, and about the intentions and actions of government itself are crucial to private sector's calculation of risk and potential reward. Governments need to raise the quality of the information they themselves provide and to ensure that the private sector also discloses essential information. Capital market development, for example, is hindered when public and private enterprises are not compelled to publish audited accounts; likewise without transparency in the financial systems, capital and financial markets remain circumscribed to a narrow range of firms and instruments, and the soundness of the banking system remains at risk. An efficient market economy needs openness in this sense: openness is also strengthened, conversely, by a competitive economy, where there are many sources of information and where economic signals (such as prices) carry rich and relatively undistorted information.

47. Transparency of decision making is a safeguard against corruption, wastage and the abuse of executive authority. Competition and deregulation, the removal of unnecessary controls, clear rules and disclosure are important first steps. Many countries have sophisticated and strict laws against corruption, but these are not always enforced. The Bank has been assisting borrowers remove unnecessary controls and to reduce regulations, improve domestic and external procurement procedures and make budgets and Central Bank accounts more transparent. Where corruption has been pervasive, more drastic measures may be called for, such as Indonesia's use of the SGS to manage its customs services.

48. Corruption is a two-way street. Donors have an important responsibility to ensure that their national commercial considerations do not undermine good economic management in the developing world. Encouraging governments to develop sound public investment programs and respecting the priorities established is an important contribution that donors can make. A document entitled "Good Procurement Practices for Official Development Assistance" was prepared by the OECD's Development Assistance Committee (DAC) in consultation with the Bank. More recently, through a DAC Working Party on Financial Aspects of Development Assistance, a greater effort is being made to ensure that competition for contracts under donor-financed projects is not a source of corruption and does not contribute to distorted investment priorities. The intention is to ensure greater transparency and fair trade practices through a common band of concessionality levels, more open procurement procedures for large projects, an upper income limit for tied aid, ICB procedures, etc. Project preparation through joint appraisals and cofinancing with multilateral development banks, including the World Bank, is seen as one way to ensure sound investments and consistency with country priorities. When such cofinancing is not possible, the DAC has proposed that donors look to the Bank for advice on the appropriateness of proposed bilaterally financed large projects in the particular country economic situation. A consensus has yet to be reached on these proposals.

49. Budgets in developing countries often lack transparency. Revenues are sometimes diverted to special accounts outside the budgetary framework. Transactions with parastatals are obscured. A number of expenditure items are off-budget. Military

expenditures often escape scrutiny, avoid accountability expenditure control and auditing, in part because of the reluctance of civilian financial managers to question military procurement. High pressure salesmanship reinforced by generous trade credits in this area, as in others, can contribute to waste and corruption.

50. The Bank has been active in assisting governments to improve the transparency of budgets mainly through its public expenditure work. In undertaking such work, its main concern is that the country has systems of expenditure decision making and financial accountability that ensures that all expenditures, including military expenditures, are properly assessed and prioritized, that they are transparent, and that they are subject to expenditure controls and auditing. The Bank's focus is to assist borrowers to ensure that the overall size of public expenditures is not excessive in relation to resource availability and that adequate resources are allocated to economic and social sectors, and within these to programs that direct key services to the poor in a cost-effective manner. Its interest in military expenditures is because of its crowding-out effect on development spending.

51. Availability of information and transparency may lower uncertainty and transaction costs, but will not, by itself, bring about greater accountability in the absence of organizations and mechanisms that analyze and disseminate information. The mass media, in particular, play a key role here. The African Capacity Building Initiative is an example of the potential role of donors in strengthening the analytical and research capacities of institutions in developing countries. Long-term training/twinning arrangements -- whether these are formal institutional connections or the informal evolution of relations, like those of certain universities in the developed world with close links to the economic establishments in certain developing countries -- can play a key role.

IV. THE ROLE OF THE BANK

Key Elements of an Approach

52. Governance is a concern for the Bank for two sets of reasons. First, *from a broader perspective*, both history (see Section II) and the Bank's own experience show that good governance, in the sense that it has been used above, is central to creating and sustaining an enabling environment for development.

53. Second, *from the Bank's perspective*, as noted in Section I, sound development management is inextricably linked with the returns to and the efficacy of investments that the Bank helps finance and so to the Bank's underlying objectives of helping countries reduce poverty and increase sustainable growth.

54. The Bank has a long record of helping countries build the institutions and practices essential to an efficient and modern economy and must continue to set high standards for itself and its borrowers. Section III in this paper and Annex I cite the many ways in which borrowers are being assisted in improving development management. The Bank's concern here arises not merely from the impact of such assistance on country performance but also, as a financial institution, such assistance is part of sound portfolio management.

55. Until recently, in such areas as accountability and the legal framework, the Bank has tended to focus its attention narrowly on its own intervention rather than on the country context within which those interventions were taking place. Thus, the Bank insists, in all cases, on proper systems of

audited accounts for its project entities but has not often focussed on the constraints within which the overall system of financial accountability was operating. It has often encouraged borrowers to introduce new laws and regulations (e.g. trade and investment legislation) without always examining whether the legal system as a whole is operational and whether laws will be implemented effectively. This has changed rapidly in recent years. Just as Bank public sector management work has broadened from strengthening project-related agencies to a broader concern with overall civil service and parastatal reforms, similar shifts are now taking place in these other areas in a few countries. This is evident from the following illustrative list of activities being pursued in different Regions of the Bank.

Accountability

(a) ***At the macro level:***

- *Strengthening accounting* in the public sector, focussing on a range of actions, depending on country situation and need such as the availability of comprehensive and timely information, classification of expenditures in a manner consistent with budget and programs, appropriate analysis for decision making, comparison of budget and actual results, improving the organization and responsibility for accounting in the finance ministry, and legal requirements for financial reporting. (paras. 6-11 in Annex I)

- *Auditing reforms* to enable appropriate independence of the audit organization specified in the legal structure, greater attention to "value for money" auditing, and improvements in the educational system and professional training. (paras. 13-14 in Annex I)

- *Country-wide accountability assessments and projects* have been undertaken in Madagascar, Indonesia and Bolivia along the above lines. (para. 11 in Annex I)

- *Decentralization*: Assisting governments to establish or strengthen systems of financial accountability as they devolve financial power to local authorities. (paras. 16-19 in Annex I)

(b) ***At the sector level:***

- Strengthening the capacity and accountability of ministries and institutions that develop policies, establish expenditure priorities and oversee the delivery of essential services.

(c) ***At the micro level:***

- Assessment of *choice and participation options* in the design and preparation of projects producing and delivering services. (paras. 20-24 and 28-31 in Annex I)

- Encouraging *beneficiary participation* where appropriate, in the design and implementation of Bank projects, based on lessons drawn from the ongoing Operations-PRE study of Bank experience with popular participation. (Box 5 in Annex I)

- Selective and focussed use of *local NGOs* to enhance service delivery and ensure that the voice of the poor is heard in project design. (paras. 25-27 in Annex I)

Legal Framework for Development

- *Legal reforms*, including better communication of laws, ensuring consistency of laws, addressing constraints to implementation of laws, updating legal systems, training of the judiciary in business and economic laws, and encouraging extra-judicial alternatives when legal systems are overburdened, such as commercial arbitration and other dispute settlements mechanisms. (paras. 32-60 in Annex I)

- *Legal Sector Reviews*, undertaken at the request of borrowers, with a view to removing impediments to private sector activity.

Information and Transparency

- *Transparency*: Assisting governments improve the transparency of budgets and public expenditure programs; assisting with the preparation of environmental assessments and encouraging borrowers to share these with those affected by projects; assisting improve domestic and external procurement (Box 13 in Annex I and paras. 71-75) mechanisms and institutions to ensure competition, transparency (including disclosure of selection criteria), and fair contract conditions in public procurement etc.

- *Economic and social information:* Assisting governments improve the collection and dissemination of economic and social data. (paras. 76, Annex I)

- *Analysis and dissemination capacity:* Strengthening the capacity to understand, process and use information. The Africa Capacity Building Initiative will contribute to this process as well as long-term twinning/training arrangements. The training of economic journalists to raise the level of public awareness and policy debate may also yield returns. (para.76-77, Annex I)

56. Much of the above work represents a natural extension of the Bank's work on public sector management. It is, like the PSM work, technical in nature and complements other efforts undertaken in economic reforms, such as elimination of monopolies, deregulation or removal of controls to contribute to good economic management and reduce opportunities for rent-seeking. Indeed, there is much that the Bank has been doing routinely which indirectly contributes to good governance.

Limitations of the Bank's Role

57. In undertaking such work, the Bank faces some inherent limitations: those of any external agency, of its legal mandate, of its comparative advantage, and of the skills and resources available to it. First, as an external agency, the Bank cannot substitute for the political commitment that governments must bring to reforms in this area. Outsiders can assist and advise, but unless governments are committed to reform, changes that are brought about will not be sustainable. Full ownership of reforms is as important in this area as it is with economic policy reforms.

58. Second, the Bank's legal mandate clearly delimits its areas of concern. By way of illustration, the Bank may support government efforts at decentralization. It may, through its economic and sector work make a persuasive case for or against decentralization of particular functions. But the decision to decentralize is one that only governments can take. Similarly, the Bank is

rightly concerned with financial and economic accountability, but political accountability is outside its mandate. Similarly, the Bank may assist in strengthening local governments; it may not, however, have conditionality requiring local government elections. With regard to the legal framework for development, the Bank's concern is with its procedural and institutional aspects. The substantive elements of such a framework have political connotations that may sometimes lie outside the Bank's mandate. Here the General Counsel's memorandum provides clear general guidance, although such distinctions can, sometimes, be difficult to make in practice. It is important to note the underlying motivations behind the restrictions in the Articles of Agreement. These restrictions help to protect the Bank's reputation for technical excellence and objectivity and its status as an international institution that is guided solely by its concern for economic development and not by any political agenda of its own.

59. Third, the Bank's past experience provides a counsel of caution. The accompanying PSM paper is evidence that work in this area is likely to prove difficult and not yield quick results. The Bank's early experience with integrated rural development projects in the 1970s taught many valuable lessons. These projects were ambitious ventures into the public sector and social engineering. Of the many lessons learned from that experience, some reinforce the need for the exercise of care and humility in tackling problems of governance. The lessons include the need for a more differentiated approach between regions, countries and project type; the need for strong government commitment at an early stage; the need for training and retraining Bank staff to meet the complex needs of these projects; the need for long-term institution building and for avoiding project institutional arrangements that lead to frequent conflict with other parts of national and local governments; emphasis on developing human capital rather than quick physical implementation: the realization that expatriate technical assistance is a poor substitute for developing local capability. There were also other important lessons not directly related to governance involving the incentive frameworks, the role of the private sector and over-optimism on the availability of profitable technical packages.

60. Finally, work on development management and institution building is expensive and time consuming. However, such work will be handled like all other claims on budget resources, through a determination of priorities within existing country programs, based on need, borrower receptivity, etc. As noted below (para. 64), selectivity would be important in terms of countries and the range of activities to be pursued. The Bank should, of course, not attempt to take too much on itself. There are UN and other agencies who have experience in some relevant areas, which the Bank can tap through collaboration and its aid coordination function. Given that the rationale for the Bank's involvement in governance is that it helps improve the effectiveness of its programs and projects, and not as a new line of business, high quality work and improved Bank practices in this broad area should help the Bank to move further towards an "implementation culture", leading over the longer run, to increased cost efficiencies for the Bank itself and greater effectiveness of Bank interventions.

61. The skill-mix problem also raises difficulties. Many governance concerns can and are being addressed by various specialists in the broad PSM field, although experienced auditors, accountants, lawyers, tax specialists, management specialists and the like, are generally in short supply in the Bank. The LAC region has gradually built up a range of new skills through judicious hiring and use of consultants. Consultants can play an important role; Bank staff need to ensure

though that consultants are sensitive to the Bank's institutional concerns. Here again, the Bank needs to assist borrowers to draw on skills in other agencies, but recognize that there will nevertheless be significant trade-offs.

V. IMPLICATIONS FOR BANK PRACTICE

62. Bank actions relating to the governance dimension of development would be chosen selectively from the following range of options depending upon country circumstances and needs, the state of the dialogue with the borrower, and budgetary constraints:

- *Assisting* governments in reforms that they have identified or assisting them to identify reforms when they have asked for such assistance. The Bank is already experiencing a growing demand for technical assistance in support of a legal and procurement framework in Africa and Eastern Europe and strengthening decentralization in Latin America.

- *Persuading* governments through dialogue and economic and sector work of the need for reforms. Institutional and public sector management assessments and public expenditure reviews and financial accountability and legal sector reviews in Africa and Asia are examples of how this has begun to happen.

- *Crafting* country lending strategies and levels to take account of the impact of governance issues on development performance.

- *Helping* countries deal with the especially complex issues of poverty and the environment (see para. 21 above), where the quality of governmental performance is particularly important.

- *Projecting* a long-term vision of an enabling environment, as in the 1991 WDR but at country level, and supporting such fundamental ingredients as universal literacy, expanded primary education, better information on development issues and a supportive environment for a growing private sector.

- *Improving* implementation performance through greater efforts at assisting borrowers build ownership of adjustment programs, understanding the political and social structure of the country as well as its laws and customs, and increasing attention to fostering an "implementation culture" in the Bank, including greater emphasis on beneficiary participation in project design.

As a practical matter, given differing country circumstances as well as budgetary and staff constraints, a ***measured and selective approach*** must be pursued. The main elements of this approach are set out and some of the actions outlined above are elaborated, in the paragraphs that follow.

63. First, the Bank, through its interventions, should continue to exploit opportunities for improving development management, whenever appropriate, through a variety of means including assisting borrowers break up monopolies, removal of controls and other avenues for corruption, beneficiary participation in projects, etc.

64. Second, selectivity is necessary in allocating budgetary resources and developing work programs. The selectivity needs to be in terms of the choice of countries for specific work on the key dimensions of development management outlined above, and in terms of the range of activities the Bank can take on and support at any given time. Such work can only be embarked upon in countries where there is a clear commitment to and need for improving development management along these dimensions. Many of the Bank's borrowers may neither want the Bank to be so involved nor require such assistance. Where there is need but no commitment, such work would waste resources. Similarly, the dimensions of development management the Bank chooses to assist should reflect both the chances of success from such an involvement as well as the Bank's own ability in terms of skills and resources to assist effectively.

65. Third, in countries where the Bank is active in improving the governance dimension of development management, it needs to assist in the design of highly differentiated responses, taking account of the country's institutional needs, its political economy, its society, and history. The objective in each case must continue to be to help strengthen the enabling environment for sustainable and equitable development. This requires high quality analysis, usually as part of appropriate Economic and Sector Work.

Country Strategy and Implementation Issues

66. It is important to note in this context that a strong emphasis by the Bank on prudent financial management and attention to auditing and accounting or a legal framework suitable for development will tend to surface deeper and more general problems of governance. Thus, for example, sophisticated systems of financial accounting and auditing may be established but the government may not absorb or use the results to good effect. A legal framework could be created, but arbitrariness or corruption in its implementation could undermine its value. This has already been the experience with sensitive issues of PSM such as civil service reform where political constraints to the success of such work have emerged. Where lack of progress is due not to weaknesses in capacity but to lack of government commitment, the Bank then faces a problem which needs to be reflected in its country strategy and dialogue.

67. When political commitment to sound development management is weak, the Bank normally takes up these issues in its dialogue with borrowers while remaining proactive in seeking ways to help the country improve performance in some of the key areas. This dialogue is supported by economic and sector work, where appropriate. In such a dialogue, governance issues are not discussed in isolation but as an integral part of a government's overall development program. In conducting this dialogue, the level at which issues are discussed is a function of their sensitivity and requires the judgements of senior managers. Technical issues are handled at staff levels, but sensitive issues are handled at an appropriately high level (Country Director and above).

68. The issue of political commitment to sound development management is also surfacing increasingly at consultative group meetings. The General Counsel's legal memorandum noted that the Bank should not act as the agent of donor countries at these meetings. As Chair of these meetings, it is normal for the Bank to inform the country of widely-held donor concerns, particularly when these would affect Bank-assisted programs.

69. When dialogue fails, the Bank's own lending to the country is likely to be affected. Lending levels have long been responsive to issues of development management and

development performance, and will continue to be so. Judgments of performance are already routinely made for purposes of IDA allocation and in assessing creditworthiness. This involves judgments about the quality of development management as it relates to growth and to poverty reduction, consistent with the policy paper on poverty (World Bank, 1990e). There is no need for additional criteria to reflect concerns with governance: merely the effective and consistent application of existing criteria based on a greater awareness of the importance of issues of governance for development performance.

70. *Poverty and the environment* are two critical areas of country strategy which present particular challenges of governance. The Bank needs to pay attention to the equity as well as cost-effectiveness of social expenditures in its poverty assessments and public expenditure reviews, including addressing questions of the adequacy of social safety nets (especially important in middle-income countries). The legal framework can also greatly influence the access of disadvantaged groups, such as women or landless people, to public services and economic opportunities. On environmental matters, even non-interventionist governments face relatively extensive requirements for administrative and regulatory decision making, much of it discretionary, in areas -- like forest policy or pollution control -- where property rights are uncertain and market processes, therefore, cannot easily produce a socially desirable outcome. The Bank is considering how these inherent difficulties can be overcome and potentially abusive discretionary powers curbed for example, by separating surveillance from administrative responsibility. WDR 1992 will discuss some of these issues of environmental policy and governance.

71. Given absorptive capacity constraints, and the long-term nature of the task of developing appropriate institutions and the strengthening of budgetary decision making and accountability, development management concerns must be integrated, where appropriate and relevant, into a long-term perspective of a country's development strategy and prospects. In the Africa Region, as a follow-up to the Long-Term Perspective Study on Sub-Saharan Africa and the Maastricht conference which discussed it, the UNDP and the Bank, with assistance from the Netherlands Government, are assisting interested African countries to develop such perspectives. The objective, in this case, is to use the exercise to help develop a national consensus on development objectives and instruments, and to put government adjustment programs within the framework of a long-term development strategy aimed at poverty reduction and consistent with environmental concerns. Countries elsewhere may wish to consider a similar approach. For the Bank, this means taking a longer-term view of its own interventions to assist borrowers improve economic management, recognizing that quick results may be unrealistic, and focussing on human and institutional capacity development. This also implies that some aspects of this work should be supported by investment operations rather than with adjustment lending. Carefully designed long-term technical assistance is also appropriate.

72. This long-term approach would reinforce efforts underway to strengthen ownership of adjustment programs. The technical complexity of the preparatory work on *adjustment operations* and the speed with which borrowers require resource transfers, sometimes leave insufficient time for adequate dialogue and can cause the Bank to contribute to programs whose ownership is weak and that are then seen to be externally imposed. In an ideal world, sufficient preparation time would permit a better understanding of the political economy of the country, and through a more intensive and extensive dialogue, greater ownership and understanding of the program

by the borrower is assured. However, governments and Bank staff frequently do not have that luxury. Governments often delay adjustment and come to the Bank for assistance on adjustment when they are facing a serious crisis. There is, then, an inherent conflict between the need for quick support of sensitive policy reforms and the need to build ownership and understanding of the program. Moreover, greater ownership comes after a program begins to show results. It, nevertheless, remains important to ensure that operations are designed, taking into account, the political economy of the country. It is also important to ensure that ownership of the program, however narrow at the start, is genuine, and is broadened over time. At the same time, the strength and integrity of adjustment programs must be protected.

73. Beyond adjustment lending, fostering an "*implementation culture*" requires attention to good governance in the design of projects, as well as a deliberate focus on implementation. Best practice includes simple project design, discourages creation of autonomous project implementation units, encourages use of existing structures to implement projects, increases supervision, suggests prior action and conditionality rather than delayed dated covenants, recommends recruitment of key staff well before effectiveness and pays special attention to the fiscal effects of projects. All of these recommendations, coming more and more sharply into focus in Bank operations, are instances of the approaches to good development management discussed in this paper.

74. *Beneficiary participation* is, in many instances, an important component of institutionalizing an implementation-oriented approach as well as a means of improving the effectiveness of particular projects. The Bank, as noted, is attempting to spread best practice in this area. This will require skills in organizing participatory processes, mediating conflicting points of view while achieving results in a timely manner. In some cases, it means identifying intermediaries through which the Bank can work. It may also mean working with local NGOs; in other instances, this may mean searching for special skills in local sociologists, development managers, anthropologists or consultants who can be brought into projects for particular aspects of project work. Timetables may sometimes need to be adjusted in order to accomodate this labor intensive work -- often at the beginning of the project cycle. The Bank's learning process on popular participation is addressing these issues (Box 5, Annex I).

Implications for Research

75. Much of the Bank's current policy and research work in public sector management bears on "governance" issues. For example, studies underway examine ways to introduce greater public accountability in public finance and in civil service management, while work on regulatory institutions and on the political economy of adjustment also addresses some of the questions discussed in this paper. Much uncharted territory remains, and current work could be extended in several directions.

76. One such is further research on the rule of law, to explore the minimal juridical conditions for broad-based development. For example, in areas such as contract enforcement, employment and tenancy transactions, recourse against public agencies and judicial independence, is there relatively consistent and culture-neutral experience on which countries can base their own efforts? Another important area is the accountability of public agencies, where it would be useful to evaluate the wide variety of mechanisms and models available. These include contracting out of services to private providers (on which some work is in progress), decentralization of provision and/or finance, ombudsman

mechanisms, "customer-driven" service systems and others. Further research could follow up some of the findings of WDR 1991 to explore the two-way relationship over time between economic growth and changes in governance.

VI. CONCLUSION

77. Management proposes to proceed with the following:

(i) Dissemination to the staff of the key messages for the Bank in this paper together with the Board's guidance.

(ii) A broad-based dialogue with borrowers, interested academics and others in all Regions. This has already begun in the Africa Region.

(iii) A research program along the lines discussed in paras. 75-76.

(iv) A progress report to the Board on the Bank's ongoing experience with governance issues in about two years' time.

ENDNOTES

1. Webster's Unabridged Dictionary

2. Governance, in general, has three distinct aspects: (i) the form of political regime (parliamentary/presidential, military/civilian, authoritarian/democratic); (ii) the processes by which authority is exercised in the management of a country's economic and social resources; and (iii) the capacity of governments to design, formulate, and implement policies, and, in general, to discharge government functions. The first aspect clearly falls outside the Bank's mandate. The Bank's focus is, therefore, on the second and third aspects.

3. This discussion was itself partly prompted by criticisms of early drafts of the LTPS from African reviewers who felt this issue needed to be aired.

4. This gives rise to the so-called "Principal-Agent" problem which relates to how the Principal can most effectively induce the Agent to act the way the Principal would like. There is a growing body of literature on "Agency theory." See Eisenhardt, 1989.

5. North draws an important distinction between institutions and organizations. "Institutions, together with the standard constraints of economic theory, determine the opportunities in a society. Organizations are created to take advantage of those opportunities; as the organizations evolve, they alter the institutions" (North, 1990: 7).

6. Lucien Pye argues persuasively that "culture is not a matter of the rule of the irrational as opposed to objective rational behavior, for the very character of rational judgements varies with time and place. Common sense exists in all cultures, but it is not the same from culture to culture. Sentiments about change, judgements about utility, expectations as to what different forms of power can and cannot accomplish are all influenced by cultural dispositions....People cling to their cultural ways not because of some vague feeling for their historical legacies and traditions, but because their culture is part and parcel of their personalities" (Pye, 1985).

7. The concepts of "exit" and "voice", which originated in Albert Hirschman's classic work, *Exit, Voice and Loyalty* (Hirschman, 1970), have been adapted by Samuel Paul to the issue of accountability (Paul, 1991).

8. For example, under a Bank-supported Madagascar Environment Program - The Land and Rural Resources Directorate (DPRA), a public titling agency, for which the Bank has been a lead donor, has been struggling unsuccessfully for some time with formal legal arrangements which would ensure that disadvantaged people who invest in land, will have access to future benefits from their investments. Having failed the formal legal way to do this, they pursued a different course. A survey of the current, traditional land tenure system is under way to understand traditional rights and control mechanisms, and to understand how investment decisions are made and benefits derived. This survey, which is highly participatory, builds on people's knowledge of the land around their communities and of the rights and obligations traditionally allocated to groups and individuals. Once this survey is completed, it is planned that the DPRA will set up village discussions in which individual rights will be agreed upon for a specified period and verbal community consensus will sanctify these rights. This community agreement will be updated on a regular basis every few years. The results of the village discussions, and the community agreements about individual rights that follow, will be included in reports to be given the status of official (legal) documents.

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ANNEX I
KEY DIMENSIONS OF GOVERNANCE

A. ACCOUNTABILITY

> "[Accountability] is found where rulers readily delegate authority, where subordinates confidently exercise their discretion, where the abuse of power is given its proper name, and is properly punished under a rule of law which stands above political faction."
>
> *John Lonsdale (1986)*

The Nature and Scope of Accountability

1. Accountability, at its simplest, means holding public officials responsible for their actions. Political leaders are ultimately responsible to their populations for government actions and this means that there has to be accountability within government. How this happens varies widely in different countries, depending upon cultural characteristics, history, political institutions, administrative capacities and the public's access to and use of information. At a broad level, economic objectives of public accountability include ensuring congruence between public policy and actual implementation, and the efficient allocation and use of public resources. This not only requires systems of financial accountability, but also the capacity and willingness of governments to monitor their overall economic performance. At the micro level, the primary concern is similar efficiency in investment and in the production and delivery of goods and services in the public sector.

2. Accountability is important throughout the economic system, not just within government. Governments also have an important role to play in ensuring accountability in the private sector, through company and securities legislation, competitive policy, and regulatory oversight. As the state sheds many productive investments in developing countries, this function becomes particularly important.

3. Public accountability involves three inter-related groups: (i) the general public and particularly recipients of public services, who are interested in service providers being accountable to them; (ii) political leaders and supervisors of service providers, who would like the service providers to be accountable to them for a mixture of public policy and private/parochial interests; and (iii) the service providers themselves, with objectives and interests often different from the first two.

4. The phenomenon of "capture" of public services and resources by relatively narrow special interests is an ever-present problem in all countries. It is made worse by monopoly, and also by limited capacity of the public to demand *and* monitor good performance, especially since it is often hard to measure the benefits of public services. These factors make improvements in public accountability an especially complex and difficult undertaking.

5. The historical evolution of accountability reveals three features. First, micro-level accountability has become more important as the role of the state has expanded and made it impossible to apply broad political accountability to all the myriad actions of modern government. Second, the focus in public accountability tends to be on inputs,

especially public expenditure, rather than on outputs or impacts, which are often diverse and complex to measure. Third, except for legal accountability for government action in some countries, accountability has mostly been by internal administrative controls by political leaders, government agencies and bureaucrats acting as proxies for the public. But hierarchical control is often ineffective, especially when collusion between supervisory and subordinate personnel is likely. Micro-level accountability, remains critical, especially in ensuring government responsiveness to the views and needs of the "publics" for which services are intended.

Macro-Level Accountability

6. There are two key aspects of macro-level accountability that are particularly relevant: financial accountability, and accountability for overall economic performance.

Financial accountability involves:

(i) A properly functioning government accounting system for effective expenditure control and cash management;

(ii) An external audit system which reinforces expenditure control by exposure and sanctions against misspending and corruption;

(iii) Mechanisms in place to review and act on the results of audits and to ensure that follow-up action is taken to remedy problems identified.

7. Without a well-functioning system of financial accountability, government efficiency is poor, and the probability of corruption increases greatly. Corruption is clearly an issue of concern not only because of potential misuse of external resources (including the Bank's) but also because it generally reduces the efficiency of resource use (Box 1).

8. The Bank has historically focussed on financial accountability, especially in the context of investment projects. As is the experience of other donors, compliance with accounting and auditing covenants has been uneven. The problems encountered in these areas are not project specific but are symptomatic of weaknesses in country-wide financial accountability. The need for improved financial accountability at the national level is of particular relevance in countries where the Bank is undertaking adjustment lending and is, in effect, providing substantial resources directly to government budgets.

9. To address this issue, the Bank is pursuing in selected countries a three-pronged strategy. First, it is trying to *improve borrower performance* through stricter enforcement and the introduction of penalties for non-compliance. The penalties include not extending closing dates, conditioning further processing of loans to compliance with requirements on past loans and suspending disbursements.

10. Second, it is trying to *encourage more systematic review of auditing and accounting capacities and needs during project preparation*, and encouraging greater contracting out for project accounting and audit services.

11. Third, it is helping to *strengthen borrower capacity* through country-wide reviews of auditing and accounting systems, and following up with assistance. In Ghana and Madagascar, Economic Management Support Projects aim to remedy deficiencies in public financial management in those countries. The projects would clear the backlog of government accounts and introduce new accounting methods and software to

BOX 1
Reflections on Corruption

Corruption is the misuse of power for personal gain. Many people, anywhere, can be tempted to misuse power for personal gain, if permitted to do so at no cost or risk to themselves. Thus, corruption occurs in all countries in many different forms. It tends to emerge and increase in any country when inequalities are acute, resources scarce, rules unclear, disclosure and punishment unlikely, and upward mobility is restricted. Efforts to reduce its incidence need first to identify the *kind* of corruption (graft, bribery, theft, conflict of interest, nepotism, bias, or favoritism), its *frequency* (pervasive, occasional, or intermittent), and its *perpetrators* (contractors, public officials, political elite, businessmen, foreign suppliers).

The causes of corruption relate to political and economic conditions within the society and their linkages to problems in the world economy (Theobald, 1990: 10-11; 161-169). As such, causes are as complex as types of corruption are varied. While distinguishing between symptoms and causes is important, sometimes symptomatic relief provides opportunities for needed social and economic change leading to more lasting "cures". For example, bribery of public officials allocating essential licenses can be mitigated by clear rules, disclosure, and effective enforcement. Further, the amount of licensing can be reduced with clear rules. The longer-term measure of civil service reform adds more long lasting relief. Only over time, and with major policy reform, can improved economic performance increase economic opportunities and thereby provide the environment and context for diminished corruption. Yet, every generation has to make its own struggle against its resurgence.

Competition, clear rules, and disclosure are important first steps. Many countries have sophisticated and strict laws addressing corruption. Yet the existence of legislation alone is insufficient. The problem may lie with a lack of dependable enforcement. Simultaneously with enacting legislation, the strength and independence of the judiciary has to be secured (see para. 51).

Many political leaders in countries with serious poverty have amassed extraordinary fortunes. Foreign exchange reserves were transferred to foreign bank accounts. Such abuse, needless to say, adversely effects economic development. It unleashes cynicism which corrodes public trust – and signals to others to do likewise. Private wealth accumulated through abuse of power amidst public squalor undermines legitimacy. Yet, graft on this large scale is not possible without collusion between major private corporations and public agencies. Often the "commissions" are paid by foreigners – foreign contractors, companies, or consultants. Sometimes such activity is associated with foreign aid. Foreign companies argue that bribery is but one of the costs of doing business in a country. Financing necessarily flows through different agencies; a percentage "take" off the top is considered a fee by some, a kickback by others.

What, if anything, can donors do in these circumstances? In part, the recommendation for countries is also true for donors – *reduce the number of unnecessary regulations, and rely more on market forces; ensure that the laws of the country are observed; insist upon meeting procurement and contracting standards; upon meeting audit requirements, study audit reports; pay attention to the manner in which disbursements are handled.* Even with these safeguards, the problems are daunting. Aid coordination provides another venue for flagging the importance of supervision, audits, and attention to disbursement processes. Audits may be required, and not always performed, or where performed, they may not be read. Project supervision is difficult to maintain in the best of circumstances; when donor agencies are pressed to do more with fewer people, supervision suffers.

(continued on next page)

improve the accuracy and timeliness of financial data. Similarly, the Development Management Project in Mauritania helped to establish the Office of Auditor-General. Audit systems in the banking sector are being reformed in Poland and Algeria, while Poland

BOX 1
Reflections on Corruption

(continued)

Corruption is a two-way street. Donors have a responsibility to ensure that commercial considerations do not undermine good economic management in developing countries. Encouraging governments to develop sound public investment programs and respecting the priorities established is an important contribution donors can make. In this regard, the Development Assistance Committee (DAC) of the OECD, in consultation with the Bank, has prepared a document entitled "Good Procurement Practice for Official Development Assistance". More recently through an OECD/DAC Working Party on Financial Aspects of Development Assistance a greater effort is also being made to ensure that competition for contracts under donor-financed projects is not a source of corruption and does not contribute to distorted investment priorities. The intention is to ensure greater transparency and fair trade practices through a common band of concessionality levels, more open procurement procedures for large projects, upper income limit for tied aid, more transparency in large projects, e.g. through ICB procedures and mandatory consultation, etc. Project preparation through joint appraisals and cofinancing with multilateral development banks including the World Bank is seen as one way to ensure sound investments. When such cofinancing is not possible, the DAC has proposed that donors look to the Bank for advice on the appropriateness of proposed bilaterally financed large projects in the particular country situation. A consensus has yet to be reached on these proposals.

Some observers have also suggested that one of the next steps may be to have donors more fully exchange information with one another about companies, contractors, or consulting groups which have been identified as having participated in graft, bribery, or other corrupt behavior. This 'blacklisting' of corrupt companies or contractors by donors would provide a useful disincentive for these practices.

has also requested technical advice on audits and evaluations of government programs and accounts. In January 1990, the Africa Region set itself a target of 12 projects or project components aimed at strengthening financial management capabilities of borrowers through FY92. The Asia Region established a Task Force on Auditing which also suggested the need for a more comprehensive approach to the problem. In Indonesia, the Bank is supporting a comprehensive Accountancy Development Project (Box 2). These country-level reviews need to focus on coverage, timeliness and quality of financial control of projects and public expenditures, but also take account of legislative or other review of government policies and programs and of public access to information.

12. ***Accountability for Economic Performance***: The Bank has also addressed issues of economic accountability. As described in the Public Sector Management (PSM) paper, public expenditure reviews have focussed on the efficiency of resource use in public investment programs, in the parastatals sector, in the social sectors, and more recently, in employment and wage issues in civil services. This has led frequently to the identification of reforms including the removal of white elephants from public investment programs, privatization, restructuring and closure of state enterprises where appropriate, reallocation of resources in favor of primary health and primary education, and the removal of "ghost workers" and rationalization of employment levels in the public sector. Increasing attention is being paid to strengthen the capacity of governments to monitor and evaluate their own economic performance, including issues of resource use.

13. Governments could do more to strengthen the overall monitoring and

BOX 2
Indonesia-Accountancy Development Project

Indonesia's government accounting practice had changed little since the 1864 Dutch Financial Administration Act. Finding that they could not cope with the increasing complexity of government financial transactions, the government requested Bank support for an accountancy project. Budget reports and financial statements did not provide a comprehensive view of the financial situation and were often delayed. It took three years before government expenditures for a given period were reported to Parliament.

In the private sector, the accounting system had fallen behind other skills required in industry and commerce. The shortage of trained accountants and managers who could produce and use accounting information was severe. The professional body of accountants – the Indonesian Institute of Accountants – was relatively young and lacked detailed accounting and auditing standards to guide the profession, a code of ethics and disciplinary processes to regulate it.

The Bank-financed accountancy development project will address all these areas by:

- improving accounting practices in the public sector by supporting the introduction of modernized government accounting;
- improving accounting practices in the private sector by supporting the development of technical standards and a code of ethics for the accountancy profession;
- supporting the government's program to raise the quality of accounting faculties and to prepare for future expansion of accountancy education and training; and,
- improving the legislation on accounting, auditing and disclosure requirements.

The modernization of government accounting is being carried out with the use of local and foreign specialists who are assisting in the design of a uniform chart of accounts and a clear and specific classification of expenditures. Similar changes in accounting practices will be adopted by public enterprises and by lower levels of government.

With regard to private sector accounting, the World Bank will support the Indonesian Institute of Accountants to continue the Certified Accountant's professional education. Accounting principles and auditing standards will be formulated for more consistent financial reporting by commercial and industrial businesses and a code of ethics will be developed.

In accounting education, the Bank will finance programs for personnel development, procurement of teaching equipment and materials, research, fellowships to train accounting teachers, and loan programs for institutions and students. The improved quality of accounting programs in universities and institutions will permit expansion of accountancy enrollments and increase the supply of accounting professionals.

The proposed project will be implemented over five and half years. Its total cost is US$162.5 million, of which the Bank loan will finance US$112.0 million.

evaluation function, currently largely donor driven and project specific. Yet in many countries, departments are required by legislation to prepare annual reports on their activities. Some countries have performance monitoring ministries. OED has tried to encourage these activities, and more work under PSM projects is under way. This will need to be a gradual process, given the competing claims on resources.

14. In some industrial countries (and a few developing countries), a current wave of PSM reforms seeks to raise the efficiency with

which public resources are used by giving public managers greater freedom to run their operations but substantially increasing their accountability through objectives, specific targets and performance monitoring. There has also been an attempt to link such efficiency concerns to broader notions of performance in implementing government policy objectives. This accountability is sometimes reflected in contracts, programs or memoranda of understanding. A number of developing countries have adopted the use of such memoranda in the context of parastatal reforms, which are then negotiated by heads of government departments and chief executives of public enterprises. These have had mixed results, particularly when undertaken with inadequate preparation or discussion. This is accompanied by a movement away from a single year to a medium-term budgetary framework that provides managers with a stable resource stream. Alongside this, accounting systems and internal auditing are being strengthened, with increased emphasis on cash management and, in some cases, accrual accounting. The audit function is now being widened to include not only financial probity but also "Value-For-Money" (VFM) audits.

15. The applicability of these innovations to developing countries will vary. Some of the Bank's borrowers are probably ready for reforms along the lines described above. However, in most countries, the basic accounting and auditing systems are not in place. Greater autonomy to managers must be linked to improvements in financial information systems. Similarly, only when financial audit systems are functioning well can "Value For Money" auditing be considered.

Decentralization: The Macro-Micro Linkage

16. Decentralization is an increasingly common phenomenon in Latin America, Asia and Eastern Europe. In theory, it can lead to significant improvements in efficiency and effectiveness by reducing overloading of central government functions and improving access to decision making and participation at lower levels of government, for example, by improved service design, user financing targeting and delivery (See Box 3).

17. However, if not carefully managed, decentralization can lead to a deterioration in the use and control of resources, especially in the short term. National goals can be seriously distorted by local governments and scarce resources diverted to misuse. Moreover, radical decentralization can seriously weaken the capacity of the central government to manage the economy through fiscal and monetary means. In the late 1980s, Argentina's provincial governments were responsible for the largest and fastest-growing portion of the public sector deficit. Apart from the potential damage done to macroeconomic stability and expenditure efficiency, resources are arguably more open to capture by elite groups at the local level than at national levels.

18. Perhaps, the most serious problem is weak administrative capacity at local levels, leading to waste and corruption. The poorest local authorities, whose constituents stand to gain the most from improved delivery and targeting of social services, are precisely those least able to manage increased responsibilities.

19. The Bank's present approach to decentralization and local government development relies heavily on financial tools to ensure efficiency, including cost recovery for municipal services. An upcoming study on decentralization in LAC countries suggests the

BOX 3
Decentralization in Poland and Romania

As Poland and Romania pursue political liberalization and macroeconomic adjustment, they are also embarked on a significant decentralization of the public sector. The three issues are closely linked.

Strengthening local government is widely viewed as essential to ensuring greater responsiveness and accountability in many infrastructure and service areas that have been dominated from the center in both delivery and financing aspects. Development of political and institutional means to hold local government authorities accountable to their constituents is important because much of the justification for public sector decentralization is based on the premise that many areas of infrastructure and services are provided more efficiently at the local level since beneficiaries can better express their demand for these services, control costs and hold local authorities accountable for their actions.

Decentralization of the public sector requires fundamental reforms in the expenditure and financing responsibilities of local governments in Poland and Romania. Fiscal chaos could ensue if local revenue capacity is not enhanced and intergovernmental fiscal transfers are not controlled. A collapse of local infrastructure and services is likely if local expenditure assignment is not matched with revenue authority and local institutional capacity. Local government reforms must include, therefore, fiscal reforms at the national and local levels and local government institutional strengthening. These reforms also will be crucial to stimulating increased private sector productivity, not only through improved delivery of public infrastructure and services, and a prudent regulatory framework, but also because local governments will be key to implementing an effective policy of property rights through legal cadastre that provide security for the transfer of property.

Local governments will be key implementing institutions for the Bank's pipeline of proposed projects in both countries, primarily in the areas of infrastructure, the social sectors, environment, rural development and poverty alleviation. However, before these decentralizing countries may absorb effectively lending operations, local governments must be strengthened to discharge effectively their new and growing responsibilities. Key areas for institutional strengthening include: local taxation policy and administration (and consistency with national taxation policies); management of local enterprises (e.g. privatization and/or regulation in areas such as water supply and sanitation, transport, solid waste and housing); budgeting, accounting and audits; maintenance programming and implementation; investment planning and evaluation; and procurement practices.

Because decentralization in these countries comes after decades of tight, central control, the pace and scope of the decentralization process are issues of concern for the countries and for the Bank, and all recognize that there is no broadly recognized "road map" for public sector decentralization.

Therefore, the Bank's strategy for assistance to the decentralization process is broad and country-specific, but the short-term strategy is evolving in four key areas: (a) policy dialogue and possible inclusion of local government strengthening measures as part of the program to be supported by adjustment lending; (b) country and regional sector work on local government reform (e.g. regional work in FY91 and local government reform in Poland for FY92); (c) targeting technical assistance on local government reform (e.g. local government component of Infrastructure Technical Assistance Loan to Romania); and (d) highly selective project support through lending operations in areas critical to overall adjustment and reform (e.g. proposed housing project loan to Poland).

need for a more comprehensive strategy, with greater attention to mechanisms such as hearings or surveys, which allow local preferences to be ascertained. In Mauritania, a project helped to establish the institutional framework for the creation of municipalities. In this instance, local elections followed, providing the public with one accountability

mechanism. In Indonesia, an upcoming project provides assistance for (i) strengthening the institutional and human resource capabilities of local governments by increasing the efficiency and effectiveness of previously fragmented training programs, and (ii) strengthening the institutions and coordinating capacities of local government and administration. Other initiatives could focus on strengthening the oversight function of national government. Venezuela has successfully used an executive council (COPRE) to marshal ideas, try out policies and legislation, and develop guidelines and administrative models. Future Bank efforts such as the Africa Municipal Development Program could build on these experiences.

Micro-level Accountability

20. Micro-level accountability can reinforce macro-level accountability when: (i) there is competition, or scope for the public to "**exit**" when dissatisfied with a service. This can have a salutary effect on the agency concerned, through a reduction in its revenues and a related threat to the careers or pay of its staff; (ii) there is participation, so that the public can influence the quality or volume of a service through some form of articulation of preferences or demand. If such "**voice**" makes the public agency more responsive, accountability is enhanced.[1] In the National Irrigation Administration in the Philippines, the exercise of voice resulted in a greatly improved irrigation system (Box 4). Often however, competitive provision is more efficient except where national monopolies or market failure are predominant -- and it is undesirable to regard participation mechanisms as a substitute for (rather than an adjunct to) the availability of alternative providers. In any case, there are inherent problems (free riding, elite dominance, resource diversion) in collective action: the costs and benefits of "voice" options need to be evaluated case by case (Olson, 1965; 1982).

21. There are invariably numerous barriers to exit and voice. Legal and policy-induced barriers are more easily dealt with; natural barriers, such as spatial barriers (e.g. an isolated village can afford only one school) are more difficult to remove. Services that the poor (weak voice) require and for which alternative sources of supply are difficult to find (low exit) will be the most difficult to deal with.

22. ***Exit mechanisms***: There are several possible exit mechanisms, notably deregulation, contracting out of services to multiple private providers, public-private, and public-public competition. The key element is contestability: when incumbents are made to bid for contracts along with outside competitors, they will be more careful about their performance and their terms. Similarly, when regulations favor new entrants, the knowledge of potential entry can mitigate monopolistic behavior on the part of incumbents (Baumol and Lee, 1991). New technologies can be used, where cost effective, to broaden choice and access (e.g. mobile courts, mobile schools and health clinics or the use of VCRs or television for education).

23. ***Voice mechanisms***: Dissemination of information about services can aid the public in demanding greater accountability from service providers. Periodic evaluation of services can exert pressure. For example, a poll of beneficiaries' views on the service or the gathering of data from both beneficiaries and service providers can sometimes be an effective alternative to elaborate participation arrangements. Complaints procedures and institutional mechanisms such as ombudsman are ways of providing voice when there is no need or incentive for collective action. "Hotlines" can be established to help prod response to unsatisfactory services. These mechanisms are in place in some countries, and their effectiveness varies widely: in particular, elites tend to make the most use of

BOX 4
The Philippine Communal Irrigation Program

In May 1982, the World Bank approved a US$72 million loan to the Philippines for a communal irrigation program that would involve the participation of farmer beneficiaries in all phases of the project planning, design, and construction of the system. The project would involve construction or rehabilitation of 144 communal irrigation projects covering about 33,500 hectares in 35 provinces of 11 regions. After completion of a system, the farmers would assume full control of its operation and maintenance.

The project was remarkable in two ways: first, it was one of the most participatory projects ever to involve the Bank. Second, the initiative for the participatory approach came from a government agency, the National Irrigation Administration (NIA), which had been developing and testing the participatory approach for five years.

Before the participatory approach was introduced, nearly all of NIA's professional field staff in charge of communal projects were trained exclusively in technical subjects such as construction, design, and survey. The participatory approach, however, required the addition of staff oriented toward people and trained in building the problem-solving capacities of local people. Consequently, NIA hired community organizers who could work with the farmers to develop irrigation associations.

NIA hired six community organizers for its first participatory project in 1976. By early 1983, the number had expanded to 401. Of that number, 295 worked on communal projects and 106 on national projects. The gradual approach to expanding the program allowed the community organizers to accumulate learning. Organizers who worked on initial projects became the trainers and supervisors for later arrivals.

Evaluations in 1989 concluded that: "participation produced consistently positive results. The canals and structures were viewed by the farmers as more functional and the system was more productive, with greater increases in rice yields and in irrigated area in the dry season. The irrigation associations were more likely to use water distribution methods that assured greater equity of water access to the members and were more likely to use sound financial management practices. They contributed more to construction costs at the time of construction and subsequently paid a greater percentage of their loans due. The costs of achieving the wide range of benefits demonstrated for the participatory projects was only 3% of the total cost of construction."

This program, widely studied around the world as a model of the possibilities of increasing effectiveness and sustainability, is still under way. A new Bank loan in 1988 for the operation and maintenance of the national system (which is distinct from the communal system) provided funds for community organizers and farmer training. Work has begun on a follow-up loan for the communal program.

these services. Consequently, they are most useful to the poor when the service is "non-excludable," like drinking water, roads, or public facilities.

24. Participation of public representatives in decision-making or regulatory bodies is one way of enhancing "voice." Users' representatives, for example, can be appointed to the board of directors of these organizations or hold equity shares of utilities. Where direct participation of users in decision making is difficult or inappropriate, a consultation process can be instituted through public hearing, advisory panels, etc. Legal action by consumer action groups is also a possibility, though not common in developing countries.

Governments and NGOs

25. Some developing countries have witnessed a mushrooming of private voluntary organizations (e.g. India, the Philippines, Bangladesh, Kenya, Zimbabwe, Senegal, Colombia, Mexico, and Chile to name a few), while some other countries clearly have not (e.g. C.A.R. or Malaysia) and depend much more heavily on governmental organizations and initiatives. Various factors contribute to the emergence of a strong voluntary sector, among them culture, level of development, and the stimulus provided by the influx of external NGOs after a natural disaster. A powerful factor clearly is government hostility or encouragement.

26. Government policies determine the enabling environment for NGOs and the roles that they assume. Governments determine in the first instance through rights such as freedom of association, or of speech whether NGOs can function effectively. Regulatory policies -- and fiscal policy -- also affect the environment within which NGOs operate. Precisely because NGOs may be a channel to the poor, or may be advocates on behalf of the poor, NGOs can be used by governments and donors to reach beneficiaries that are otherwise difficult to involve in the flow of project benefits. They can also be called upon to assume roles in the provision of benefits or in communicating between different constituencies. But it is also the case that some governments are suspicious of NGOs precisely because of their advocacy on behalf of the poor. There are, thus, pressures to coopt NGOs and make them extensions of the state.

27. Direct donor funding can be an important means of supporting NGO activities. But it carries with it a number of attendant risks including shifting NGO accountability from their natural constituents to donors, and making them vulnerable to subtle pressures from governments who must approve direct funding of NGOs (Fowler, 1991). The existing literature (mostly sponsored by bilateral donors) shows that NGOs tend to be effective at reaching low-income groups, especially in remote areas, and at working in a relatively participatory way. They tend to be weak in planning and administration. NGOs' most important contribution may not be service delivery but a pilot role for social initiatives urging and developing new approaches which are sometimes replicated on a larger scale. There can be, as a result, synergies between governments and NGOs; governments learn more about the needs of widely dispersed publics while NGOs acquire more effective management skills. The rapidly changing relationship between the State and NGOs needs further research and reflection.

The Bank's Role in Promoting Exit and Voice

28. The Bank is active in promoting deregulation and improving the working of markets in structural adjustment loans, in parastatal reforms and in much of its sector lending. The Bank has, in recent years, also worked to expand participation and the involvement of NGOs in Bank-financed projects. In FY89 and FY90, NGOs were significantly involved in 50 of the projects the Board approved. In some sectors, most notably agriculture and population, NGOs are contributing significantly to effective project implementation. NGO criticism, although sometime unduly harsh, has nevertheless contributed to the redesign or improved implementation of a number of Bank-financed projects.

29. Voice can also be enhanced through **popular participation** in the design and implementation of Bank-financed projects. Bank experience suggests that participation can be important to project success and

BOX 5
Popular Participation and the Bank

"We affirm ... that the economic crisis cannot be resolved ... without the full and effective contribution, creativity and popular enthusiasm of the vast majority of the people."

ARUSHA, 1990

Popular participation is the process by which people, especially disadvantaged people, influence decisions which affect them. The term "popular" refers not only to the absolute poor, but also to a broader range of people who are disadvantaged in terms of wealth, education, ethnicity, or gender. "Participation" means influence on development decisions, not simply involvement in the implementation or benefits of a development activity, although those types of involvement are important and are often encouraged by opportunities for influence.

The World Bank has learned from its experience that popular participation is important for the success of projects economically, environmentally, and socially. The most important lesson has been that popular participation is a question of efficiency, as well as being desirable in its own right. In one study, the Bank evaluated 25 projects five to ten years after completion. Strong beneficiary organizations (an instrument of facilitating participation) proved to be a key factor in determining project sustainability (World Bank, 1985). Another study of 68 Bank-financed projects found that the economic rate of return was twice as high for projects which had been sensitive to local social and cultural realities (Kottak, 1985).

The Bank's experience with participatory projects is limited, but growing. Participatory approaches have most often been adopted in projects designed to help particular communities -- agriculture, especially irrigation, forestry, and livestock; urban development and rural water supply; population, health, and nutrition. Social investment funds are a promising way for governments to support community-initiated micro-projects. A recent review reveals that in virtually every participatory project the Bank has financed, participation has contributed to project effectiveness (World Bank, 1990b). Individuals, households, groups, and communities are more likely to have a stake in, contribute to, and maintain projects which respond to their needs, knowledge, and initiative.

But popular participation is also valuable for bigger projects. The Bank's experience with environmental issues and adjustment loans indicates that public consultation and information sharing can improve the design and build public support for large-scale investments and policy decisions. This approach is working, for instance, in Mexico's Hydroelectric project, India's Upper Krishna Dam project, and Ghana's Private Investment and Sustained Development Promotion Credit.

Operations and PRE are pursuing a modest program of action and learning, supported by SIDA trust-fund resources, designed to strengthen the Bank's support for popular participation where this would contribute to the development effectiveness of Bank-related operations. Learning is being stressed because there are relatively few large-scale participatory development projects in the developing world. It is important to learn in what situations participation is worth the effort, and, in those cases, how the Bank and borrowing governments can effectively promote participation more widely. To date, Bank-supported participatory projects have been the exception rather than the rule, sometimes stemming from the personal commitment of individual task managers.

In most situations, the constraints on popular participation are external to the Bank (the intrinsic difficulties of engaging low-income people in project decisions, for example, and reluctance on the part of some governments). But improvements in income and education, together with increased interest among borrowing member governments, are relaxing external constraints in some situations. While grappling with the problems of making government implementing agencies more people-centered, the learning process is focussing especially on ways the Bank's own operational practices could be more supportive of participatory approaches.

sustainability. It is especially useful for activities focussed on particular communities and dependent on their active cooperation, but it is also relevant to large scale infrastructure projects. Participatory approaches in Bank projects have been tested successfully in sectors (notably, irrigation, forestry, livestock and agricultural credit, urban development and rural water supply, health and nutrition, environment and social investment funds). The Bank has recently embarked on an effort to learn better how to foster popular participation in Bank-supported activities (Box 5).

30. Attention to "exit" and "voice" options at the design stage of relevant Bank-financed service delivery projects will complement the strengthening of internal control systems. The use of such mechanisms, however, will cause accountability to improve only when this leads to a change in the behavior of the service provider -- its efficiency, access, and quality of service, not just its compliance with internal rules. This must be reinforced with incentives that reward responsiveness to users and the wider public.

31. Accountability at the micro-level will, in turn, be sustained only when the government and society at large are concerned and wish to improve it. Comparative information on how different countries perform in respect of key public services can be a powerful tool to generate national and international interest in this area. Selected performance indicators based on good professional judgment can be assembled on these services from as many countries as possible for wide dissemination (including the WDR) (Box 6). It will provide the data for governments, scholars, media and the public at large to see where they stand in respect to the level and quality of their services.

B. THE LEGAL FRAMEWORK FOR DEVELOPMENT

> "The Rule of Law is not a Western idea, nor is it linked up with any economic or social system...As soon as you accept that man is governed by law, and not by whims of men, it is the Rule of Law."[2]

32. The literature on the rule of law is voluminous and the concept lends itself to endless discussions at a jurisprudential level with limited practical relevance. The emphasis here is on a pragmatic view of the rule of law in the context of economic development and Bank operations.

33. The General Counsel has defined the rule of law as "a system based on objective rules which are actually applied and on functioning institutions which ensure the appropriate application of such rules" (Shihata, 1991: 42-43). There is empirical evidence that investment is adversely affected by uncertainty. Investment will not take place and will not succeed without a system which provides a minimum of stability and predictability.

34. Stability and predictability create a climate in which business risk may be rationally assessed and the cost of transactions lowered. In turn, some elements of the rule of law are a necessary condition for stability and predictability. It is primarily this connection of the rule of law with the level of investment and the more efficient use of resources that explains its importance as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself. It is only to the extent that it establishes some of the pre-conditions for economic development that it is legitimate to bring it within the

BOX 6
Improving Accountability and the Environment

The deteriorating quality of air, water and land resources in many developing countries is linked to problems of accountability and capacity. Government decision-makers in charge of natural resource management often contribute to environmental deterioration through poor management decisions. Poor decisions are a function both of inadequate incentives, and of an inability to project the actual effects of well-meant decisions or to evaluate alternative uses of scarce government funds.

Environmental resource management is further complicated by the multi-sectoral nature of many decisions. Water resources, for example, are affected by solid waste systems, storm water drainage, the demands of commercial, household and recreational users, and the requirements of ecological habitats.

Research currently underway in the Bank addresses this problem. The "Service Level Indicators for Capital" (SLIC) research sponsored by the International Economics Department is seeking service level indicators for public facilities (sewerage, water, etc.) and for natural resources, based on measures of quantity, quality and reliability for both users and decision-makers. Included in this research effort is a framework for applying Service Level Indicators through Benefit/Cost analysis. This extends the usefulness of these measures into investment decisions. SLIC creates a bottom-up measure of resource performance, provides an information base which allows users and managers to view how decisions are made and the effects they have, and establishes a transparent accounting framework for government service and natural resource decisions based on the level of services they provide to users. SLIC indicators are currently being formulated in a number of different Urban Development projects in Indonesia.

Service indicators for water resources can be related to the specific uses described above for water resources. Indicator sets for each purpose would be specified by aggregating relevant measures. Service levels for industrial or agricultural water supply users would be based on physical measures; for household water users or recreational users, service levels might be based on total health risk; for ecological habitat, service levels could be the number of viable ecosystems exposed to risk in the river stretch or habitat area.

By identifying and monitoring the specific environmental quality measures identified as important by decision-makers and users, SLIC will improve the effectiveness of infrastructure and natural resource management decisions, and help establish operations and maintenance priorities for public infrastructure. In addition, by measuring these indicators over time, SLIC should be able to establish trends in environmental resource quality, improving natural resource accounting, and defining more precisely the relationship between natural resources and economic development. And as SLIC enables line managers to make better decisions, publicly available service level indicators can also enable users to hold service providers accountable for the level and quality of the services they receive, both from government facilities, and from other providers.

purview of the Bank. The Bank's interest in the rule of law is from the vantage point of development management. As we will see below, the aspects of the rule of law are varied and so are the views about them. Not all have the same bearing on the purposes of the Bank. Moreover, how the legal system operates is highly culture specific and the Bank needs to approach work in this area with a proper understanding of the historical and cultural context.

35. From the great variety of definitions, two major aspects of the rule of law emerge. The first is sometimes called the instrumental notion of the rule of law. It concentrates on the formal elements necessary for a system of

law to exist without judging the content of the laws or their purpose.

36. The second aspect refers to the content of the law and is linked to concepts such as justice (e.g. the element of due process), fairness (the principles of equality) and liberty (civil and political rights). In the view of many, the formal aspect has to be complemented by substantive principles of the rule of law to create a "fair" legal system. In terms of the Bank's work, a "fair" legal system would have to be conducive to balanced development, e.g. a system which facilitates growth and responds to the needs of the poor. These would seem to represent issues the Bank is normally concerned with in its project and policy lending. They are outside the scope of this analysis which focusses on the basic "processes of the formulation and application of rules," (Shihata 1991: 45) and analyzes each of the five elements listed in "Issues of 'Governance'." In so doing, we incorporate the Bank experience so far, and draw conclusions for Bank operations and the relationship of the rule of law with the other elements of governance considered in this paper. The five elements are: (i) a set of rules known in advance; (ii) rules to be actually in force; (iii) mechanisms to ensure application of the rules; (iv) resolution of conflicts through binding decisions of an independent judicial body; and, (v) procedures for amending rules when they no longer serve their purpose.

A Set of Rules Known in Advance

37. This comprises three elements: the existence of rules as a set (denoting coherence), their communication (with accuracy, clarity and effectiveness) and the application of rules only known in advance (non-retroactivity of laws). Communication and coherence are two elements with which the Bank has been concerned. As regards *communication*, many developing countries inherited formal rules for the communication of laws similar to those of the metropolis. Frequently, the obligation of governments to disseminate new laws was and still is limited to their publication in gazettes. The law is available but the citizens have the burden of acquainting themselves with the law.

38. Publication of the official gazettes in many countries has ceased. The Bank has assisted or is in the process of assisting several countries to restart at least publication of the gazette (Box 7). It is also assisting in making the law more accessible and better known within the government itself.[3] However, in many developing countries, large segments of the population are illiterate, the media are ineffective and languages are diverse. Under these circumstances, there are obvious limitations as to how much the law can be known and understood by the average citizen and it is necessary that law be as clear and explicit as it is technically feasible.

39. To the extent that economic policies must be reflected in rules which are to be complied with, governments need to make these rules known through all possible means of communication. Rules are understood here in a broad sense and include legislation, courts' decisions, guidelines, etc. When land is being expropriated, for instance, simple explanatory pamphlets outlining the rights of those affected and explaining how they can exercise those rights should be made available to the population affected. Knowledge by people of their own rights contributes to limiting the arbitrary behavior of government officials and assist in creating the climate of predictability associated with the rule of law.

40. As regards the *coherence* of the rules, when conditioning disbursements in specific Bank operations on the enactment or modification of certain laws, it is essential for the success of the operation that the country implements its own rules. A decree, for

BOX 7
Communication of the Law

MAURITANIA: Development Management Project (Credit 1865 MAU)

The publication of the Mauritanian Official Gazette was done under a contract between the Government of Mauritania and a French printing company located in Bordeaux. This arrangement was however not effective and the Gazette was rarely published. Then the Government of Mauritania, with the assistance of IDA and the French Government, decided to print and publish the Official Gazette domestically. To do so, a contract was awarded to a private printer and the functioning of the Department of the Legislation (Services of the Presidency) was improved within the framework of the above-mentioned IDA Credit. The French Government provided technical assistance in the preparation of the Official Gazette using the French Official Gazette as a model.

The Official Gazette which had not been published for over two years, has now been published in French and Arabic on a monthly basis for the last two and a half years.

GUINEA: Second Economic Management Support Project (Credit 1963 GUI)

The Guinean Official Gazette was experiencing delays of up to two years in the printing of its issues. In order to correct this situation, the Secrétariat Général du Gouvernement (SGG) obtained, as part of this project, US$80,000 from USAID to finance printing of the Official Gazette for two years, and signed a contract with a private printing company to ensure its regular publication. In addition, the contract provided that the backlog caused by the two-year delay in the publication of the Gazette be gradually eliminated.

As of January 1989, the Official Gazette has been published fortnightly. Texts of a general nature and government decrees are published within a month of their signature. The backlog of previously unpublished legislation is being cleared.

The SGG is responsible for the distribution of the Official Gazette within the Government and the subscriptions and sales to public. It is expected that, as revenues from legal notices increase, the Official Gazette will be able to fund itself.

LAO PDR

In 1975 the National Congress of the People's Representative in the Lao People's Republic abolished the former constitution and all existing laws and regulations. In 1989 the government endorsed the establishment of a new economic mechanism, separating the state's administrative and regulatory function from production activities and increasing the role of the private sector. Under a component of a UNDP-funded project supporting the New Economic Mechanism, the Bank will assist the government to prepare and implement key economic and financial legislation, to train lawyers in business law and to establish a center of economic law. As part of such activities the project will make a proposal to the government to establish an official gazette to publish and promulgate new laws and regulations.

instance, should not derogate from legislation. There should be no contradictory statutes. There are, for instance, countries whose constitution forbids private ownership of the means of production. In the context of private sector development operations, the Bank needs to ensure that the operation is based on a sound legal premise (Box 8). In this respect, it would be advisable that, whenever possible, local legal expertise be brought into the picture together with any expertise from abroad as may be needed.

Rules to be Actually in Force

41. It is not enough for a law to be on the books: it has to be applied, it has to be in force in reality and not only in the formal sense, and most important, it has to be complied with. When a law is left in

BOX 8
Legal Inconsistencies in Eastern Europe and Africa

The centralized systems of state planned economies of Eastern European countries face a number of legal problems in their efforts toward economic reform and the development of market economies. Lately, these countries have been introducing reform elements for private sector development. However, contradictions and inconsistencies are often encountered. For example, several countries have started privatization efforts. In this process some have already amended their constitution to make provision for private property rights. Others have not yet changed their constitution to this effect, but, nevertheless, proceed with the privatization effort. In the context of Bank operations an effort should be made to address these issues which can hamper reform. Following are some examples.

In Romania, there has been considerable legislative activity. With regard to private sector development, the law on Restructuring State Economic Units as Autonomous Units and Commercial Companies was passed in September 1990; a draft law on Privatization (currently under consideration) will govern this issue. Other laws under preparation will cover bankruptcy, commercial and company law, foreign investment and small and medium enterprise development (to supersede Law No. 54 defining and permitting small enterprises, which was passed in early 1990). These laws are reducing the role of the government in productive activities while retaining its monitoring functions, introducing private ownership and encouraging foreign investment through joint ventures. The legal framework is, however, operating under the severe constraint of the clearly defined property rights. The Parliament has been given two years from the time of its inception to develop the relevant provisions.

By contrast, in Czechoslovakia, amendments were introduced to the Constitution effective May 1, 1990, recognizing all forms of ownership rights, and providing that they (whether state, cooperative or private) enjoy the same level of protection and that no form of property ownership has a privileged status. A law on Small Privatization was introduced effective December 1, 1990, while a law on Privatization is currently under consideration.

Another example which illustrates the effects of inconsistencies and contradictions in a legal system is the following: the socialist economic system has been protected by the rules of constitutional law, labor law, administrative law, as well as by the rules of criminal law. In the Soviet Union, "undesirable" economic behavior has been controlled through criminal or administrative sanctions for behavior which violates accepted socialist norms and undermines the economic system. There are several articles in the criminal and administrative codes of most republics which criminalize behavior that in a market system is rational and economically desirable. It seems that many of these articles will be eliminated in the next major revision of the codes. In the meantime, however, the existing criminal codes continue to stand and to hamper the economic reform effort. Prosecution under most of these articles continues, with thousands of convictions per year. Even if it is not feasible to amend the codes immediately, steps need to be taken to limit the effect of these provisions on those who wish to engage in new forms of legitimate business.

Although the Eastern European countries are the most striking example, similar examples can be found elsewhere. For instance, Guinea-Bissau is presently amending its Constitution, approved May 16, 1984, as part of a general political transition from a socialist state to a more "capitalist" state. An impediment to developing the private sector is Article 12 of the Constitution, which provides for state ownership of all land (leases are granted to private individuals), minerals, banks, insurance companies, etc. Article 13 also provides for state control of foreign trade and exchange transactions. One of the objectives of the legal technical assistance provided to Guinea under the Second Economic Management Support Project is to coordinate the various donor financed pieces of legislation so that they dovetail as a whole.

abeyance or is not respected, the answer does not necessarily need to be a new law. An analysis of why the old law does not work will avoid placing yet another law on the books.

42. The reasons why laws are ineffective vary greatly. In many developing countries, the fact that many laws are not applied is often related to their inadequacy to the local situation. They had been transplanted from other countries and not adjusted to the local situation. Alternatively, they were not updated to current developments in the countries concerned. For a law to be effective, one has to consider many elements leading to its observance. Such diverse factors as custom, geography, technology, and history play a role in inducing obedience to laws. Because of these factors, the same law and its sanctions in different times and places within different physical and institutional environments will not induce the same behavior. Furthermore, societies evolve and laws may become obsolete. There is a certain inertia in legal systems and they simply may not have been updated to take into account social, business or technological changes.

43. Another obvious reason why laws fail to be applied is the absence of competent administrators of the legal system. The law is not only a set of rules but it encompasses procedures and institutions for implementing these rules. To the extent these are lacking, laws most likely will remain on paper.

44. Donors must be sensitive to the variables which affect the success of the transfer of legal institutions and the application of the laws. They must also be aware of the limitations of sanctions to induce behavioral change. Punishment best enforces already institutionalized law, nudging the occasional deviant into conformity. In many instances, it is more appropriate to use incentives and roundabout measures to achieve results, normally, at lower costs than punishment and to the relief of over-burdened courts.

45. As regards legal institutions, the Bank may assist in improving the efficiency or competence of judicial systems to reduce the costs of economic transactions. In advising governments to adopt new laws, the Bank should be fully aware of implementation constraints. As regards enforcement of the laws, some aspects of it have a clear bearing on economic development and have been the subject of Bank operations; for instance, improvement of tax collection, and changes in security laws to permit financial institutions to foreclose on debt and mortgages (Box 9).

Mechanisms to Ensure Application of the Rules

46. Mechanisms must exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures. The concept of the rule of law requires furthermore that all government officials act within the ambit of the law. State power ought to be exercised under the authority of law. The proper application of the rules by government officials is the essential element of establishing legality and -- in conjunction with the idea of justice -- legitimacy. To act within the law means that the executive branch of the government bases its actions on the statutory power from which government officials derive their authority and that the exercise of such authority is within the boundaries set by the law.

47. Of course, the legislation authorizing government actions cannot prescribe for all circumstances precise and clearly-defined standards. Thus, while the proper application of the rules should ensure predictability, it must always leave some room for flexibility. Further, market competition functions as a limit to public discretionary power. (Citizens can choose private provision over public provision services.) Yet, there are complex choices on how to delegate discretionary power to the bureaucracy. Traditionally, the rule of law called for narrow grants of discretion. But the complexity and variety of

BOX 9
Enforcement

In Guinea under the Private Sector Promotion Credit, the deficient functioning of the judicial system and the legal void on bank sureties has been identified as major constraints for banking activity in the country. Banks are unable "to enforce their rights as creditors through foreclosures or other court-approved actions, due in particular to debtor-judge collusion and rampant corruption" (GUI Report; 5207-55). This operation is a modest start to address these problems and it will be followed by training of the judiciary and legal professions in banking and commercial matters and by improvements in material working conditions.

In Sri Lanka, the Association has been working in two operations in the financial sector to reform the laws allowing financial institutions to foreclose on collateral pledged under loans. Sri Lankan law had prevented direct execution by institutions, who were forced in each case to go to court to get a judgment before they could move against the property. This protection for debtors stemmed from historical concerns about unscrupulous money lenders but did not match the needs of a modern economy. On the advice of the Association the law was changed to permit direct execution. The result is a law which establishes a better balance between the rights and obligations of debtors and creditors.

In the Philippines as part of the Financial Sector Adjustment Loan, the Bank not only advised that the lengthy holding period for repossession by debtors of pledged property be shortened to a more reasonable period, but also that the 1905 bankruptcy law be revised to make it less punitive on debtors and more rehabilitative, in the interests of both creditors and debtors.

issues in modern times have led to increasing delegation of authority to the executive branch based on broad standards, discretion secures flexibility and responsiveness to different situations which could not have been predicted by the legislatures. (For example, environmental legislation often must accord discretion to local public officials.) Discretion represents a counterweight to legal formalism.

48. Discretionary power is not absolute power. Discretion in law is always limited. The most basic guidelines for the exercise of discretion require that any exercise of powers be based on reasons, that these reasons be applied consistently, fairly, and impartially, and that they be intelligibly related to a framework of purposes, policies, principles and rules.

49. As with all exercise of power, there is a need to ensure the respect for these limitations to secure the correct exercise of discretion. Thus, there is a need for mechanisms to ensure the proper application of laws, and rules that regulate how to depart from them. Several different forms of checking administrative action and avoiding the abuse of discretionary power have been adopted in various legal systems ranging from review by independent civil and criminal courts to specialized administrative courts and ombudsmen.

50. In addressing the issue of functioning and effective institutions, the Bank has assisted borrowers to improve their civil service and to establish well-defined administrative structures. Support of civil service reform has concentrated on better training for civil servants, pay structures and the need to ensure that the financial remuneration of civil servants is adequate. The Bank is advising governments on how to improve their administrative decision-making processes and to establish administrative structures which clearly assign authority and responsibility.

51. At times, the proper application of the rules is hampered by an overabundance of -- in some instances -- contradictory or obsolete rules and regulations which overwhelm the bureaucracy. The Bank is assisting countries to review, update and simplify their legal systems.[4] Such reforms of legal systems will improve the administrative capacity of the government to regulate the economy and to reach administrative decisions based on a clear set of new and relevant laws (Box 10).

Conflict Resolution

52. Conflicts in the application of the rules can be resolved through binding decisions of an independent judicial or arbitral body. The existence of an independent judicial or arbitral body which can render binding decisions with respect to conflicts in the application of the rules is an essential element of the rule of law concept. The law loses its conflict-resolving and confidence-inspiring function if there is no independent and credible judicial system which assures that private contractual arrangements are respected and that the law is applied uniformly by the executive. With regard to the first aspect, it is obvious that confidence in the enforceability of agreements and commitments is instrumental to the proper functioning of an economy and the conduct of private economic activities. If there are unreasonable delays and high costs in enforcing laws and agreements between private parties, the efficient conduct of economic activities is hampered. With regard to the second aspect -- i.e. the check on government actions -- it is also evident that a strong judiciary can provide an effective shield against the concentration of arbitrarily exercised executive power.

53. The state of the judiciary in a number of developing countries is precarious. Even in those countries where there is a nominally independent judiciary, the courts are usually overworked and dispute resolution takes a long time. Often, the courts lack proper facilities and there is an urgent need for improving the training of the persons involved in the administration of justice. Despite all this, arbitration proceedings outside the court system are not well-developed.

54. There are several Bank operations under preparation that will assist member governments in the training of judges in economic and business law and may go as far as recommending certain division of labor in the court system so that commercial matters would be handled by specialized courts. (Box 11).

55. In assisting to make the court system more efficient and competent the donors may wish to look beyond the basics of training and of providing adequate physical facilities. For instance, many developed countries also have in the past encountered the problem of a judiciary too unwieldy, expensive and slow to handle disputes. The answer has not necessarily been to improve on the courts but to expand extra-judicial means of settlement by permitting commercial arbitration.[5] Another alternative is to search what caused the growth of disputes by updating or clarifying archaic or uncertain legal situations. The business world has also responded by rationalizing business practices through the development of standard forms and patterns of doing business. The courts themselves may help by mass handling of certain commercial matters, e.g. garnishment and collection of debt. These are areas within the mandate of the Bank in as much as functioning rules and institutions, including an effective dispute-settlement mechanism, are essential for economic development.

Amendment Procedures

56. *There are known procedures for amending the rules when they no longer serve their purpose:* As noted above, the rule of

BOX 10
Reform of the Regulatory Framework

GHANA: Financial Sector Adjustment Credit (Credit 1991 GH)

Banking activities in Ghana have been governed by laws and regulations enacted in the 1960s and early 1970s with a number of amendments and decrees issued on an ad hoc basis since the enactment of the original legislation. Several serious omissions in this body of legislation, together with weak bank supervision, led to the concentration of risk in the portfolios of banks, inadequate capital and reserves, inflated profits and unrecognized loan losses.

In connection with the IDA-financed Financial Sector Adjustment Credit, the Government of Ghana established a committee of legal experts to review the existing legislation, draft the changes necessary to improve the regulatory framework and introduce prudent standards to ensure the viability of the banking system. Risk exposure limits as a percentage of capital have been set on a bank's exposure to a single customer or related group. A minimum capital-adequacy ratio has been established, taking into account the quality of the bank's assets as well as its off-balance-sheet risks. Banking supervisors will have the ability to mandate even a higher capital-adequacy ratio, when, in their opinion, conditions warrant. Banks which do not meet the minimum guidelines are not allowed to pay dividends. New regulations specifying the format and content of audit reports and the minimum scope of audit reviews have been introduced together with uniform accounting and auditing standards and prudent reporting requirements. The accounting standards include guidelines for loan portfolio review and classification, the treatment of interest on non-performing loans, and provisioning for potential loan losses. Monetary penalties for violations of laws and regulations are strengthened and will be periodically revised to serve as a deterrent to illegal and imprudent acts.

POLAND: Structural Adjustment Loan (Loan 3247 POL)

In Poland, the Government's Economic Transformation Program (ETP), pursues structural reform towards the establishment of a market economy. The SAL will support reform initiatives mainly in the areas of: (i) enterprise restructuring, privatization, private sector development, with emphasis on appropriate legislation to define the "rules of the game" (including privatization, demonopolization and competition), the establishment of an adequate institutional framework for enterprise restructuring; (ii) financial sector reform, with emphasis on improved banking regulation and supervision, introduction of adequate accounting and auditing standards, etc. and (iii) social safety.

SRI LANKA: Economic Restructuring Credit (Credit 2128 CE)

The Economic Restructuring Credit (ERC) supports the Government's efforts aimed at stabilizing the economy and implementing structural reforms. In addition to addressing the country's serious internal and external imbalances, the size of the public sector, its claim on resources and the efficiency with which it uses its resources, the ERC also focuses on the development of the private sector through improvements in the existing regulatory framework and incentive system and through transfer to the private sector of activities and assets now being managed by the public sector.

law is instrumental in creating a climate of predictability and stability -- as the antithesis to governmental arbitrariness. Rules that are constantly changing cannot fulfill this function. Neither can rules that are arbitrarily repealed, amended or waived. The perception of arbitrariness and subjectivity is created by ad hoc decisions whereby the creation, amendment or invalidation of laws is undertaken without known and established procedures. Laws created this way will be perceived by those affected as not being enacted through "the right process." Furthermore, it will lead to a general lack of

Box 11
Improving the Judiciary

BANGLADESH: Financial Sector Adjustment Credit (Credit 2152 BD)

The court system in Bangladesh took an average of 10-15 years to dispose of suits brought by financial institutions against defaulting borrowers. The result was that transaction costs were extremely high and collection rates were very low. With the assistance of the Association and the International Monetary Fund, Bangladesh enacted a Financial Loan Courts Act in 1990 which established special commercial courts in the major economic centers of Bangladesh, whereby financial institutions could bring actions against defaulting borrowers and the loans could be adjudicated. Progress, which to date, has been highly favorable, is being monitored under the Financial Sector Adjustment Credit and involves the establishment of courts, appointment of judges and disposal of cases.

obedience to the law beyond the particular rules, and affect the credibility of the whole legal system.

57. The requirement of procedures in place for amending or repealing laws is limited to the existence of such procedures. It is the prerogative of the country concerned -- and outside the mandate of the Bank as stated earlier -- to decide how the legislative process is organized, including whether a separate legislative body should exist. What matters is that the public is aware of the process through which laws can be amended, repealed or waived.

58. In the context of attempts by borrowers to introduce legal reforms, the Bank has stressed the importance of having appropriate procedural rules in place for enacting and/or repealing laws. In order to improve the technical capabilities of the countries concerned in drafting procedural rules and regulations, the assistance financed by the Bank has supported governments' legal offices, i.e. Attorney General, Ministry of Justice, etc., and consisted of training and technical assistance (Laos, Guinea and, under preparation, Angola and Mongolia).

59. The foregoing analysis of the procedural and institutional elements of the rule of law has focussed on their contribution to establishing a "good order" understood as "a system in place, based on abstract *rules* which are actually applied and on functioning *institutions* which ensure the proper application of such rules" (Shihata, 1991: 43). The existence of such a system is needed for economic development; in particular, the economic reform policies introduced by many of the Bank's members and supported through Bank operations cannot be implemented effectively if these reform measures are not translated into workable rules and applied by functioning institutions in a proper and appropriate manner. Thus, the elements of the rule of law discussed above address these processes of the formulation and application of rules and constitute the procedural framework and institutional system which -- if adhered to by the governments concerned -- lead to *stability* and *predictability* and elicit *compliance* with the rules.

60. The rule of law and the various other elements of sound development management are closely interrelated. By simplifying existing rules and limiting discretion in certain decisions the Bank has assisted in reducing the opportunities for corruption. The publicity

that the Bank has insisted on in the administration of certain processes such as procurement has increased transparency in decision-making. Also, the development of communication systems for making the laws known helps in making governmental bureaucracies more accountable.

C. INFORMATION AND TRANSPARENCY

> "Information is now a crucial determinant of the pace of social and economic change."
> *Report of the South Commission (1990: 196)*

61. A competitive market economy requires that economic actors have access to relevant, timely, and reliable information. The less available or credible the information the greater the uncertainty and risk, and therefore the cost, of committing capital or labor. In all countries government is a major source of information, and sets many of the requirements for other providers as well. Information about the economy, about particular market conditions, and about government policies and intentions is all central to private sector calculations, and is either provided by government or greatly influenced by what government requires other entities to make publicly available.

62. Governments have legitimate reasons to withhold some types of information -- on aspects of state security, for example, or where premature disclosure could invite behavior undermining the policy (e.g. changes in exchange rates). Aside from these special cases, three areas are discussed where improved information and greater transparency are beneficial: economic efficiency, transparency as a means of preventing corruption, and the importance of information in the analysis, articulation and acceptance of policy choices.

Information, Transparency and Economic Efficiency

63. Economic efficiency requires that information about government policies and actions be available, that major processes of economic decision-making (for example the budget) are reasonably transparent, and that there is some opportunity for public comment or influence in the process of economic policy-making. This last aspect is of course greatly influenced by a country's government and traditions about political participation and public debate -- questions beyond the Bank's purview. With that limitation in mind, there are three important reasons for greater transparency in policy making as it impacts upon economic efficiency.

64. First, where government economic decision-making is unexamined and uncontestable the dangers of corruption and diversion of public resources (including external assistance) increase. Transparency is not a sufficient condition to control corruption, but it is in most circumstances a necessary one, as will be discussed below.

65. Second, closed decision-making increases the risk of government error -- and of negative reactions. Government's impact on the private sector environment, through an array of influences from monetary and exchange rate policy through taxation and expenditure policies to public procurement, is pervasive and profound. Where decisions in these areas are taken in relative isolation from private-sector reactions, the likelihood of costly mistakes increases -- fiscal policy is a common example. In other instances, governments may be surprised by angry public reactions to the economic consequences of secretly made decisions -- for example, over pricing and subsidies -- when a more open

process of public education and debate might have both improved policy design and eased public acceptance.

66. Third, the efficiency and effectiveness of economic actors, and the competitiveness of markets, requires broadly based access to relevant information. A common problem hindering the development of capital markets, for example, and of equity-based financing in particular, is the lack of clear disclosure rules based on audited accounts of private and public enterprises. Lack of transparency in financial markets often leads to arbitrary and capricious relations between commercial banks and their clients. Without proper accounts and disclosure, neither bank lending nor investment through the capital markets can be based on a firm assessment of credit worthiness. This assessment is necessary to evaluate risk and adequately price the cost of capital to the borrower. The capital market remains circumscribed to a narrow range of firms and instruments protected by either implicit governmental guarantees or by the "reputation" of the most powerful economic groups. A lack of transparency may be especially damaging for banking systems. It can lead to a large accumulation of non-performing assets which would cause bank failure, except for the fact that throughout the developing world deposits are usually explicitly or implicitly guaranteed by the state. Private losses are therefore socialized, as non-competitive risk-taking siphons resources from productive uses to speculative activities.

67. The Bank has been primarily concerned to work with governments to ensure broad awareness and acceptance of economic reform programs (e.g. in the context of structural adjustment operations), and to focus government attention particularly on the impact of its actions on private sector confidence and the business environment. Madagascar's government, on its own initiative, and without Bank involvement, has issued guidelines for openness which represent remarkable progress for a government that leaned towards secrecy not long ago (Box 12).

68. The Bank is also active in several specific areas where transparency is an important issue: in public expenditure decision-making (see PSM paper); in assisting governments to improve public procurement; and, increasingly, in the assessment of environmental impact. Public disclosure of environmental assessments is one instrument that the Bank is encouraging governments to use as a way of ensuring greater accountability and transparency. This is particularly critical in ensuring that people involved in involuntary displacement by development projects (such as the Narmada and Upper Krishna river) are kept fully informed of the results of such assessments. Thus, under the Ecuador Municipal Development and Urban Infrastructure project (FY91) an attempt is made to ensure public review of environmental impact studies of infrastructure projects.

Prevention of Corruption

69. Clearly, the main weapon against corruption is to reduce the opportunities for it to a minimum -- to eliminate economic distortions and administrative controls, and therefore to reduce the scope for illicit arbitrage and bribery, "dash," "speed money" and the like. Transparency in government business has a vital ancillary role. The Bank's involvement in transparency is through its work on public expenditure (transparency of budgets, elimination of "caisse noires"), through its assistance to governments in establishing transparent procurement procedures and conducting environmental assessments.

70. Since central government ministries as principals must -- and should -- delegate to a wide variety of agents the implementation of

BOX 12
Transparency in Government:
The "Ten Commandments" in Madagascar

The following are excerpts from an Official Communication published in the December 18, 1990 issue of the Official Gazette of Madagascar.

FROM: The President of the Democratic Republic of Madagascar

TO: The Prime Minister and Head of Government and the Presidents of Institutions

...

The terms of annexed communication from the Prime Minister...will serve as a rule of conduct and as general guidelines...The Government and other institutions of the Republic are requested to ensure that this is given the widest possible circulation and is applied in both the central and the local public services...

Communications

My own observations and complaints reaching my office lead me to submit the following proposals with a view to establishing a proper code of conduct within the Administration as regards its relations with the public. The principal aim is to improve attitude and behavior in the Administration and to preserve trust between the Administration and the public.

1. The Administration must not be permitted arbitrarily to block correspondence addressed to it.

...

The principle must be that the authority that is addressed must forward the request to the authority with power of decision. The former is free to issue a favorable or unfavorable opinion, but must nonetheless pass the request on. If it believes that the dossier is incomplete, or deficient in some other way, it should inform the applicant and ask him to put matters right; this is particularly important as regards our incentives for investors...

...

2. The Administration should assist the public.

...

3. The Administration should facilitate inquiries by the public.

...

Requests from the public sometimes relate to laws or regulations that contain all the relevant information being sought. The Administration should therefore make leaflets, etc., available to the public...In brief, each agency should make available to the public all the necessary information regarding the activity...Within each agency, a public information unit should be established...

...

4. The Administration must establish and observe set periods for handling requests.

Few laws or regulations stipulate that the Administration must respond within a certain period. As a result, the public is at the mercy of officials and is never certain as to when it will get a reply...Some departments have made efforts to improve this situation by stipulating maximum periods...This practice should be extended to all agencies...

(continued on next page)

policy choices, there are inevitably asymmetries in who has access to quality information. Reporting and monitoring systems can update the information base of principals but there are always opportunities for agents to engage in rent-seeking, or private appropriation of gains to be made from insider information. Monitoring and supervision of these agents is a perennial management concern; making most information a matter of public record is one of the mechanisms for doing so. Guidelines on public information policy generally include criteria for users, rules about time lapses prior to disclosure, and clear rules for access. Precisely because information is scarce, and therefore valuable, information policy needs careful attention.

71. Few areas of government activity are more prone to problems of corruption than

BOX 12
Transparency in Government:
The "Ten Commandments" in Madagascar

(continued)

5. The Administration must have the courage to question certain principles.

(a) The principle that silence is equivalent to a refusal...it is time to stipulate that silence...after a certain period has elapsed, is equivalent to acceptance...

(b) The legal principle of implicit rejection.

It is high time the Administration understood that time is money.

6. The Administration must opt systematically for the automaticity of decisions.

The administration's discretionary power must be reduced to a strict minimum by the publication of clear and precise rules of the game, which it must respect. Regulations and laws that have an impact on the public must move towards this objective, which is also stated as a principle...regarding the conceptual framework for the preparation of laws.

7. The Administration must do away with anonymity.

The myth of the anonymous civil servant is no longer appropriate in a modern administration. The names and positions of agents interacting with the public should appear on nameplates on their doors or be posted on signs in their offices so that people know who they are dealing with. The use of badges could be courteous innovation....

8. No official should have permanent tenure of a position requiring contact with the public. Periodic rotation, even if only within the organization, is strongly urged... The Head of State issued a directive on September 12, 1990 to the effect that enforcement agents should not remain in the same position for more than three years...This measure...should be extended to other officials in contact with the public....

9. The Administration must know how to punish and reward.

There are some good officials and they must be encouraged and rewarded...Poor officials, on the other hand, should be punished and their promotion should be prohibited.

The best way to assess an official that works with the public is to listen to what the public thinks about him. An official, fully documented register could be provided for members of the public to record their complaints or their satisfaction...

10. The Administration must evaluate itself and be open to external audits.

Self-evaluation is carried out by an internal audit unit which each agency must establish to monitor its operations, verify how, and how fast, dossiers are handled and study users' complaints....

that of customs and procurement. Some countries have resorted to correcting the mismanagement of customs by contracting out the customs service to a wholly independent private sector enterprise (Indonesia). Public procurement, on the other hand, is not a self-contained procedure which can be handled in this manner -- though inspection and supervisory services can play a valuable role. Further, procurement is a critical aspect of project and program implementation.

72. Procurement difficulties are symptomatic of problems of government capacity, and of the inherent pressures when large contracts are in play. Since 1983, the Bank has been systematically undertaking country Procurement Assessment Reviews (CPAR) which review public procurement

laws, procedures, and institutions in borrowing countries to identify any fundamental conflict with Bank procurement guidelines, and to decide on acceptability of local procedures for contracts which are appropriate for ICB. The procedures are assessed from the perspective of competition, transparency, disclosure of selection criteria, award to lowest qualified bidder, fair contract conditions, mechanisms for dispute settlement, and an assessment of institutional capability and efficiency in implementing Bank operations.

73. With the advent of adjustment lending, the CPAR has expanded to parastatal and private sector procurement practices and their compatibility with practices in market economies in developed countries. To date, CPARs have been completed for 60 countries with the remainder in the process of being completed; they are updated every four years.

74. Where institutions are weak or procedures inefficient, the loan includes technical assistance components, or support to hire procurement agents. Thus, for example, technical assistance has been provided to improve the institutional framework and introduce more efficient procedures in Uganda and Madagascar. In other cases, new procurement codes have been issued. In the Philippines, action was taken under a Debt Management Loan to streamline overall procurement rules and procedures so as to permit greater delegation of authority to implementing agencies and to establish standards to shorten contract award procedures. Work initiated under this project has been pursued under subsequent projects (the Fifth Highway project) and guidelines acceptable to the Bank are now available for local procurement of goods and consultants. This has facilitated an easing of regulations relating to contractors thereby increasing their willingness once again to accept government contracts.

75. Several countries do not require public bid opening, and permit bargaining even after bids have been opened. The Bank is attempting, in such cases, to review the rationale for existing local procurement regulations rather than simply requiring conformance to Bank guidelines. It is attempting through local seminars and discussions, to focus attention, for example, on the importance of procurement processes to the development of local contracting capacity and pointing to the value for a development perspective, of adopting revised national systems to conform to international norms. In almost all reforming Central and Eastern European countries, institutions were not familiar with local or international competitive bidding. However, these countries are now requesting and showing receptiveness to Bank technical assistance on procurement legislation and procedures (Box 13). In 1990, the Africa region convened a conference on public procurement procedures at which African public officials presented papers along with procurement experts from developed countries on the merits of different approaches to improving the efficiency of public procurement.

Analysis and Dissemination Capacity

76. The collection and dissemination of economic data has been a focus of Bank assistance and advice for a long time, and has included, for example, support for statistical offices, technical assistance where appropriate, and capacity building. Despite these efforts, and the importance of data collection and dissemination, however, adequate economic information has been a casualty of the economic crisis and government stringency, especially in much of Africa. Central Banks which once produced excellent reports on the economy (as in Ghana) have ceased to do so, and government statistical series in many countries have become less timely, reliable, and complete. Given the expanded and more

BOX 13
Changing Procurement Policies and Practices in Eastern Europe

The countries of Eastern and Central Europe (Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia) are rapidly accelerating their transition from centrally planned to market-oriented economies, a process involving profound changes, also in the field of public procurement. They are increasing their externally supported investment project operations, in cooperation with bilateral agencies and international financing institutions. During the past forty years, the countries have performed public procurement through direct allocation of resources, or negotiated contracts. They do not have a recent background in using open, competitive bidding procedures, and vary in their abilities to applying international procurement practices.

The countries lack the requisite public procurement laws and related legal systems, regulations and experienced procurement officers. New and comprehensive legal systems for public procurement are required at all levels of government: national and local, and would ideally apply to all sectors. At the same time, training of procurement personnel would need to be performed on an urgent and massive basis, to implement the new procurement practices. The delays in project implementation caused by inefficient procurement practices may result in opportunity, interest, and inflationary costs of considerable magnitude (10-20% of total project costs).

The World Bank has, at the invitation of several of the countries, advised their senior officials on the requirements for implementing the needed legal and policy changes, and to train involved personnel. Contacts have also been made with multilateral and bilateral agencies which have a direct interest in the issues, with the objective of their participating financially and technically with the Bank in country and regional projects which would address the problems through technical assistance. Financing of such projects could also come from Bank loans, should the countries so request.

sophisticated requirements implied by the Bank's poverty and environment agenda, this is an area deserving more emphasis. China's post-reform Statistical Yearbooks are an example of how substantial breakthroughs can be made in the quality and availability of economic information.

77. The capacity of NGOs and institutions (professional associations, trade unions, business organizations, grass roots groups, research centers, universities and mass media) to articulate the needs of important constituencies, analyze policy requirements and contribute to policy formulation is an important aspect of accountability. Building this capacity is a central aspect of developing an enabling environment for growth. Information must be understood, processed, and used effectively. Capacities need to be developed -- in the universities, in policy research institutes, in economic committees of legislatures where appropriate, and in the media -- to understand information about development issues, and to contribute to broader public education in turn. The African Capacity Building Initiative represents a potential instrument for strengthening the role and capacities of a wide variety of non-governmental institutions. The Bank's External Affairs Department has also done much to improve access to economic information for developing country journalists.

ENDNOTES - Annex I

1. The concepts of "exit" and "voice" which originated in Albert Hirschman's classic work, Exit, Voice and Loyalty (Hirschman, 1970) have been adapted by Samuel Paul in his work for the PRE Working Paper No. 614 on accountability (Paul, 1990).

2. Sir Adetokunbo A. Ademola, Chief Justice of Nigeria, in his address to the Convention on the Rule of Law, organized by the International Commission of Jurists (Lagos, 1961).

3. This is the case of the legal information system included in the Social Sector Management Technical Assistance Project in Argentina (Loan 2984 AR).

4. A practical example is Ghana. The legal and regulatory framework governing private sector activities is being reviewed by the government in order to eliminate obsolete laws and revise other laws to reflect the policy change from a command economy to a free market system. This follows the changes of the regulatory framework for the financial sector which has already led to encouraging results.

5. For example, the Indonesia Report concluded that strengthening the arbitration system and arbitral bodies could improve contract enforcement and avoid some of the constraints in the judicial system.

ANNEX II
TASK FORCE ON GOVERNANCE

Adamolekun, Oladipupo O.	AFTPS
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Campbell, Tim	LATIE
Chaudry, Shahid A.	LATPS
Dia, Mamadou	AFTIM
Einhorn, Jessica P.	FODDR
Gruss, Hans Jurgen	LEGAF
Harris, Randolph L. P.	CODOP
Heyneman, Stephen Paul	EMTPH
Isenman, Paul	PRDDR
Jones-Carroll, Charlotte	PBDCP
Kohli, Harinder S.	EMTDR
Lacey, Robert Mark	EDICD
Lamb, Geoffrey B.	PRDPD
Landell-Mills, Pierre M.	AFTDR
Lateef, K. Sarwar *	EXTIE
Nankani, Gobind T.	LA1IN
Okonjo-Iweala, Ngozi N.	OPNSV
Pachter, Lisa	EXTIE
Paul, Samuel	CECPS
Pellegrini, Anthony J.	EMTIN
Rigo, Andres	LEGAF
Ritchie, Daniel	ASTDR
Sagasti, Francisco	EXTDR
Schiavo-Campo, Salvatore	AF3CO
Shakow, Alexander	EXTDR
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The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: September 10, 1991 07:04pm

TO: Mary Shirley (MARY SHIRLEY)

FROM: Sarwar Lateef, EXTIE (SARWAR LATEEF)

EXT.: 31760

SUBJECT: RE: Governance paper

I suspect that with the complimentary distribution (external) plus staff demand within the Bank, we will use up the 2000 copies. The initial distribution to managers alone must have reached 500. So if we have to reprint, we might as well get it in a form more enticing to external audiences like the tax and forestry paper. But that's obviously your call.

CC: Geoffrey B. Lamb (GEOFFREY B. LAMB)
CC: Coralie Bryant (CORALIE BRYANT)
CC: Alexander Shakow (ALEXANDER SHAKOW)
CC: Sonia Benavides-Paz (SONIA BENAVIDES PAZ)
CC: Institutional ISC Files (INSTITUTIONAL ISC FILES)

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: September 10, 1991 06:57pm

TO: Sarwar Lateef (SARWAR LATEEF)

FROM: Mary Shirley, CECPS (MARY SHIRLEY)

EXT.: 37483

SUBJECT: RE: Governance paper

I am not clear as to why the present printing is not suited to an external audience. Unless there is a problem with uncleared or unsuitable content I would see no reason not to use the present paper for a wider distribution. To reprint the paper because it needs minor copy editing (something I'm not sure of anyway) and a different color cover strikes me as a needless expense. You can understand my reaction is partly influenced by the fact that my budget has taken a lot of hits from PUB already for the PSM and PSD papers.

CC: Institutional ISC Files (INSTITUTIONAL ISC FILES)
CC: Sonia Benavides-Paz (SONIA BENAVIDES PAZ)
CC: Alexander Shakow (ALEXANDER SHAKOW)
CC: Coralie Bryant (CORALIE BRYANT)
CC: Geoffrey B. Lamb (GEOFFREY B. LAMB)

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: September 10, 1991 11:29am

TO: Mary Shirley (MARY SHIRLEY)

FROM: Coralie Bryant, PRDPD (CORALIE BRYANT)

EXT.: 31264

SUBJECT: Dissemination: Governance

Mary,

I had hoped we would have a chance top talk about this at the PSM retreat but as that didn't happen -- let's turn to it now. We have gotten the Governance Discussion paper through the printing stage and the distribution center has handled the preliminary distribution requested by Sarwar (all level 26s and up, all Division Chiefs, etc). In addition Sarwar will have 100 copies; and we will keep some here.

As you know, the Conablegram refers to your leadership of the Task Force with reference to the dissemination, so we will have the lot sent over to you. Perhaps, among other things you want to do in this regard, it might be good to send 10 (?) copies to each member of the Task Force? (There are people calling about getting copies all the time--I have fielded such calls -- as has Sarwar -- so far, but assume you will want all such calls forwarded to you at this point.) If you would like to discuss next steps, if any, let me know.

CC: Sarwar Lateef (SARWAR LATEEF)
CC: Geoffrey B. Lamb (GEOFFREY B. LAMB)
CC: Lynette Alemar (LYNETTE ALEMAR)
CC: PRD Policy Development Unit (PRD POLICY DEVELOPMENT UNIT)

ROUTING SLIP	Date Sep23, 1991
NAME	ROOM NO.
Ms. Brenda Turner, EXE	E-1229

	URGENT		For Action/Comment		Per Your Request
	Appropriate Disposition		Information/Discard		Returned
	Approval/Clearance		Note And Return		See My E-Mail
	File		Per Our Conversation		Signature/Initial

RE: Governance

REMARKS

As promised by Sonia Benavides of EXTIE, attached is a copy of the Governance paper for your files. Mr. Conable had signed a memo to Bank managers dated August 29 on this subject.

From	Room No.	Ext.
Lynette Alemar	S13-121x	31023

P-1862

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: September 10, 1991 11:29am

TO: Mary Shirley (MARY SHIRLEY)

FROM: Coralie Bryant, PRDPD (CORALIE BRYANT)

EXT.: 31264

SUBJECT: Dissemination: Governance

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CC: Sarwar Lateef (SARWAR LATEEF)
CC: Geoffrey B. Lamb (GEOFFREY B. LAMB)
CC: Lynette Alemar (LYNETTE ALEMAR)
CC: PRD Policy Development Unit (PRD POLICY DEVELOPMENT UNIT)

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: September 5, 1991

TO: Mr. Ivan Radan, GSDPT

FROM: Geoffrey Lamb, Chief, PRDPD

EXTENSION: 32544

SUBJECT: Authorization of Overtime Charges

Attached is form 14 requesting the printing of the paper, "Managing Development: The Governance Dimension." Please charge all overtime related to this order to PRDPD (620/20).

Thank you for your assistance in expediting this request.

THE WORLD BANK/IFC/MIGA

PRINTING REQUEST

This form must be typed — **Read instructions on reverse**

(Leave This Space Blank)

RECEIVED
91 SEP -5 PM 5:22
9202878 80 Winston x 80701

Title (or Description) of Item to be Printed	Report/Form No.	Report/Revision Date
Managing Development: The Governance Dimension		

Select One: ☒ Report ☐ Form ☐ Letterhead ☐ Complimentary Slip ☐ Other (specify) _____

No. of Pages	Quantity	Job	Classification (for reports only)	Date and Time Required
72 (inc. cover)	2,000	☐ New ☒ Rerun		09/09/91 10:00 am

Requested By	Ext.	Room No.	Dept./Div. Acronyms	Dept./Div. Nos.
Mr. Geoffrey Lamb, Chief, PRDPD	32544	S13-119	PRD/PD	605/20

SPECIFICATIONS

SIZE: ☒ 8-1/2x11 ☐ 8-1/2X14 ☐ 11X17 ☐ Other _____

TEXT: Color of Paper White No. of Pages _____ Print ☐ 1 side ☒ 2 sides

COVER: Color of Paper Sand Print ☐ 1 side ☐ 2 sides

COVER HEADING: ☒ World Bank ☐ IFC ☐ MIGA Masthead _____

CONSTRUCTION: ☐ Assemble ☒ Saddle-stitch ☐ Perfect Bind ☐ Staple upper left corner ☐ Staple two on side ☐ Pad ☐ Fold Finished Size _____ No. of Holes to be Punched: on top _____ on side _____ ☐ Carbonless No. of Parts _____

MAPS – Requesting departments are responsible for clearing all new, revised or previously printed maps with the Cartography Section, GSDPG. The Print Shop requires clearance before any map is printed or released from shelf stock.

Map Cleared By	Date	List ALL MAPS (by IBRD No.) in this space	Charts (by no.) in this space

PRINTING APPROVAL – Printing requests for reports and discussion papers must be be cleared by the Internal Documents Unit, JB3-180. — Approval Initials and Date

Order of Assembly/Additional Instructions

Delivery Instructions

580 ~~excess~~	copies to	Distribution Unit D-110	in room no. D-110
~~excess~~ 200	copies to	Lito Velasco	in room no. ~~S13-155x~~
	copies to	Sarwar Lateef	in room no.
excess	copies to	Mary Shirley	in room no.

Signature _____ Date _____

FOR PRINT SHOP USE ONLY

PRESS: ☐ Chief ☐ T-51 ☐ GTO ☐ Davidson ☐ Xerox ☐ Blue Lines ☐ Harris ☐ WEBCOM ☐ Apollo ☐ Didde ☐ Shinohara

COVERS: ☐ CI ☐ CII ☐ CIII ☐ CIV

BINDERY: ☐ Macey ☐ Saddle ☐ Perfect

No. of Pages to Tip _____

Text Signatures _____

Press for Cover _____

COVER INKS: ☐ Black ☐ Other _____

COVER STOCK: _____

No. of Sheets per Pad _____

Special Instructions

INSTRUCTIONS

This form must be typed.

What clearances do I need?

For Reports and Discussion Papers

This request MUST be cleared by the Internal Documents Unit, JB3-180

For Maps

To ensure that all maps included in Bank reports and publications are current and to avoid portraying politically embarrasing situations, maps must FIRST be cleared by the Cartography Section, GSDPG, before any printing request is made. This applies to all maps (or map negatives) older than six weeks -new, revised, previously printed or in the Print Shop shelf stock; or maps which were prepared by Cartography - whether they have appeared in non-Bank publications or have been produced utilizing PC graphics or mapping software packages. Request for clearances should be made to Cartography at least two weeks before the map is to be bound in a report to allow for any necessary changes and for the completion of the map printing cycle. For more details, refer to Administrative Manual Statement 7.10, Annex B or the reverse side of Form 1548, "Request for Cartographic Services."

What do I do once I have completed this form?

For Reports, Discussion Papers, Other Documents

Hand carry White, Yellow & Pink copies of this form to the Print Shop, GSDPG. The Pink copy will be stamped with the date and hour received at the Print Shop and returned to you. Keep Goldenrod copy for your records.

For Forms

Submit White, Yellow & Pink copies of this form to the Forms Unit, ITFIS, together with a blank copy of the form to be printed. Keep Goldenrod copy for your records.

For Stationery (e.g. letterheads, envelopes, complimentary slips)

Submit White, Yellow & Pink copies of this form to the Material Services Section, GSDMM, with a copy of the item to be printed or a marked up sample of what you want. Keep Goldenrod copy for your records.

FORM 339
(11-88)

THE WORLD BANK/IFC
DISTRIBUTION REQUEST

DOCUMENT TITLE						
Managing Development: The Governance Dimension						
DOCUMENT DATE	DATE OF DISTRIBUTION		FREQUENCY OF ISSUANCE		NO. OF COPIES TO DISTRIBUTE	
Aug. 29, 1991	Sept. 10, 1991		one time		one	
REQUESTED BY	DEPT.	DEPT. NO.	DIV.	DIV. NO.	ROOM NO.	EXT.
Mr. Geoffrey Lamb, Chief, PRDPD	PRD	605	PD	20	S13-119	32544

	All Staff	VPs/ DGO	Dept. Dirs.	Div. Chiefs	Chief/Res. Reps.	Advisers All	Advisers Econ.	Advisers Sr.	Economists All	Economists Chief	Economists Sr.	Economists Lead
BANK & IFC	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
Office of the President (EXC)	☒											
Executive Directors/Alternates	☐											
BANK ONLY	☐	☒	☒	☒	☒	☐	☐	☒	☐	☒	☐	☒
SVPFI	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Treasurer's	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Controller's	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Financial Policy and Risk Management	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
SVPOP	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Cofinancing	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Financial Intermediation Services	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Regional Offices	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
Country Department	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Technical Department	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
SVPPR	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Development Economics and Chief Economist	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Sector Policy and Research	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Operations Evaluation Staff	☐	☐		☐		☐	☐	☐	☐	☐	☐	
Legal	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Secretary's	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
SVPEA	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Personnel	☐	☐		☐		☐	☐	☐	☐	☐	☐	
IFC ONLY	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
CEXVP	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Vice President & General Counsel	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Engineering	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Portfolio Operations	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Investment Operations	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Finance & Planning	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐

SPECIAL INSTRUCTIONS

Copies will be sent by Print Shop when ready.

☐ Special list maintained by the Distribution Unit (Specify) _____

SEND SURPLUS COPIES TO (Name)	ROOM NO.	SIGNATURE	DATE
Mr. Geoffrey Lamb, Chief, PRDPD	S13-119	G.R.Lamb	

WHITE/YELLOW - Distribution Unit; PINK - Originator

1920 / Bnd

THE WORLD BANK/IFC
DISTRIBUTION REQUEST

FORM 329
(11-88)

SPRWPR — 2 Boxes — 240 copies T8101

PRPPD — 5 Boxes — 600 — 513-157

Mary Shirley — excess — N 9051

BANK ONLY
SVPFI
Treasurer's
Controller's
Financial Policy and Risk Management

SVPDP
Cofinancing
Financial Intermediation Services
Regional Offices
Country Department
Technical Department

SVPPR
Development Economics and Chief Economist
Sector Policy and Research

Operations Evaluation Staff

Legal

Secretary's

SVPEA
Personnel

IFC ONLY
CEXVP
Vice President & General Counsel
Engineering
Portfolio Operations
Investment Operations
Finance & Planning

SPECIAL INSTRUCTIONS

☐ Special list maintained by the Distribution Unit (Specify)

SEND SURPLUS COPIES TO (Name)	ROOM NO.	SIGNATURE	DATE

WHITE/YELLOW - Distribution Unit; PINK - Originator

FORM 339
(11-88)

THE WORLD BANK / IFC
DISTRIBUTION REQUEST

DOCUMENT TITLE						
Managing Development: The Governance Dimension						
DOCUMENT DATE	DATE OF DISTRIBUTION	FREQUENCY OF ISSUANCE	NO. OF COPIES TO DISTRIBUTE			
Aug. 29, 1991	Sept. 10, 1991	one time	one			
REQUESTED BY	DEPT.	DEPT. NO.	DIV.	DIV. NO.	ROOM NO.	EXT.
Mr. Geoffrey Lamb, Chief, PRDPD	PRD	605	PD	20	S13-119	32544

	All Staff	VPs/ DGO	Dept. Dirs.	Div. Chiefs	Chief/Res. Reps.	Advisers All	Advisers Econ.	Advisers Sr.	Economists All	Economists Chief	Economists Sr.	Economists Lead
BANK & IFC	☐	☐	X	☐	X	☐	☐	☐	☐	☐	☐	X
Office of the President (EXC)	XX											
Executive Directors/Alternates	☐											
BANK ONLY	☐	X	X	X	X	☐	☐	XX	☐	X	☐	XX
SVPFI	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Treasurer's	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Controller's	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Financial Policy and Risk Management	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
SVPOP	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Cofinancing	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Financial Intermediation Services	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Regional Offices	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
Country Department	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Technical Department	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
SVPPR	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Development Economics and Chief Economist	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Sector Policy and Research	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Operations Evaluation Staff	☐	☐		☐		☐	☐	☐	☐	☐	☐	
Legal	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Secretary's	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
SVPEA	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	
Personnel	☐	☐		☐		☐	☐	☐	☐	☐	☐	
IFC ONLY	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
CEXVP	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Vice President & General Counsel	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Engineering	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Portfolio Operations	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Investment Operations	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐
Finance & Planning	☐	☐	☐	☐		☐	☐	☐	☐	☐	☐	☐

SPECIAL INSTRUCTIONS

☐ Special list maintained by the Distribution Unit (Specify) _____

SEND SURPLUS COPIES TO (Name)	ROOM NO.	SIGNATURE	DATE
Mr. Geoffrey Lamb, Chief, PRDPD	S13-119	G R Lamb	

WHITE/YELLOW - Distribution Unit; PINK - Originator

THE WORLD BANK/IFC/MIGA

PRINTING REQUEST

This form must be typed — **Read instructions on reverse**

(Leave This Space Blank)

Title (or Description) of Item to be Printed	Report/Form No.	Report/Revision Date
Managing Development: The Governance Dimension		

Select One: [X] Report [ ] Form [ ] Letterhead [ ] Complimentary Slip [ ] Other (specify) _____

No. of Pages	Quantity	Job	Classification (for reports only)	Date and Time Required
72 (inc. cover)	2,000	[ ] New [X] Rerun		09/09/91 10:00 am

Requested By	Ext.	Room No.	Dept./Div. Acronyms	Dept./Div. Nos.
Mr. Geoffrey Lamb, Chief, PRDPD	32544	S13-119	PRD/PD	605/20

SPECIFICATIONS

SIZE: [X] 8-1/2x11 [ ] 8-1/2X14 [ ] 11X17 [ ] Other _____

TEXT: Color of Paper White No. of Pages _____ Print [ ] 1 side [X] 2 sides

COVER: Color of Paper Sand Print [ ] 1 side [ ] 2 sides

COVER HEADING: [X] World Bank [ ] IFC [ ] MIGA Masthead _____

CONSTRUCTION: [ ] Assemble [X] Saddle-stitch [ ] Perfect Bind [ ] Staple upper left corner [ ] Staple two on side [ ] Pad [ ] Fold Finished Size _____ No. of Holes to be Punched: on top _____ on side _____ [ ] Carbonless No. of Parts _____

MAPS – Requesting departments are responsible for clearing all new, revised or previously printed maps with the Cartography Section, GSDPG. The Print Shop requires clearance before any map is printed or released from shelf stock.

Map Cleared By	Date	List ALL MAPS (by IBRD No.) in this space	Charts (by no.) in this space

PRINTING APPROVAL – Printing requests for reports and discussion papers must be be cleared by the Internal Documents Unit, JB3-180. — Approval Initials and Date

Order of Assembly/Additional Instructions

Delivery Instructions

580	copies to	Distribution Unit D-110	in room no.	D-110
excess	copies to	Lito Velasco	in room no.	~~S13-155x~~
_____	copies to	_____	in room no.	_____
_____	copies to	_____	in room no.	_____

Signature _____ Date _____

FOR PRINT SHOP USE ONLY

PRESS: [ ] Chief [ ] T-51 [ ] GTO [ ] Davidson [ ] Xerox [ ] Blue Lines [ ] Harris [ ] WEBCOM [ ] Apollo [ ] Didde [ ] Shinohara

COVERS: [ ] CI [ ] CII [ ] CIII [ ] CIV

BINDERY: [ ] Macey [ ] Saddle [ ] Perfect

No. of Pages to Tip _____

Text Signatures _____

Press for Cover _____

COVER INKS: [ ] Black [ ] Other _____

COVER STOCK: _____

No. of Sheets per Pad _____

Special Instructions

INSTRUCTIONS

This form must be typed.

What clearances do I need?

For Reports and Discussion Papers

This request MUST be cleared by the Internal Documents Unit, JB3-180.

For Maps

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What do I do once I have completed this form?

For Reports, Discussion Papers, Other Documents

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For Forms

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For Stationery (e.g. letterheads, envelopes, complimentary slips)

Submit White, Yellow & Pink copies of this form to the Material Services Section, GSDMM, with a copy of the item to be printed or a marked up sample of what you want. Keep Goldenrod copy for your records.

Managing Development:
The Governance Dimension

A
Discussion
Paper

August 29, 1991

The World Bank
Washington, D.C.

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

August 29, 1991

MEMORANDUM TO BANK MANAGERS

Subject: Managing Development: The Governance Dimension

Attached is a discussion paper, entitled: "Managing Development: The Governance Dimension". The paper was prepared by a Bank-wide Task Force. It follows on the General Counsel's Legal Memorandum on "Issues of Governance in Borrowing Members" dated December 21, 1990. The paper was discussed by Executive Directors meeting as a Committee of the Whole on July 16, 1991.

The paper discusses approaches to the governance issue which promote the Bank's work and protect its reputation for technical excellence, professionalism and objectivity. I fully endorse the main messages of the paper.

I want to emphasize that this is not a policy paper or a call for a new initiative. It establishes a coherent framework for efforts going on in different parts of the Bank, and reaffirms certain basic propositions: that efficient and accountable public sector management and a predictable and transparent framework for economic activity are critical to the efficiency of both markets and government interventions -- and hence to economic development. A similar message is contained in the 1991 World Development Report.

The discussion of the paper in the Committee of the Whole was both lively and thoughtful. Governance is an emotive word, and more importantly, a potentially contentious issue internationally and within many of our member countries. It is not surprising that there were divergent views expressed by Executive Directors on the subject. Despite these differences, the approach taken in the paper received widespread support. In particular, several Executive Directors emphasized the following messages of the paper:

- Problems of governance are universal and are not particular to one Region, or only to the developing world. Each country is different, and a thorough understanding of the historical, social and cultural traditions of each country should underpin the Bank's response to such problems.

- There is a need to take a long-term approach to issues of governance.

- The Bank should be selective in its work on governance, recognizing the efforts of Bank and external donors cannot substitute for the domestic political commitment needed to undertake successful reforms.

There remains some apprehension among our borrowing members that our staff might exceed the Bank's mandate in ways which could be interpreted as interfering in the political affairs of our borrowers. This concern, given the difficulty of drawing neat lines in this area, is understandable. I am confident that you will respect the sensitivities and concerns of borrowers while not shying away from issues relevant to development performance when these need to be raised.

Until our borrowing members achieve a greater level of comfort with dialogue on governance matters and our own experience with it matures further, it is advisable that delicate policy issues are discussed only by senior managers (Directors and above). Technical issues, of course, can continue to be handled at staff level.

I want to thank the Task Force on Governance chaired by Sarwar Lateef for doing a good job on a difficult, nebulous subject. This group, now chaired by Mary Shirley, could assist you in the dissemination of this paper.

Barber B. Conable

MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION*

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* *This paper was prepared by a Task Force with participation from the Operations; Policy, Research and External Affairs; Legal; Corporate Planning and Budget; and Finance Complexes (see Annex II).*

MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION
A DISCUSSION PAPER

EXECUTIVE SUMMARY

(i) This discussion paper is a review of issues of governance that lie within the Bank's mandate. Such an analysis was anticipated in Mr. Shihata's Legal Memorandum of December 21, 1990, discussed at a Board Seminar on April 11, 1991, which set out "a legal framework for the Bank's dealing with this issue". For purposes of this paper, governance is defined as the manner in which power is exercised in the management of a country's economic and social resources for development. The Bank's concern with sound development management extends beyond the capacity of public sector management to the rules and institutions which create a predictable and transparent framework for the conduct of public and private business, and also to accountability for economic and financial performance. Given the limited nature of the Bank's direct operational experience in this area other than that covered under public sector management, this paper defines major concepts, and surveys Bank experience to date. It also highlights some of the issues that have emerged as the Bank addresses a wider range of concerns in this area.

(ii) The Bank's interest in governance arises from its concern for the effectiveness of the development efforts it supports. From this perspective, sound development management, in the broadest sense of the word, is critical to ensuring adequate returns and the efficacy of programs and projects that the Bank finances, and so to the underlying Bank objectives of helping countries reduce poverty and increase sustainable growth. The Bank has a long record of helping countries build the institutions and practices essential to an efficient modern economy, and must continue to set high standards for itself and its borrowers. Its experience provides a number of examples of best practice (some of which are described in this paper, and some in the accompanying review of work on public sector management) that have been seen to have a demonstrable positive impact on development management in its borrowers.

(iii) The Bank's experience has also shown that when programs and projects appear technically sound but fail to deliver results, the reasons are sometimes attributable to weak institutions, lack of an adequate legal framework, damaging discretionary interventions, uncertain and variable policy frameworks and a closed decision-making process which increases risks of corruption and waste. Much needed legal reforms may come to naught, if laws are not enforced or there are severe delays in the settlement of cases. Privatization efforts may not succeed or be politically sustainable and the supply response to improved pricing policies may not occur unless clear rules and institutions contain transaction costs (i.e. the cost of arranging, monitoring and enforcing contracts). Sophisticated public expenditure reforms may founder if accounting systems are so weak that budgetary policies cannot be implemented or monitored, or when lax procurement encourages corruption which distorts public investment priorities. Public investments may waste resources unless those who will use, and often pay for, the resulting services are involved in their design and operations.

(iv) These examples illustrate a broader point: good governance is central to creating

and sustaining an environment which fosters strong and equitable development, and is an essential complement to sound economic policies. Governments play a key role in providing two sets of public goods: the rules to make markets work efficiently, and, more problematically, correcting for market failure. In order to play this role, they need revenues, and "agents" to collect revenues and produce the public goods. This in turn requires systems of accountability, adequate and reliable information, and efficiency in resource management.

(v) Productive institutional arrangements will vary between countries based on their cultural traditions and historic relationships. And they will continue to evolve as the economy grows, becomes more complex and more integrated with international markets. Mature institutional frameworks take a great deal of time, but there is no guarantee that arrangements which are supportive of economic growth and poverty alleviation will, in fact, emerge. The state may behave in a predatory manner or pursue strategies that hinder the development of efficient property rights. Or its agents may behave in an opportunistic manner and indulge in rent-seeking. Good governance is a continuum, and not necessarily unidirectional: it does not automatically improve over time. It is a plant that needs constant tending.

(vi) Recognizing the importance of sound development management, the Bank's emphasis in recent years has shifted rapidly from its own interventions to the overall country context within which those interventions are taking place. In the area of public sector management, attention has shifted from improving management of project-related agencies to more general reform of the civil service and public enterprises, and to the central economic agencies that are responsible for macro-economic policy. A similar broadening of focus is now taking place in such "areas" as accountability and the legal framework.

(vii) *Public sector management* (PSM) issues are addressed in an accompanying paper which reviews experience in selected areas. The primary focus of the Bank's work has been in public expenditure management, civil service reform and parastatal reform. The initial results have been positive, but often in trying circumstances. The effort has been long and arduous, reflecting obstacles of a socio-political nature.

(viii) This paper focusses on three other key dimensions: accountability, the legal framework for development, and information and transparency:

(ix) *Accountability* at its simplest means holding public officials responsible for their actions. Economic objectives of public accountability include congruence between public policy and actual implementation, and the efficient allocation and use of resources. This not only requires systems of financial accountability but also the capacity and willingness to monitor the overall economic performance of the government. At the micro level, the primary concern is with efficiency in the production and delivery of goods and services in the public sector. The Bank has addressed issues of both economic and financial accountability. Its public expenditure work has assisted governments address a range of public resource management issues, and has supported reforms of sector-wide institutions to improve accountability in service delivery. In terms of financial accountability, to improve compliance with accounting and audit covenants, the Bank is assisting some borrowers address country-wide constraints to accounting and auditing through assessments and technical assistance projects. The Bank is also assisting governments establish adequate oversight and administrative capacity at central and provincial/local levels as they move to

decentralize key economic functions of government.

(x) Macro-level accountability can be reinforced at the micro-level both through competition and by enhancing opportunities for participation or other means of articulating the interests of the affected public. The Bank does a great deal to encourage competition through deregulation and contracting out of services, and generally by assisting governments to break up monopolies and barriers to entry. Participation can be encouraged through dissemination of information on services, complaints procedures, and public hearings. The use of local NGOs and the encouragement of beneficiary participation in project design and implementation is encouraged in Bank projects, where appropriate.

(xi) *Predictability and the legal framework for development:* Predictability implies that rules and regulations are clear and applied even-handedly, and that lines of authority are clear. An efficient civil service helps provide continuity and predictability; Bank PSM work is intended to support these goals. The rule of law is a key element of predictability and stability where business risks may be rationally assessed, transaction costs lowered, and governmental arbitrariness reduced. It is this connection of the rule of law with the more efficient use of resources that justifies its consideration by the Bank. Five basic elements of the rule of law have been identified as relevant to sound economic development and, therefore, to the Bank: (a) there must be a set of rules known in advance; (b) these rules must be actually in force; (c) there must be mechanisms to ensure application of the rules; (d) conflicts must be resolved through binding decisions of an independent judicial body or through arbitration, and (e) there are known procedures for amending the rules when they no longer serve their purpose.

(xii) The Bank has, in recent years, assisted borrowers in ensuring coherence of rules and improved communication; in helping to improve the efficiency of institutions which administer laws of significance to the economy; in the training of judges in commercial law; in encouraging extra-judicial means of settling disputes (e.g. commercial arbitration); and in developing capacity to put in place appropriate procedural rules for enacting and repealing laws. Effective legal reforms require careful preparation, and a thorough understanding of local conditions and the cultural and historical context. With this in view, the Bank has, in a few cases, been carrying out comprehensive reviews of legal systems as they relate to development activity.

(xiii) Adequate and reliable *information* is a precondition for both accountability and the rule of law, and refers to the availability of and access to information from public and private sources, and transparency of decision-making processes. The availability of accurate information about the economy, in general, about market conditions and about the intentions of government critically affects the efficiency and competitiveness of the private sector. Yet, information flows are grossly inadequate in many countries and transparency of decision making low. The Bank has been assisting borrowers improve economic information flows, transparency in budgetary and monetary accounts, and procurement procedures. These measures help to increase the effectiveness of resource use and to reduce corruption and waste.

(xiv) Much of the work described under accountability, the legal framework for development, and information and transparency represents a natural extension of the Bank's work on public sector management. It is technical in nature and complements other efforts undertaken in economic reforms, such as the elimination of monopolies or removal of controls which help reduce rent-seeking.

Indeed, there is much that the Bank routinely does which indirectly contributes to improving development management.

(xv) However, in undertaking this work, the Bank's role itself is subject to a number of limitations. As an *external* agency, it cannot substitute for the political commitment that governments must bring to reforms in governance. Full ownership is as important in this area as it is in economic policy reforms. The Bank's *legal* mandate provides clear limits to its role, although the legal restrictions help to protect the Bank's reputation for objectivity and technical excellence and its status as an international institution guided solely by concern for economic development and not by any political agenda. The Bank's *past experience* with complex institution building efforts has been mixed, and suggests that it move with caution and absorb the lessons from those experiences. A further limitation arises from *resource constraints*. Work on governance is expensive and time consuming, and is limited by skill availability. However, such work will be handled like all other claims on resources through a determination of priorities within country programs based on need, borrower receptivity, cost, etc. The Bank should, of course, not attempt to take too much on itself, and needs to collaborate with other UN agencies and donors, where possible.

(xvi) Given these constraints, a measured and selective approach is called for. The main elements of this approach are: First, the Bank, through its interventions, needs to continue to exploit opportunities for improving development management, whenever appropriate, through a variety of means including assisting borrowers break up monopolies, removal of controls and other avenues for corruption, beneficiary participation in projects, etc.

(xvii) Second, selectivity is called for in allocating resources and developing work programs. The selectivity needs to be in terms of the choice of countries for specific work on the dimensions of development management outlined above, and in terms of the range of activities the Bank can take on and support at any given time. Such work should only be embarked upon in countries where there is a clear commitment to and need for improving development management along these dimensions. Many of the Bank's borrowers may neither want the Bank to be so involved nor require such assistance. Where there is need but no commitment, such work would waste resources. Similarly, the dimensions of development management the Bank chooses to assist should reflect both the chances of success as well as the Bank's own ability in terms of skills and resources to assist effectively.

(xviii) Third, in countries where the Bank is active in improving development management, it needs to assist in the design of highly differentiated responses, taking account of the country's institutional needs, its political economy, its society, and history. The objective in each case must continue to be to help strengthen the enabling environment for sustainable and equitable development. This requires high quality Economic and Sector Work.

(xix) The emphasis above is on the technical issues of development management. It is important to be aware, however, that a strong emphasis by the Bank on prudent financial management and attention to auditing and accounting or a legal framework suitable for development will tend to bring deeper and more general problems of governance into sharper relief. Thus, for example, sophisticated systems of financial accounting and auditing may be established but the government may not absorb or use the results to good effect. A legal framework could be

created, but arbitrariness or corruption in its implementation could undermine its value. This has already been the experience with sensitive issues of PSM such as civil service reform where political constraints to the success of such work have emerged. Where lack of progress is due not to weaknesses in capacity but to lack of government commitment, the Bank then faces a problem which needs to be reflected in its country strategy and dialogue.

(xx) When political commitment to sound development management is weak, the Bank normally takes up these issues in its dialogue with borrowers while remaining proactive in seeking ways to help the country improve performance in the key areas of concern. This dialogue is supported by economic and sector work, where appropriate. In such a dialogue, governance issues are not discussed in isolation but as an integral part of a government's overall development program. In conducting this dialogue, the level at which issues are discussed is a function of their sensitivity and requires the judgements of senior managers. Technical issues are handled at staff levels, but highly sensitive issues are handled at an appropriately high level (Country Director and above). Donor concerns regarding such lack of political commitment to sound development management are also surfacing increasingly at consultative group meetings. As Chair of these meetings, the Bank would normally inform the country of widely-held donor concerns, particularly when these are likely to affect Bank-assisted programs.

(xxi) When dialogue fails, the Bank's own lending to the country is likely to be affected. Lending levels have long been responsive to issues of development management and performance, and will continue to be so. Judgements of performance are already routinely made for purposes of IDA allocation and in assessing creditworthiness: there is no need for additional criteria to reflect concerns with governance: merely the effective and consistent application of existing criteria based on a greater awareness of the importance of issues of governance for development performance.

(xxii) Given absorptive capacity constraints, and the long-term nature of the development of appropriate institutions and economic decision-making processes, development management concerns need to be integrated into a long-term perspective of a country's development strategy and prospects. As a follow-up to the Long-Term Perspective Study on Sub-Saharan Africa, and the Maastricht conference at which it was discussed, the UNDP and the Bank are assisting interested African countries develop such perspectives. This also implies that some aspects of this work should be supported by investment operations rather than adjustment lending and that long-term capacity building technical assistance is called for.

(xxiii) Such a long-term approach needs to be supplemented by other measures to strengthen implementation capacity. This implies greater efforts at helping build ownership of adjustment programs, a more conscious effort to understand the political and social structure and the customs and laws of its borrowers, the need to foster an "implementation culture" within the Bank and to sensitize staff to the need to handle issues in this area with humility, sensitivity and caution, and the need to encourage participation by beneficiaries, where appropriate, in Bank projects.

(xxiv) Management proposes to disseminate to staff the key messages for the Bank in this paper together with the Board's guidance. A broad-based dialogue with borrowers, interested academics and others has been initiated in the Africa Region and depending upon this experience, could be extended elsewhere. The Bank's research program in

this area needs to develop further. A progress report on the Bank's unfolding experience with governance would be appropriate in two years' time.

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MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION
A DISCUSSION PAPER

I. INTRODUCTION

Definition and Purpose

1. The Bank's interest in governance arises from its concern for the effectiveness of the development efforts it supports. A general definition of governance is the "exercise of authority, control, management, power of government."[1] A more relevant definition for Bank purposes is "the manner in which power is exercised in the management of a country's economic and social resources for development."[2] The Bank's concern with sound development management thus extends beyond the capacity of public sector management to the rules and institutions which create a predictable and transparent framework for the conduct of public and private business and to accountability for economic and financial performance.

2. Public sector capacity issues are discussed in detail in the accompanying paper, *The Reform of Public Sector Management: Lessons of Experience* (PSM paper) (World Bank, 1991b), and will be referred to only briefly in this paper. The major focus here is on the overall management of resources for development -- with a special emphasis on accountability, the legal framework for development, and information and transparency.

3. In his legal memorandum of December 21, 1990, discussed in a Board seminar on April 11, 1991, the General Counsel set out "a legal framework for the Bank's dealing with this issue as a prelude to any future analysis of the manner in which the Bank may take it on operationally" (Shihata, 1991). Given the limited nature of the Bank's direct operational experience outside the public sector management area, this initial review defines major concepts and surveys Bank experience to date. The paper also cites best practice and highlights issues that have emerged as the Bank addresses a wider range of concerns in this area.

Relevance for the Bank

4. Governance issues are not new to the Bank. As a development institution, the Bank has grappled with these issues from its inception. However, the relatively good growth performance of developing countries between 1965 and 1980 helped conceal the deep-seated problems of governance which affected the efficient use of resources and retarded adjustment efforts to respond to a changing external environment. By the beginning of the 1980s, as growth decelerated sharply and the developing world was adversely affected by a severe worsening in the terms of trade, the emergence of a climate of relative scarcity began to expose governance issues in many countries. At the same time, it was becoming increasingly clear that investment lending could not achieve its objectives in the absence of an appropriate policy environment.

5. Structural adjustment lending and related public sector management (PSM) reforms aimed at creating an enabling environment for growth. Their focus was on reducing the area of government intervention in incentive policies, on the more efficient use of public resources and on reducing fiscal deficits, thereby indirectly addressing those governance issues which affected the management of resources. Despite some

encouraging success with adjustment lending and public sector reforms, the enabling environment is still deficient in many cases. Improvement in the efficacy of Bank-supported investments and policy reforms thus depends in such cases, on further improvements in the institutional framework for development management.

6. For some of the Bank's borrowers, the effectiveness of both adjustment and investment operations is impeded by factors which contribute to poor development management. These include weak institutions, lack of an adequate legal framework, weak financial accounting and auditing systems, damaging discretionary interventions, uncertain and variable policy frameworks and closed decision- making which increases risks of corruption and waste. There are examples of countries where corruption has adversely affected development. In those countries, pervasive patronage in government has perverted public investment choices to finance white elephants, usually by contracting excessive foreign debt. Monopolies were sanctioned and allocated to friends of those in power, at great economic cost to the nation. There are also examples where good progress in policy reforms has been offset by uncertainties in the investment climate. In some countries which have made good progress in establishing realistic relative prices, the expected private sector response has been inhibited by inconsistent behavior towards business by some government agencies, by inconsistencies between new government policies and the existing legal framework, or by discrimination against certain ethnic groups with strong business communities. In Eastern Europe, the lack of a legal framework conducive to private sector development is a severe impediment to privatization and new investment. In some Latin American countries, rapid decentralization has outstripped systems of accountability and civil service institutions at provincial and local government level, fuelling already unsustainable fiscal deficits.

7. The Africa Region was the first to articulate the Bank's concerns in its Long-Term Perspective Study on Sub-Saharan Africa (LTPS) (World Bank, 1989) in a frank discussion of the "crisis of governance".[3] The LTPS proved a stimulus to the debate now underway in both developing and developed countries on issues of governance in general, and in the Bank, as it relates to economic development. Another stimulus has been the rapid political changes in Eastern Europe, Latin America and parts of Asia and Africa. These changes have been accompanied by changes in the role of the state to reflect a greater preoccupation with the creation of an enabling environment for development, larger responsibilities for the private sector, a reduction in direct government involvement in production and commercial activity and the devolution of power from the center to lower levels of government. These changes have usually been associated with difficult economic reforms and macro-economic adjustment requiring considerable skill on the part of governments in developing a political consensus around these reforms. By its function, the Bank is intimately involved in this broad reform process and governments are increasingly turning to it to address a much broader range of economic management issues, including the legal framework and systems of procurement and financial accountability.

8. Bilateral donors have been increasingly sensitive to public criticism of concessional aid flows to governments which lack democracy, have a poor human rights record, or are seen to be corrupt, and have been pursuing a broader governance agenda through political channels.

9. The Bank's mandate, as laid down in its Articles of Agreement as applied in

practice, is the promotion of sustainable economic and social development. Its concern for governance must be driven by that mandate. The General Counsel's memorandum identified five aspects of governance that are beyond the Bank's mandate: the Bank cannot be influenced by the political character of a member; it cannot interfere in the partisan politics of the member; it must not act on behalf of donor countries in influencing the member's political orientation or behavior; it cannot be influenced in its decisions by political factors that do not have a preponderant economic effect; and its staff should not build their judgments on the possible reactions of a particular Bank member or members. This memorandum then suggested that governance may be relevant to the Bank's work if it is addressed in terms of having good order and discipline in the management of a country's resources. In this respect, the General Counsel considered the need for rules and institutions and mentioned, by way of illustration, a number of areas that may fall within the Bank's mandate such as civil service reform, legal reform, accountability for public funds and budget discipline (Shihata, 1991: 47-54).

10. Section II of this paper describes the nature of the governance problem from the Bank's perspective. Section III summarizes key dimensions of governance and the Bank's experience with each dimension. (Three of these dimensions -- accountability, the legal framework for development, and information and transparency -- are discussed in greater detail in Annex I.) Section IV discusses the role of the Bank. Section V discusses implications for Bank practice; and Section VI outlines next steps.

II. THE NATURE OF THE PROBLEM

The Role of Governments

11. Even in societies that are highly market-oriented, only governments can provide two sorts of public goods: rules to make markets work efficiently, and in some cases, corrective interventions where there are market failures (McLean, 1987: 19-21). With respect to rules, without the institutions and supportive framework of the State to create and enforce the rules, to establish law and order, and to ensure property rights, production and investment will be deterred and development hindered (Eggertson, 1990). This is because high "transaction costs" (i.e., the cost of arranging, monitoring and enforcing contracts) would inhibit such activities. Compensation for market failure is more problematic. Governments in the 1970s relied on this rationale to rush into unwise policies and investments, although often their own policy interventions were responsible for market failures and the investments did not yield adequate returns. Governments now increasingly recognize the need for more restraint and for taking "market-friendly" steps to deal with problems. In addition, the State must play a key role in ensuring the provision of services such as education, health, and essential infrastructure, particularly when such services are directed at the poor and are not forthcoming from the private sector. A well-educated labor force and adequate infrastructure are fundamental to the quality of private investment.

12. However, to finance such expenditures, the state needs revenues. The state also needs "agents" who will collect taxes from the public and produce and deliver essential services (such as education and health, and a legal framework).[4] This, in turn, requires systems of accountability --

accountability within government and from the government to those to whom it delivers services. For the system to work, adequate and reliable information flows are essential. Without it, the rules are not known, accountability is low, and uncertainties excessive. Thus, accountability, publicly known rules, information and transparency are all key elements of sound development management. Moreover, the institutional framework needed to provide these public goods must be managed efficiently.

13. Productive institutional arrangements will vary between countries, based on their cultural traditions and historic relationships. And they will continue to evolve as the economy grows and becomes more complex and more integrated with international markets. Mature institutional frameworks take a great deal of time to develop, but there is no guarantee that arrangements which are supportive of economic growth and poverty alleviation will, in fact, emerge. The state may behave in a predatory manner or pursue strategies that hinder property rights. Its agents may behave in an opportunistic manner and indulge in "rent-seeking". Why do some states behave differently from others? What are the conditions that permit success? The historical evidence is far from clear. However, institutional economists, like Douglass North, argue that institutions, defined as "the rules of the game in a society" (North, 1990: 3),[5] determine the performance of economies. Efficient institutions emerge when there are built-in incentives to create and enforce property rights, defined in the broadest sense. The example most often cited is that of the contrasting paths pursued by England and Spain in the seventeenth century, when both countries faced severe fiscal crises. The path pursued by England led to a burst of innovative activity; that of Spain led to a decline of such activity. Thus, to quote North:

> "In England, Parliament created the Bank of England and a fiscal system in which expenditures were tied to tax revenues. The consequent financial revolution not only finally put the government on a sound financial basis, but laid the ground for the development of the private capital market. More secure property rights; the decline of mercantilist restrictions, and the escape of textile firms from urban guild restrictions combined to provide expanding opportunities for firms in domestic and international markets. Both the growing markets and the patent law encouraged the growth of innovative activity....
>
> In Spain, repeated bankruptcies between 1557 and 1647 were coupled with desperate measures to stave off disaster. War, the church, and administering the complex bureaucratic system provided the major organizational opportunities in Spain and in consequence the military, priesthood, and the judiciary were rewarding occupations. The expulsion of the Moors and Jews, rent ceilings on land and price ceilings on wheat, confiscations of silver remittances to merchants in Seville (who were compensated with relatively worthless bonds called juros) were symptomatic of the disincentives to productive activity" (North, 1990: 114-115).

14. Such historical contrasts illustrate the importance to development of the "underlying institutional characteristics" of societies. Institutional economists point out that in order to understand better why these characteristics are different in different societies, we need to know more about the interaction between culture and formal rules and institutions.

15. The role of culture in shaping institutions and rules is an area of some contention in academic circles. Some argue that the importance of cultural divergences diminishes as the market economy progressively transforms society. Others, citing Japan, stress that norms and values of consensus and reciprocity may soften the impersonal nature of the market, and that national cultures impart a long-term, culturally specific shape to the legal and other institutions that support the functioning of the market. These two views are not necessarily inconsistent; the issue is one of degree.

16. The current debate on governance, therefore, needs to take account of cultural differences.[6] The concepts that are discussed in this paper mean different things to different cultures. The concept of "contract", which is at the heart of accountability and the rule of law, carries implicit the notion that rights and obligations incurred at a given point of time through an abstract legal device -the contract - will be honored at a later point of time by all parties concerned. Some cultures may have different conceptions of the relative importance of contractual agreements in relation to other rights and obligations. These may include, for example, strong and binding ethnic or kinship ties. Social norms may affect, for example, attitudes towards evading taxes or what constitutes conflict of interest.

17. The spread of political and legal systems modelled on Western traditions may lead to the simultaneous existence of two sets of norms and institutions for dealing with broadly defined rights and obligations, with Western notions of the rule of law, private property rights and contracts superimposed on ideas such as "consensus", "communal property" and "reciprocity", which have evolved over long periods of time in many non-Western cultural settings. While these different ways of anchoring social rights and obligations may or may not hamper the functioning of modern economic institutions, such as the market, it is important to be aware of them when pursuing policy reforms and institution building.

When Governance Fails

18. The institutional characteristics for managing development, thus, vary widely among countries and do not permit easy generalization. Nor is it practical to attempt a taxonomy, classifying states, say, by different governance characteristics. This complexity arises from the unique imprint of history, geography and culture on each country's institutions and rules, and the multidimensional nature of governance as a concept. Thus, each country is at a different level of political, economic and social development reflecting a wide array of historical, geographic and cultural factors. A number of the Bank's borrowers have been relatively successful in creating the institutions and rules that promote broad-based economic development. Some others are on their way to doing so, while yet others still labor under severe political, institutional and economic constraints on better government performance. What is said in this paper about government performance must be applied to individual countries in their context.

19. But poor governance is readily recognizable. The key symptoms are, inter alia:

- failure to make a clear separation between what is public and what is private, hence, a tendency to direct public resources for private gain;

- failure to establish a predictable framework of law and government behavior conducive to development, or arbitrariness in the application of rules and laws;

- the existence of excessive rules, regulations, licensing requirements, etc., which impede the functioning of markets and encourage rent-seeking;

- priorities inconsistent with development, resulting in a misallocation of resources;

- excessively narrowly-based or non-transparent decision making.

20. Such "problems" may be due to lack of capacity or to volition, or both, and may be of varying severity. However, it is when they are sufficiently severe and act in tandem that they create an environment that is hostile to development. In such circumstances, the authority of governments over their peoples tends to be progressively eroded. This reduces compliance with decisions and regulations. Governments then tend to respond through populist measures or, as in some authoritarian regimes, they resort to coercion. Either way, the economic cost can be high, including a diversion of resources to internal security, and escalating corruption. Poor development performance can in turn contribute to poor governance by further eroding the confidence of citizens in their governments, and causing governments to behave insecurely.

21. The absence of good governance has proved to be particularly damaging to the "corrective intervention" role of government. Programs for poverty alleviation and environmental protection, for example, can be totally undermined by a lack of public accountability, corruption and the "capture" of public services by elites. Funds intended for the poor may be directed to the benefit of special interest groups, and the poor may have inadequate access to legal remedies. Similarly, the enforcement of environmental standards, which benefit the population as a whole but which may be costly to powerful industrial and commercial groups, can be emasculated by poor governance. Industrial emissions standards, forest protection policies and guidelines for the incorporation of environmental concerns into public expenditure decisions may be worth little more than the paper they are written on unless rules are clear, information is available to the public, and government officials are accountable. In the case of the environment, problems are magnified by difficulties of monitoring and enforcement, which enable official government policies to be ignored.

22. Among the underlying causes of poor development management is the level of economic, human and institutional development. Lack of an educated and trained manpower and weak institutions can substantially reduce the capacity of countries to provide sound development management. Poverty and illiteracy make poor governance more possible. This is not, though, to suggest that development automatically brings good governance; nor to imply that sound economic management is not possible in poor countries. There are a number of Asian counter-examples, both authoritarian and democratic. It is simply that poverty, illiteracy and weak institutions make the task of good development management much more complicated and problematic.

23. Pervasive corruption is particularly damaging to development. Corruption occurs in all countries and in many different forms. It tends to thrive when resources are scarce, and governments, rather than markets, allocate them; when civil servants are underpaid; when rules are unreasonable or unclear; when controls are pervasive and regulations excessive; and when disclosure and punishment are unlikely. Although there have been isolated instances of governments being both corrupt and successful at promoting development, in general, corruption weakens the ability of governments to carry out their

functions efficiently. "Bribery, nepotism, venality and lack of dedication to duty," notes the 1991 WDR, "can cripple administration and dilute equity from the provision of government services, and thus also undermine social cohesiveness" (World Bank, 1991a). Graft on a large scale is not possible without collusion with private companies or foreign suppliers, with officials of foreign governments sometimes turning a blind eye, -- a problem of international governance.

24. Other causes of poor development management are a high degree of concentration of political power and the colonial inheritance. On the positive side, many former colonies inherited systems of financial accountability, an independent civil service, and a legal framework. However, since these were imported from outside, they have not always taken root. Colonial rule implied accountability to the colonial power, rather than to citizens; it thus sometimes destroyed indigenous systems of accountability.

25. Colonial rule has sometimes bequeathed standing armies, thus, diverting resources away from development and making fragile civilian governments prone to military coups and related political instability. The 1991 WDR estimates that since 1948, there has, on average, been one coup attempt per developing country every five years (World Bank, 1991a: 7.2). Colonially imposed frontiers have sometimes led to border disputes and ethnic strife. During the Cold War, such strife has, on occasion, been fuelled by arms exports to the rival factions/states.

26. These symptoms and causes of poor governance are not unique to any particular form of government. The 1991 WDR examined the evidence on the relative performance records of democracies and authoritarian regimes and noted that the democratic-authoritarian distinction itself "fails to explain whether or not countries initiate reform, implement it effectively, or survive its political fall-out" (World Bank, 1991a: 7.11). Authoritarian regimes were just as likely to yield to the interests of narrow constituencies. The report concluded that "there was no evidence to support the view that authoritarian governments, on average, show greater promise for achieving rapid growth" (p.16). Moving beyond growth to social development, the report notes that some studies suggest that for a given level of income, "improvements in social indicators are associated with freedom and liberty" (7.11).

27. In sum, governance is a continuum, and not necessarily unidirectional: it does not automatically improve over time. It is a plant that needs constant tending. Citizens need to demand good governance. Their ability to do so is enhanced by literacy, education and employment opportunities. Governments need to prove responsive to those demands. Neither of these can be taken for granted. Change occurs sometimes in response to external or internal threats. It also occurs through pressures from different interest groups, some of which may be in the form of populist demands. While donors and outsiders can contribute resources and ideas to improve governance, for change to be effective, it must be rooted firmly in the societies concerned, and cannot be imposed from outside.

III. DIMENSIONS OF GOVERNANCE

28. As indicated in the foregoing discussion, there are four key dimensions of governance that are of relevance to the Bank's work: capacity and efficiency issues in public sector management, accountability, predictability and the legal framework for development, and information. These are now discussed in turn (See Annex I for a more detailed discussion of accountability, the legal

framework for development, and information and transparency).

(a) Improving Public Sector Management

29. When the capacity of the public sector to manage the economy and deliver public services is weak, the prospects for development are poor. The public sector in many developing countries has been characterized by uneven revenue collection, poor expenditure control and management, a bloated and underpaid civil service, a large parastatal sector that provides poor returns on the scarce public funds invested in it and weaknesses in the capacity of core economic agencies to design and implement policies that would address these problems. Not only does this state of affairs contribute to large fiscal deficits requiring adjustment measures, but it also progressively erodes the capacity of the state to provide economic and social services.

30. The Bank's involvement in this area, till the 1980s, was overwhelmingly in the institutional development of the agencies implementing Bank-financed projects. With the introduction of adjustment lending, the Bank began to focus on improvements in overall public sector management, and the improvement of sector-wide institutions and service delivery. Within this dimension, three areas have received primary attention in the 1980s: public expenditure management, civil service reform, and parastatal reform. Within public expenditure management, the emphasis has been on assisting borrowers improve public investment programming and the budget process. Less advanced have been efforts to improve the execution and monitoring of public expenditure programs. Under civil service reform, in the short term, the emphasis has been on cost-containment measures; in the medium term, on strengthening personnel management and the effectiveness and efficiency of public agencies. In the management of public enterprises, the Bank has been assisting borrowers rationalize the size of the public enterprise sector, privatize, restructure, or liquidate public companies, as appropriate, improve the competitiveness of the policy environment, and clarify the relationship between the central government and public enterprises with a view to increasing the returns on the government's investment in the sector. The core agencies for key sectors and for national economic management have been assisted to strengthen management of these reform programs and to give greater priority to and to increase efficiency in the delivery of social services. Decentralization and tax reform are other areas where the Bank has supported government efforts to improve public sector efficiency (as noted in the Tax Reform Policy Paper).

31. The accompanying PSM paper provides a review of selected issues and concludes that initial results have been positive, often in trying circumstances. The effort has been long and arduous, reflecting obstacles of a socio-political nature. In public expenditure management, imperfect accountability has gone hand in hand with weak institutional capacity. In civil service reform, there is a shift in emphasis to improved personnel management. In all cases, the need for strong political commitment is noted. It is particularly difficult to ensure commitment to reforms over time. Tensions between economic benefits and political costs are typical of reforms in this area.

(b) Accountability

32. Accountability, at its simplest, means holding public officials responsible for their actions. How this happens varies widely from country to country, depending upon cultural traditions, history, political institutions, administrative capacities and the public's access to and use of information. For the Bank, accountability must be seen from the

viewpoint of development management. At a broad level, economic objectives of public accountability include congruence between public policy and actual implementation, and the efficient allocation and use of public resources. This not only requires systems of financial accountability, but also the capacity and willingness to monitor the overall economic performance of the government. At the micro level, the primary concern is comparable efficiency in investment and in the production and delivery of goods and services in the public sector.

33. The Bank has addressed issues of both economic and financial accountability. As noted above, public expenditure reviews have focussed on the efficiency of resource use in public investment programs, in the parastatals sector, in the social sectors, and more recently, in employment and wage issues in civil services. This has led frequently to the identification of reforms including the removal of white elephants from public investment programs, privatization, restructuring and closure of state enterprises, reallocation of resources in favor of primary health and primary education, and the removal of "ghost workers" and rationalization of employment levels in the public sector. Through sector adjustment or investment loans, the Bank also assists reforms of sector-wide institutions, with a view to improving the efficiency and accountability of institutions responsible for service delivery. In the area of overall economic performance monitoring, the Bank's Operations Evaluation Department (OED) has for long advised planning and performance ministries on monitoring and evaluation functions. Greater attention to this issue is also being paid under PSM projects.

34. In the area of financial accountability, the Bank has tended to focus on project implementation agencies. However, compliance with accounting and audit covenants has often been disappointing, reflecting weaknesses in country-wide accountability mechanisms. To address this problem, the Bank has been pursuing a three-pronged strategy: (i) improving borrower incentives to comply with accounting and audit covenants; (ii) encouraging a more systematic review of auditing and accounting issues during project preparation; and (iii) strengthening borrower capacity through country-wide reviews of accounting and auditing. For example, accounting and auditing functions are being strengthened in Ghana, Madagascar, Mauritania and Indonesia. The LAC Region has been actively helping governments strengthen agencies critical to accountability and transparency, such as tax and customs officers, Central Banks and the offices of Controller-Generals. Accountability assessments are also underway in some countries. To be effective, such reviews need to focus on the processes by which audited reports are reviewed and action taken to deal with the corruption and waste identified.

35. Decentralization is sometimes seen as the means of reducing an overload of central government responsibilities by relying on local decision making, micro-level accountability and through participation of beneficiaries in the design and monitoring of service deliveries. However, decentralization must be managed with care if it is not to result in fiscal imbalances, wastage and corruption due to a lack of adequate oversight from national authorities, weak administrative capacity at local levels and the risk of capture of institutions by local elites. Both in Latin America and Eastern Europe, the Bank has been active in assisting with the rapid decentralization proceeding in those regions, mainly through technical assistance for the strengthening of local governments and for ensuring fiscal and financial accountability. In Mauritania, an institutional framework for the creation of municipalities is being established.

36. Micro-level accountability can sometimes reinforce macro-level accountability through competition or the provision of alternatives, that is, opportunities for "exit", or by enhancing opportunities for participation, public comment or complaint, or other forms of "voice".[7] Exit mechanisms include deregulation, contracting out, public-public and public-private competition. The Bank has encouraged exit through deregulation and contracting out of services in various projects and generally by encouraging break-up of local or national monopolies. Voice can be encouraged through dissemination of information on services, complaint procedures, public hearings, public feedback on development activities and services, representation on boards, participation by beneficiaries in the design of projects, and the encouragement of local NGOs which are able to reach poor or marginal groups who would otherwise be voiceless. Popular participation in project design and implementation has been shown to have a significant positive effect on the efficacy of projects. Inevitably, however, there are some attendant risks that need to be factored in when pursuing these means (see paras. 19, 25 and 26 in Annex I). NGOs were involved in 50 Bank-financed projects in each of the past two fiscal years, compared to 15 projects in FY88. Some 20 projects, with exceptionally participatory approaches, are being studied by an Operations-PRE learning group in an exercise designed to draw lessons from Bank experience with popular participation. The Philippines Communal Irrigation Project remains a particularly good example of successful beneficiary participation on a large scale producing consistently good results. Best practice consists of a systematic effort during project preparation to explore, where appropriate, opportunities to enhance competition and participation.

(c) Predictability and the Legal Framework for Development

37. Predictability implies "standard operating procedures, institutionalized rules, non-personalized decision making and modest levels of discretion and regularized procedures for establishing and implementing policies" (Brautigam, 1991). In systems with high predictability, rules and regulations are clearly promulgated and generally and consistently applied, and lines of authority are clear. The civil service provides a measure of continuity. In most countries, predictability is imperfect. The Bank's concern is to support the continued evolution towards ensuring at least a minimum level of predictability. The Bank is increasingly involved in assisting its borrowers to improve the quality and efficiency of the civil service which, when successful, will help enhance predictability (see the PSM paper).

38. A sound legal framework for development, a further key element of predictability, is an area of focus in this paper. The General Counsel defined the rule of law in terms of a "system based on objective rules, which are actually applied, and on functioning institutions, which ensure the appropriate application of such rules." Reforms proposed by the Bank, he argued, "cannot be effective in the absence of a system which translates them into workable rules and makes sure they are complied with" (Shihata, 1991: 42-43). Such a system is needed to create a climate of stability and predictability, where business risks may be rationally assessed, transaction costs lowered, and governmental arbitrariness reduced. It is this connection of the rule of law with the more efficient use of resources that justifies its consideration by the Bank as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself; it is only to the extent that it establishes a set of preconditions for development that it comes within the purview

of the Bank. The elements of the rule of law are varied. Not all have the same bearing on the purposes of the Bank. The following basic elements have been identified by the General Counsel:

39. ***There must be a set of consistent rules known in advance.*** The Bank is assisting former socialist economies and others to ensure that new economic measures are not in conflict with existing laws or constitutional provisions. More can be done by most governments to communicate laws effectively and to explain to citizens the content of legislation. The Bank is assisting some borrowers in this area.

40. ***These rules must actually be in force.*** Laws are frequently ineffective or are not applied because they are perceived as obsolete or irrelevant, or because enforcement capacity is inadequate. The underlying reasons for non-compliance with the rules are manifold; some borrowers (with Bank assistance) are analyzing the causes and improving the efficiency and competence of the institutions which administer the laws.

41. The ***application of the rules*** requires flexibility and executive branch discretion to deal with diverse situations. To avoid abuse of that discretion requires systems of review. Some countries have independent or specialized courts or ombudsmen; civil service reform will also address the underlying causes of abuse. Rationalization of obsolete rules and regulations, by updating and simplifying legal systems, is being attempted with Bank assistance.

42. To assure a business environment conducive to investment and commercial activity, ***conflicts must be resolved through binding decisions of an independent judicial body or through arbitration.*** Confidence in the enforceability of agreements and commitments is critical to the proper functioning of an economy. The Bank is beginning to be active in this area with several operations under preparation that will assist borrowers train judges in economic and business fields and handle commercial matters in specialized courts. Other dispute settlement measures such as commercial arbitration can also be useful.

43. Finally, ***there should exist known procedures for amending the rules when they no longer serve their purpose.*** When laws are changed arbitrarily and subjectively without recourse to established procedures, they lack acceptance and invite evasion. While it is outside the Bank's mandate to determine what legislative process should be in place to amend laws, the Bank is assisting in a modest way in training and technical assistance for the offices of the Attorney General, Ministry of Justice, etc. in areas relating to development management.

44. The Bank's experience shows that effective legal reforms require careful preparation and a thorough knowledge of local conditions, and the cultural and historical context. Legal sectoral reviews in Indonesia and Cote d'Ivoire, and reviews of the legal frameworks for financial operations in the Philippines, Guinea and Senegal have enabled the Bank to assist borrowers tailor rules and the strengthening of institutions to country circumstances. It is also important to recognize, as noted in para. 16, that attention must be paid to local circumstances and traditions.[8]

(d) Information and Transparency

45. Adequate and reliable information refers to the availability of and access to information from public and private sources, and the transparency of decision-making processes. These are vital to both accountability and the rule of law. Their absence provides opportunities for deception,

unfair or inequitable treatment and corruption. The Bank's interest in information is once again derived from and limited to their impact on development management.

46. The availability of accurate information critically affects the efficiency and competitiveness of the private sector: information about the economy, in general, about conditions in particular markets, and about the intentions and actions of government itself are crucial to private sector's calculation of risk and potential reward. Governments need to raise the quality of the information they themselves provide and to ensure that the private sector also discloses essential information. Capital market development, for example, is hindered when public and private enterprises are not compelled to publish audited accounts; likewise without transparency in the financial systems, capital and financial markets remain circumscribed to a narrow range of firms and instruments, and the soundness of the banking system remains at risk. An efficient market economy needs openness in this sense: openness is also strengthened, conversely, by a competitive economy, where there are many sources of information and where economic signals (such as prices) carry rich and relatively undistorted information.

47. Transparency of decision making is a safeguard against corruption, wastage and the abuse of executive authority. Competition and deregulation, the removal of unnecessary controls, clear rules and disclosure are important first steps. Many countries have sophisticated and strict laws against corruption, but these are not always enforced. The Bank has been assisting borrowers remove unnecessary controls and to reduce regulations, improve domestic and external procurement procedures and make budgets and Central Bank accounts more transparent. Where corruption has been pervasive, more drastic measures may be called for, such as Indonesia's use of the SGS to manage its customs services.

48. Corruption is a two-way street. Donors have an important responsibility to ensure that their national commercial considerations do not undermine good economic management in the developing world. Encouraging governments to develop sound public investment programs and respecting the priorities established is an important contribution that donors can make. A document entitled "Good Procurement Practices for Official Development Assistance" was prepared by the OECD's Development Assistance Committee (DAC) in consultation with the Bank. More recently, through a DAC Working Party on Financial Aspects of Development Assistance, a greater effort is being made to ensure that competition for contracts under donor-financed projects is not a source of corruption and does not contribute to distorted investment priorities. The intention is to ensure greater transparency and fair trade practices through a common band of concessionality levels, more open procurement procedures for large projects, an upper income limit for tied aid, ICB procedures, etc. Project preparation through joint appraisals and cofinancing with multilateral development banks, including the World Bank, is seen as one way to ensure sound investments and consistency with country priorities. When such cofinancing is not possible, the DAC has proposed that donors look to the Bank for advice on the appropriateness of proposed bilaterally financed large projects in the particular country economic situation. A consensus has yet to be reached on these proposals.

49. Budgets in developing countries often lack transparency. Revenues are sometimes diverted to special accounts outside the budgetary framework. Transactions with parastatals are obscured. A number of expenditure items are off-budget. Military

expenditures often escape scrutiny, avoid accountability expenditure control and auditing, in part because of the reluctance of civilian financial managers to question military procurement. High pressure salesmanship reinforced by generous trade credits in this area, as in others, can contribute to waste and corruption.

50. The Bank has been active in assisting governments to improve the transparency of budgets mainly through its public expenditure work. In undertaking such work, its main concern is that the country has systems of expenditure decision making and financial accountability that ensures that all expenditures, including military expenditures, are properly assessed and prioritized, that they are transparent, and that they are subject to expenditure controls and auditing. The Bank's focus is to assist borrowers to ensure that the overall size of public expenditures is not excessive in relation to resource availability and that adequate resources are allocated to economic and social sectors, and within these to programs that direct key services to the poor in a cost-effective manner. Its interest in military expenditures is because of its crowding-out effect on development spending.

51. Availability of information and transparency may lower uncertainty and transaction costs, but will not, by itself, bring about greater accountability in the absence of organizations and mechanisms that analyze and disseminate information. The mass media, in particular, play a key role here. The African Capacity Building Initiative is an example of the potential role of donors in strengthening the analytical and research capacities of institutions in developing countries. Long-term training/twinning arrangements -- whether these are formal institutional connections or the informal evolution of relations, like those of certain universities in the developed world with close links to the economic establishments in certain developing countries -- can play a key role.

IV. THE ROLE OF THE BANK

Key Elements of an Approach

52. Governance is a concern for the Bank for two sets of reasons. First, *from a broader perspective*, both history (see Section II) and the Bank's own experience show that good governance, in the sense that it has been used above, is central to creating and sustaining an enabling environment for development.

53. Second, *from the Bank's perspective*, as noted in Section I, sound development management is inextricably linked with the returns to and the efficacy of investments that the Bank helps finance and so to the Bank's underlying objectives of helping countries reduce poverty and increase sustainable growth.

54. The Bank has a long record of helping countries build the institutions and practices essential to an efficient and modern economy and must continue to set high standards for itself and its borrowers. Section III in this paper and Annex I cite the many ways in which borrowers are being assisted in improving development management. The Bank's concern here arises not merely from the impact of such assistance on country performance but also, as a financial institution, such assistance is part of sound portfolio management.

55. Until recently, in such areas as accountability and the legal framework, the Bank has tended to focus its attention narrowly on its own intervention rather than on the country context within which those interventions were taking place. Thus, the Bank insists, in all cases, on proper systems of

audited accounts for its project entities but has not often focussed on the constraints within which the overall system of financial accountability was operating. It has often encouraged borrowers to introduce new laws and regulations (e.g. trade and investment legislation) without always examining whether the legal system as a whole is operational and whether laws will be implemented effectively. This has changed rapidly in recent years. Just as Bank public sector management work has broadened from strengthening project-related agencies to a broader concern with overall civil service and parastatal reforms, similar shifts are now taking place in these other areas in a few countries. This is evident from the following illustrative list of activities being pursued in different Regions of the Bank.

Accountability

(a) ***At the macro level:***

- *Strengthening accounting* in the public sector, focussing on a range of actions, depending on country situation and need such as the availability of comprehensive and timely information, classification of expenditures in a manner consistent with budget and programs, appropriate analysis for decision making, comparison of budget and actual results, improving the organization and responsibility for accounting in the finance ministry, and legal requirements for financial reporting. (paras. 6-11 in Annex I)

- *Auditing reforms* to enable appropriate independence of the audit organization specified in the legal structure, greater attention to "value for money" auditing, and improvements in the educational system and professional training. (paras. 13-14 in Annex I)

- *Country-wide accountability assessments and projects* have been undertaken in Madagascar, Indonesia and Bolivia along the above lines. (para. 11 in Annex I)

- *Decentralization*: Assisting governments to establish or strengthen systems of financial accountability as they devolve financial power to local authorities. (paras. 16-19 in Annex I)

(b) ***At the sector level:***

- Strengthening the capacity and accountability of ministries and institutions that develop policies, establish expenditure priorities and oversee the delivery of essential services.

(c) ***At the micro level:***

- Assessment of *choice and participation options* in the design and preparation of projects producing and delivering services. (paras. 20-24 and 28-31 in Annex I)

- Encouraging *beneficiary participation* where appropriate, in the design and implementation of Bank projects, based on lessons drawn from the ongoing Operations-PRE study of Bank experience with popular participation. (Box 5 in Annex I)

- Selective and focussed use of *local NGOs* to enhance service delivery and ensure that the voice of the poor is heard in project design. (paras. 25-27 in Annex I)

Legal Framework for Development

- *Legal reforms*, including better communication of laws, ensuring consistency of laws, addressing constraints to implementation of laws, updating legal systems, training of the judiciary in business and economic laws, and encouraging extra-judicial alternatives when legal systems are overburdened, such as commercial arbitration and other dispute settlements mechanisms. (paras. 32-60 in Annex I)

- *Legal Sector Reviews*, undertaken at the request of borrowers, with a view to removing impediments to private sector activity.

Information and Transparency

- *Transparency*: Assisting governments improve the transparency of budgets and public expenditure programs; assisting with the preparation of environmental assessments and encouraging borrowers to share these with those affected by projects; assisting improve domestic and external procurement (Box 13 in Annex I and paras. 71-75) mechanisms and institutions to ensure competition, transparency (including disclosure of selection criteria), and fair contract conditions in public procurement etc.

- *Economic and social information:* Assisting governments improve the collection and dissemination of economic and social data. (paras. 76, Annex I)

- *Analysis and dissemination capacity:* Strengthening the capacity to understand, process and use information. The Africa Capacity Building Initiative will contribute to this process as well as long-term twinning/training arrangements. The training of economic journalists to raise the level of public awareness and policy debate may also yield returns. (para.76-77, Annex I)

56. Much of the above work represents a natural extension of the Bank's work on public sector management. It is, like the PSM work, technical in nature and complements other efforts undertaken in economic reforms, such as elimination of monopolies, deregulation or removal of controls to contribute to good economic management and reduce opportunities for rent-seeking. Indeed, there is much that the Bank has been doing routinely which indirectly contributes to good governance.

Limitations of the Bank's Role

57. In undertaking such work, the Bank faces some inherent limitations: those of any external agency, of its legal mandate, of its comparative advantage, and of the skills and resources available to it. First, as an external agency, the Bank cannot substitute for the political commitment that governments must bring to reforms in this area. Outsiders can assist and advise, but unless governments are committed to reform, changes that are brought about will not be sustainable. Full ownership of reforms is as important in this area as it is with economic policy reforms.

58. Second, the Bank's legal mandate clearly delimits its areas of concern. By way of illustration, the Bank may support government efforts at decentralization. It may, through its economic and sector work make a persuasive case for or against decentralization of particular functions. But the decision to decentralize is one that only governments can take. Similarly, the Bank is

rightly concerned with financial and economic accountability, but political accountability is outside its mandate. Similarly, the Bank may assist in strengthening local governments; it may not, however, have conditionality requiring local government elections. With regard to the legal framework for development, the Bank's concern is with its procedural and institutional aspects. The substantive elements of such a framework have political connotations that may sometimes lie outside the Bank's mandate. Here the General Counsel's memorandum provides clear general guidance, although such distinctions can, sometimes, be difficult to make in practice. It is important to note the underlying motivations behind the restrictions in the Articles of Agreement. These restrictions help to protect the Bank's reputation for technical excellence and objectivity and its status as an international institution that is guided solely by its concern for economic development and not by any political agenda of its own.

59. Third, the Bank's past experience provides a counsel of caution. The accompanying PSM paper is evidence that work in this area is likely to prove difficult and not yield quick results. The Bank's early experience with integrated rural development projects in the 1970s taught many valuable lessons. These projects were ambitious ventures into the public sector and social engineering. Of the many lessons learned from that experience, some reinforce the need for the exercise of care and humility in tackling problems of governance. The lessons include the need for a more differentiated approach between regions, countries and project type; the need for strong government commitment at an early stage; the need for training and retraining Bank staff to meet the complex needs of these projects; the need for long-term institution building and for avoiding project institutional arrangements that lead to frequent conflict with other parts of national and local governments; emphasis on developing human capital rather than quick physical implementation: the realization that expatriate technical assistance is a poor substitute for developing local capability. There were also other important lessons not directly related to governance involving the incentive frameworks, the role of the private sector and over-optimism on the availability of profitable technical packages.

60. Finally, work on development management and institution building is expensive and time consuming. However, such work will be handled like all other claims on budget resources, through a determination of priorities within existing country programs, based on need, borrower receptivity, etc. As noted below (para. 64), selectivity would be important in terms of countries and the range of activities to be pursued. The Bank should, of course, not attempt to take too much on itself. There are UN and other agencies who have experience in some relevant areas, which the Bank can tap through collaboration and its aid coordination function. Given that the rationale for the Bank's involvement in governance is that it helps improve the effectiveness of its programs and projects, and not as a new line of business, high quality work and improved Bank practices in this broad area should help the Bank to move further towards an "implementation culture", leading over the longer run, to increased cost efficiencies for the Bank itself and greater effectiveness of Bank interventions.

61. The skill-mix problem also raises difficulties. Many governance concerns can and are being addressed by various specialists in the broad PSM field, although experienced auditors, accountants, lawyers, tax specialists, management specialists and the like, are generally in short supply in the Bank. The LAC region has gradually built up a range of new skills through judicious hiring and use of consultants. Consultants can play an important role; Bank staff need to ensure

though that consultants are sensitive to the Bank's institutional concerns. Here again, the Bank needs to assist borrowers to draw on skills in other agencies, but recognize that there will nevertheless be significant trade-offs.

V. IMPLICATIONS FOR BANK PRACTICE

62. Bank actions relating to the governance dimension of development would be chosen selectively from the following range of options depending upon country circumstances and needs, the state of the dialogue with the borrower, and budgetary constraints:

- *Assisting* governments in reforms that they have identified or assisting them to identify reforms when they have asked for such assistance. The Bank is already experiencing a growing demand for technical assistance in support of a legal and procurement framework in Africa and Eastern Europe and strengthening decentralization in Latin America.

- *Persuading* governments through dialogue and economic and sector work of the need for reforms. Institutional and public sector management assessments and public expenditure reviews and financial accountability and legal sector reviews in Africa and Asia are examples of how this has begun to happen.

- *Crafting* country lending strategies and levels to take account of the impact of governance issues on development performance.

- *Helping* countries deal with the especially complex issues of poverty and the environment (see para. 21 above), where the quality of governmental performance is particularly important.

- *Projecting* a long-term vision of an enabling environment, as in the 1991 WDR but at country level, and supporting such fundamental ingredients as universal literacy, expanded primary education, better information on development issues and a supportive environment for a growing private sector.

- *Improving* implementation performance through greater efforts at assisting borrowers build ownership of adjustment programs, understanding the political and social structure of the country as well as its laws and customs, and increasing attention to fostering an "implementation culture" in the Bank, including greater emphasis on beneficiary participation in project design.

As a practical matter, given differing country circumstances as well as budgetary and staff constraints, a ***measured and selective approach*** must be pursued. The main elements of this approach are set out and some of the actions outlined above are elaborated, in the paragraphs that follow.

63. First, the Bank, through its interventions, should continue to exploit opportunities for improving development management, whenever appropriate, through a variety of means including assisting borrowers break up monopolies, removal of controls and other avenues for corruption, beneficiary participation in projects, etc.

64. Second, selectivity is necessary in allocating budgetary resources and developing work programs. The selectivity needs to be in terms of the choice of countries for specific work on the key dimensions of development management outlined above, and in terms of the range of activities the Bank can take on and support at any given time. Such work can only be embarked upon in countries where there is a clear commitment to and need for improving development management along these dimensions. Many of the Bank's borrowers may neither want the Bank to be so involved nor require such assistance. Where there is need but no commitment, such work would waste resources. Similarly, the dimensions of development management the Bank chooses to assist should reflect both the chances of success from such an involvement as well as the Bank's own ability in terms of skills and resources to assist effectively.

65. Third, in countries where the Bank is active in improving the governance dimension of development management, it needs to assist in the design of highly differentiated responses, taking account of the country's institutional needs, its political economy, its society, and history. The objective in each case must continue to be to help strengthen the enabling environment for sustainable and equitable development. This requires high quality analysis, usually as part of appropriate Economic and Sector Work.

Country Strategy and Implementation Issues

66. It is important to note in this context that a strong emphasis by the Bank on prudent financial management and attention to auditing and accounting or a legal framework suitable for development will tend to surface deeper and more general problems of governance. Thus, for example, sophisticated systems of financial accounting and auditing may be established but the government may not absorb or use the results to good effect. A legal framework could be created, but arbitrariness or corruption in its implementation could undermine its value. This has already been the experience with sensitive issues of PSM such as civil service reform where political constraints to the success of such work have emerged. Where lack of progress is due not to weaknesses in capacity but to lack of government commitment, the Bank then faces a problem which needs to be reflected in its country strategy and dialogue.

67. When political commitment to sound development management is weak, the Bank normally takes up these issues in its dialogue with borrowers while remaining proactive in seeking ways to help the country improve performance in some of the key areas. This dialogue is supported by economic and sector work, where appropriate. In such a dialogue, governance issues are not discussed in isolation but as an integral part of a government's overall development program. In conducting this dialogue, the level at which issues are discussed is a function of their sensitivity and requires the judgements of senior managers. Technical issues are handled at staff levels, but sensitive issues are handled at an appropriately high level (Country Director and above).

68. The issue of political commitment to sound development management is also surfacing increasingly at consultative group meetings. The General Counsel's legal memorandum noted that the Bank should not act as the agent of donor countries at these meetings. As Chair of these meetings, it is normal for the Bank to inform the country of widely-held donor concerns, particularly when these would affect Bank-assisted programs.

69. When dialogue fails, the Bank's own lending to the country is likely to be affected. Lending levels have long been responsive to issues of development management and

development performance, and will continue to be so. Judgments of performance are already routinely made for purposes of IDA allocation and in assessing creditworthiness. This involves judgments about the quality of development management as it relates to growth and to poverty reduction, consistent with the policy paper on poverty (World Bank, 1990e). There is no need for additional criteria to reflect concerns with governance: merely the effective and consistent application of existing criteria based on a greater awareness of the importance of issues of governance for development performance.

70. *Poverty and the environment* are two critical areas of country strategy which present particular challenges of governance. The Bank needs to pay attention to the equity as well as cost-effectiveness of social expenditures in its poverty assessments and public expenditure reviews, including addressing questions of the adequacy of social safety nets (especially important in middle-income countries). The legal framework can also greatly influence the access of disadvantaged groups, such as women or landless people, to public services and economic opportunities. On environmental matters, even non-interventionist governments face relatively extensive requirements for administrative and regulatory decision making, much of it discretionary, in areas -- like forest policy or pollution control -- where property rights are uncertain and market processes, therefore, cannot easily produce a socially desirable outcome. The Bank is considering how these inherent difficulties can be overcome and potentially abusive discretionary powers curbed for example, by separating surveillance from administrative responsibility. WDR 1992 will discuss some of these issues of environmental policy and governance.

71. Given absorptive capacity constraints, and the long-term nature of the task of developing appropriate institutions and the strengthening of budgetary decision making and accountability, development management concerns must be integrated, where appropriate and relevant, into a long-term perspective of a country's development strategy and prospects. In the Africa Region, as a follow-up to the Long-Term Perspective Study on Sub-Saharan Africa and the Maastricht conference which discussed it, the UNDP and the Bank, with assistance from the Netherlands Government, are assisting interested African countries to develop such perspectives. The objective, in this case, is to use the exercise to help develop a national consensus on development objectives and instruments, and to put government adjustment programs within the framework of a long-term development strategy aimed at poverty reduction and consistent with environmental concerns. Countries elsewhere may wish to consider a similar approach. For the Bank, this means taking a longer-term view of its own interventions to assist borrowers improve economic management, recognizing that quick results may be unrealistic, and focussing on human and institutional capacity development. This also implies that some aspects of this work should be supported by investment operations rather than with adjustment lending. Carefully designed long-term technical assistance is also appropriate.

72. This long-term approach would reinforce efforts underway to strengthen ownership of adjustment programs. The technical complexity of the preparatory work on *adjustment operations* and the speed with which borrowers require resource transfers, sometimes leave insufficient time for adequate dialogue and can cause the Bank to contribute to programs whose ownership is weak and that are then seen to be externally imposed. In an ideal world, sufficient preparation time would permit a better understanding of the political economy of the country, and through a more intensive and extensive dialogue, greater ownership and understanding of the program

by the borrower is assured. However, governments and Bank staff frequently do not have that luxury. Governments often delay adjustment and come to the Bank for assistance on adjustment when they are facing a serious crisis. There is, then, an inherent conflict between the need for quick support of sensitive policy reforms and the need to build ownership and understanding of the program. Moreover, greater ownership comes after a program begins to show results. It, nevertheless, remains important to ensure that operations are designed, taking into account, the political economy of the country. It is also important to ensure that ownership of the program, however narrow at the start, is genuine, and is broadened over time. At the same time, the strength and integrity of adjustment programs must be protected.

73. Beyond adjustment lending, fostering an "*implementation culture*" requires attention to good governance in the design of projects, as well as a deliberate focus on implementation. Best practice includes simple project design, discourages creation of autonomous project implementation units, encourages use of existing structures to implement projects, increases supervision, suggests prior action and conditionality rather than delayed dated covenants, recommends recruitment of key staff well before effectiveness and pays special attention to the fiscal effects of projects. All of these recommendations, coming more and more sharply into focus in Bank operations, are instances of the approaches to good development management discussed in this paper.

74. *Beneficiary participation* is, in many instances, an important component of institutionalizing an implementation-oriented approach as well as a means of improving the effectiveness of particular projects. The Bank, as noted, is attempting to spread best practice in this area. This will require skills in organizing participatory processes, mediating conflicting points of view while achieving results in a timely manner. In some cases, it means identifying intermediaries through which the Bank can work. It may also mean working with local NGOs; in other instances, this may mean searching for special skills in local sociologists, development managers, anthropologists or consultants who can be brought into projects for particular aspects of project work. Timetables may sometimes need to be adjusted in order to accomodate this labor intensive work -- often at the beginning of the project cycle. The Bank's learning process on popular participation is addressing these issues (Box 5, Annex I).

Implications for Research

75. Much of the Bank's current policy and research work in public sector management bears on "governance" issues. For example, studies underway examine ways to introduce greater public accountability in public finance and in civil service management, while work on regulatory institutions and on the political economy of adjustment also addresses some of the questions discussed in this paper. Much uncharted territory remains, and current work could be extended in several directions.

76. One such is further research on the rule of law, to explore the minimal juridical conditions for broad-based development. For example, in areas such as contract enforcement, employment and tenancy transactions, recourse against public agencies and judicial independence, is there relatively consistent and culture-neutral experience on which countries can base their own efforts? Another important area is the accountability of public agencies, where it would be useful to evaluate the wide variety of mechanisms and models available. These include contracting out of services to private providers (on which some work is in progress), decentralization of provision and/or finance, ombudsman

mechanisms, "customer-driven" service systems and others. Further research could follow up some of the findings of WDR 1991 to explore the two-way relationship over time between economic growth and changes in governance.

VI. CONCLUSION

77. Management proposes to proceed with the following:

(i) Dissemination to the staff of the key messages for the Bank in this paper together with the Board's guidance.

(ii) A broad-based dialogue with borrowers, interested academics and others in all Regions. This has already begun in the Africa Region.

(iii) A research program along the lines discussed in paras. 75-76.

(iv) A progress report to the Board on the Bank's ongoing experience with governance issues in about two years' time.

ENDNOTES

1. Webster's Unabridged Dictionary

2. Governance, in general, has three distinct aspects: (i) the form of political regime (parliamentary/presidential, military/civilian, authoritarian/democratic); (ii) the processes by which authority is exercised in the management of a country's economic and social resources; and (iii) the capacity of governments to design, formulate, and implement policies, and, in general, to discharge government functions. The first aspect clearly falls outside the Bank's mandate. The Bank's focus is, therefore, on the second and third aspects.

3. This discussion was itself partly prompted by criticisms of early drafts of the LTPS from African reviewers who felt this issue needed to be aired.

4. This gives rise to the so-called "Principal-Agent" problem which relates to how the Principal can most effectively induce the Agent to act the way the Principal would like. There is a growing body of literature on "Agency theory." See Eisenhardt, 1989.

5. North draws an important distinction between institutions and organizations. "Institutions, together with the standard constraints of economic theory, determine the opportunities in a society. Organizations are created to take advantage of those opportunities; as the organizations evolve, they alter the institutions" (North, 1990: 7).

6. Lucien Pye argues persuasively that "culture is not a matter of the rule of the irrational as opposed to objective rational behavior, for the very character of rational judgements varies with time and place. Common sense exists in all cultures, but it is not the same from culture to culture. Sentiments about change, judgements about utility, expectations as to what different forms of power can and cannot accomplish are all influenced by cultural dispositions....People cling to their cultural ways not because of some vague feeling for their historical legacies and traditions, but because their culture is part and parcel of their personalities" (Pye, 1985).

7. The concepts of "exit" and "voice", which originated in Albert Hirschman's classic work, *Exit, Voice and Loyalty* (Hirschman, 1970), have been adapted by Samuel Paul to the issue of accountability (Paul, 1991).

8. For example, under a Bank-supported Madagascar Environment Program - The Land and Rural Resources Directorate (DPRA), a public titling agency, for which the Bank has been a lead donor, has been struggling unsuccessfully for some time with formal legal arrangements which would ensure that disadvantaged people who invest in land, will have access to future benefits from their investments. Having failed the formal legal way to do this, they pursued a different course. A survey of the current, traditional land tenure system is under way to understand traditional rights and control mechanisms, and to understand how investment decisions are made and benefits derived. This survey, which is highly participatory, builds on people's knowledge of the land around their communities and of the rights and obligations traditionally allocated to groups and individuals. Once this survey is completed, it is planned that the DPRA will set up village discussions in which individual rights will be agreed upon for a specified period and verbal community consensus will sanctify these rights. This community agreement will be updated on a regular basis every few years. The results of the village discussions, and the community agreements about individual rights that follow, will be included in reports to be given the status of official (legal) documents.

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ANNEX I
KEY DIMENSIONS OF GOVERNANCE

A. ACCOUNTABILITY

> "[Accountability] is found where rulers readily delegate authority, where subordinates confidently exercise their discretion, where the abuse of power is given its proper name, and is properly punished under a rule of law which stands above political faction."
>
> *John Lonsdale (1986)*

The Nature and Scope of Accountability

1. Accountability, at its simplest, means holding public officials responsible for their actions. Political leaders are ultimately responsible to their populations for government actions and this means that there has to be accountability within government. How this happens varies widely in different countries, depending upon cultural characteristics, history, political institutions, administrative capacities and the public's access to and use of information. At a broad level, economic objectives of public accountability include ensuring congruence between public policy and actual implementation, and the efficient allocation and use of public resources. This not only requires systems of financial accountability, but also the capacity and willingness of governments to monitor their overall economic performance. At the micro level, the primary concern is similar efficiency in investment and in the production and delivery of goods and services in the public sector.

2. Accountability is important throughout the economic system, not just within government. Governments also have an important role to play in ensuring accountability in the private sector, through company and securities legislation, competitive policy, and regulatory oversight. As the state sheds many productive investments in developing countries, this function becomes particularly important.

3. Public accountability involves three inter-related groups: (i) the general public and particularly recipients of public services, who are interested in service providers being accountable to them; (ii) political leaders and supervisors of service providers, who would like the service providers to be accountable to them for a mixture of public policy and private/parochial interests; and (iii) the service providers themselves, with objectives and interests often different from the first two.

4. The phenomenon of "capture" of public services and resources by relatively narrow special interests is an ever-present problem in all countries. It is made worse by monopoly, and also by limited capacity of the public to demand *and* monitor good performance, especially since it is often hard to measure the benefits of public services. These factors make improvements in public accountability an especially complex and difficult undertaking.

5. The historical evolution of accountability reveals three features. First, micro-level accountability has become more important as the role of the state has expanded and made it impossible to apply broad political accountability to all the myriad actions of modern government. Second, the focus in public accountability tends to be on inputs,

especially public expenditure, rather than on outputs or impacts, which are often diverse and complex to measure. Third, except for legal accountability for government action in some countries, accountability has mostly been by internal administrative controls by political leaders, government agencies and bureaucrats acting as proxies for the public. But hierarchical control is often ineffective, especially when collusion between supervisory and subordinate personnel is likely. Micro-level accountability, remains critical, especially in ensuring government responsiveness to the views and needs of the "publics" for which services are intended.

Macro-Level Accountability

6. There are two key aspects of macro-level accountability that are particularly relevant: financial accountability, and accountability for overall economic performance.

Financial accountability involves:

(i) A properly functioning government accounting system for effective expenditure control and cash management;

(ii) An external audit system which reinforces expenditure control by exposure and sanctions against misspending and corruption;

(iii) Mechanisms in place to review and act on the results of audits and to ensure that follow-up action is taken to remedy problems identified.

7. Without a well-functioning system of financial accountability, government efficiency is poor, and the probability of corruption increases greatly. Corruption is clearly an issue of concern not only because of potential misuse of external resources (including the Bank's) but also because it generally reduces the efficiency of resource use (Box 1).

8. The Bank has historically focussed on financial accountability, especially in the context of investment projects. As is the experience of other donors, compliance with accounting and auditing covenants has been uneven. The problems encountered in these areas are not project specific but are symptomatic of weaknesses in country-wide financial accountability. The need for improved financial accountability at the national level is of particular relevance in countries where the Bank is undertaking adjustment lending and is, in effect, providing substantial resources directly to government budgets.

9. To address this issue, the Bank is pursuing in selected countries a three-pronged strategy. First, it is trying to *improve borrower performance* through stricter enforcement and the introduction of penalties for non-compliance. The penalties include not extending closing dates, conditioning further processing of loans to compliance with requirements on past loans and suspending disbursements.

10. Second, it is trying to *encourage more systematic review of auditing and accounting capacities and needs during project preparation*, and encouraging greater contracting out for project accounting and audit services.

11. Third, it is helping to *strengthen borrower capacity* through country-wide reviews of auditing and accounting systems, and following up with assistance. In Ghana and Madagascar, Economic Management Support Projects aim to remedy deficiencies in public financial management in those countries. The projects would clear the backlog of government accounts and introduce new accounting methods and software to

BOX 1
Reflections on Corruption

Corruption is the misuse of power for personal gain. Many people, anywhere, can be tempted to misuse power for personal gain, if permitted to do so at no cost or risk to themselves. Thus, corruption occurs in all countries in many different forms. It tends to emerge and increase in any country when inequalities are acute, resources scarce, rules unclear, disclosure and punishment unlikely, and upward mobility is restricted. Efforts to reduce its incidence need first to identify the *kind* of corruption (graft, bribery, theft, conflict of interest, nepotism, bias, or favoritism), its *frequency* (pervasive, occasional, or intermittent), and its *perpetrators* (contractors, public officials, political elite, businessmen, foreign suppliers).

The causes of corruption relate to political and economic conditions within the society and their linkages to problems in the world economy (Theobald, 1990: 10-11; 161-169). As such, causes are as complex as types of corruption are varied. While distinguishing between symptoms and causes is important, sometimes symptomatic relief provides opportunities for needed social and economic change leading to more lasting "cures". For example, bribery of public officials allocating essential licenses can be mitigated by clear rules, disclosure, and effective enforcement. Further, the amount of licensing can be reduced with clear rules. The longer-term measure of civil service reform adds more long lasting relief. Only over time, and with major policy reform, can improved economic performance increase economic opportunities and thereby provide the environment and context for diminished corruption. Yet, every generation has to make its own struggle against its resurgence.

Competition, clear rules, and disclosure are important first steps. Many countries have sophisticated and strict laws addressing corruption. Yet the existence of legislation alone is insufficient. The problem may lie with a lack of dependable enforcement. Simultaneously with enacting legislation, the strength and independence of the judiciary has to be secured (see para. 51).

Many political leaders in countries with serious poverty have amassed extraordinary fortunes. Foreign exchange reserves were transferred to foreign bank accounts. Such abuse, needless to say, adversely effects economic development. It unleashes cynicism which corrodes public trust – and signals to others to do likewise. Private wealth accumulated through abuse of power amidst public squalor undermines legitimacy. Yet, graft on this large scale is not possible without collusion between major private corporations and public agencies. Often the "commissions" are paid by foreigners – foreign contractors, companies, or consultants. Sometimes such activity is associated with foreign aid. Foreign companies argue that bribery is but one of the costs of doing business in a country. Financing necessarily flows through different agencies; a percentage "take" off the top is considered a fee by some, a kickback by others.

What, if anything, can donors do in these circumstances? In part, the recommendation for countries is also true for donors – *reduce the number of unnecessary regulations, and rely more on market forces; ensure that the laws of the country are observed; insist upon meeting procurement and contracting standards; upon meeting audit requirements, study audit reports; pay attention to the manner in which disbursements are handled.* Even with these safeguards, the problems are daunting. Aid coordination provides another venue for flagging the importance of supervision, audits, and attention to disbursement processes. Audits may be required, and not always performed, or where performed, they may not be read. Project supervision is difficult to maintain in the best of circumstances; when donor agencies are pressed to do more with fewer people, supervision suffers.

(continued on next page)

improve the accuracy and timeliness of financial data. Similarly, the Development Management Project in Mauritania helped to establish the Office of Auditor-General. Audit systems in the banking sector are being reformed in Poland and Algeria, while Poland

BOX 1
Reflections on Corruption

(continued)

Corruption is a two-way street. Donors have a responsibility to ensure that commercial considerations do not undermine good economic management in developing countries. Encouraging governments to develop sound public investment programs and respecting the priorities established is an important contribution donors can make. In this regard, the Development Assistance Committee (DAC) of the OECD, in consultation with the Bank, has prepared a document entitled "Good Procurement Practice for Official Development Assistance". More recently through an OECD/DAC Working Party on Financial Aspects of Development Assistance a greater effort is also being made to ensure that competition for contracts under donor-financed projects is not a source of corruption and does not contribute to distorted investment priorities. The intention is to ensure greater transparency and fair trade practices through a common band of concessionality levels, more open procurement procedures for large projects, upper income limit for tied aid, more transparency in large projects, e.g. through ICB procedures and mandatory consultation, etc. Project preparation through joint appraisals and cofinancing with multilateral development banks including the World Bank is seen as one way to ensure sound investments. When such cofinancing is not possible, the DAC has proposed that donors look to the Bank for advice on the appropriateness of proposed bilaterally financed large projects in the particular country situation. A consensus has yet to be reached on these proposals.

Some observers have also suggested that one of the next steps may be to have donors more fully exchange information with one another about companies, contractors, or consulting groups which have been identified as having participated in graft, bribery, or other corrupt behavior. This 'blacklisting' of corrupt companies or contractors by donors would provide a useful disincentive for these practices.

has also requested technical advice on audits and evaluations of government programs and accounts. In January 1990, the Africa Region set itself a target of 12 projects or project components aimed at strengthening financial management capabilities of borrowers through FY92. The Asia Region established a Task Force on Auditing which also suggested the need for a more comprehensive approach to the problem. In Indonesia, the Bank is supporting a comprehensive Accountancy Development Project (Box 2). These country-level reviews need to focus on coverage, timeliness and quality of financial control of projects and public expenditures, but also take account of legislative or other review of government policies and programs and of public access to information.

12. ***Accountability for Economic Performance***: The Bank has also addressed issues of economic accountability. As described in the Public Sector Management (PSM) paper, public expenditure reviews have focussed on the efficiency of resource use in public investment programs, in the parastatals sector, in the social sectors, and more recently, in employment and wage issues in civil services. This has led frequently to the identification of reforms including the removal of white elephants from public investment programs, privatization, restructuring and closure of state enterprises where appropriate, reallocation of resources in favor of primary health and primary education, and the removal of "ghost workers" and rationalization of employment levels in the public sector. Increasing attention is being paid to strengthen the capacity of governments to monitor and evaluate their own economic performance, including issues of resource use.

13. Governments could do more to strengthen the overall monitoring and

BOX 2
Indonesia-Accountancy Development Project

Indonesia's government accounting practice had changed little since the 1864 Dutch Financial Administration Act. Finding that they could not cope with the increasing complexity of government financial transactions, the government requested Bank support for an accountancy project. Budget reports and financial statements did not provide a comprehensive view of the financial situation and were often delayed. It took three years before government expenditures for a given period were reported to Parliament.

In the private sector, the accounting system had fallen behind other skills required in industry and commerce. The shortage of trained accountants and managers who could produce and use accounting information was severe. The professional body of accountants -- the Indonesian Institute of Accountants -- was relatively young and lacked detailed accounting and auditing standards to guide the profession, a code of ethics and disciplinary processes to regulate it.

The Bank-financed accountancy development project will address all these areas by:

- improving accounting practices in the public sector by supporting the introduction of modernized government accounting;
- improving accounting practices in the private sector by supporting the development of technical standards and a code of ethics for the accountancy profession;
- supporting the government's program to raise the quality of accounting faculties and to prepare for future expansion of accountancy education and training; and,
- improving the legislation on accounting, auditing and disclosure requirements.

The modernization of government accounting is being carried out with the use of local and foreign specialists who are assisting in the design of a uniform chart of accounts and a clear and specific classification of expenditures. Similar changes in accounting practices will be adopted by public enterprises and by lower levels of government.

With regard to private sector accounting, the World Bank will support the Indonesian Institute of Accountants to continue the Certified Accountant's professional education. Accounting principles and auditing standards will be formulated for more consistent financial reporting by commercial and industrial businesses and a code of ethics will be developed.

In accounting education, the Bank will finance programs for personnel development, procurement of teaching equipment and materials, research, fellowships to train accounting teachers, and loan programs for institutions and students. The improved quality of accounting programs in universities and institutions will permit expansion of accountancy enrollments and increase the supply of accounting professionals.

The proposed project will be implemented over five and half years. Its total cost is US$162.5 million, of which the Bank loan will finance US$112.0 million.

evaluation function, currently largely donor driven and project specific. Yet in many countries, departments are required by legislation to prepare annual reports on their activities. Some countries have performance monitoring ministries. OED has tried to encourage these activities, and more work under PSM projects is under way. This will need to be a gradual process, given the competing claims on resources.

14. In some industrial countries (and a few developing countries), a current wave of PSM reforms seeks to raise the efficiency with

which public resources are used by giving public managers greater freedom to run their operations but substantially increasing their accountability through objectives, specific targets and performance monitoring. There has also been an attempt to link such efficiency concerns to broader notions of performance in implementing government policy objectives. This accountability is sometimes reflected in contracts, programs or memoranda of understanding. A number of developing countries have adopted the use of such memoranda in the context of parastatal reforms, which are then negotiated by heads of government departments and chief executives of public enterprises. These have had mixed results, particularly when undertaken with inadequate preparation or discussion. This is accompanied by a movement away from a single year to a medium-term budgetary framework that provides managers with a stable resource stream. Alongside this, accounting systems and internal auditing are being strengthened, with increased emphasis on cash management and, in some cases, accrual accounting. The audit function is now being widened to include not only financial probity but also "Value-For-Money" (VFM) audits.

15. The applicability of these innovations to developing countries will vary. Some of the Bank's borrowers are probably ready for reforms along the lines described above. However, in most countries, the basic accounting and auditing systems are not in place. Greater autonomy to managers must be linked to improvements in financial information systems. Similarly, only when financial audit systems are functioning well can "Value For Money" auditing be considered.

Decentralization: The Macro-Micro Linkage

16. Decentralization is an increasingly common phenomenon in Latin America, Asia and Eastern Europe. In theory, it can lead to significant improvements in efficiency and effectiveness by reducing overloading of central government functions and improving access to decision making and participation at lower levels of government, for example, by improved service design, user financing targeting and delivery (See Box 3).

17. However, if not carefully managed, decentralization can lead to a deterioration in the use and control of resources, especially in the short term. National goals can be seriously distorted by local governments and scarce resources diverted to misuse. Moreover, radical decentralization can seriously weaken the capacity of the central government to manage the economy through fiscal and monetary means. In the late 1980s, Argentina's provincial governments were responsible for the largest and fastest-growing portion of the public sector deficit. Apart from the potential damage done to macroeconomic stability and expenditure efficiency, resources are arguably more open to capture by elite groups at the local level than at national levels.

18. Perhaps, the most serious problem is weak administrative capacity at local levels, leading to waste and corruption. The poorest local authorities, whose constituents stand to gain the most from improved delivery and targeting of social services, are precisely those least able to manage increased responsibilities.

19. The Bank's present approach to decentralization and local government development relies heavily on financial tools to ensure efficiency, including cost recovery for municipal services. An upcoming study on decentralization in LAC countries suggests the

BOX 3
Decentralization in Poland and Romania

As Poland and Romania pursue political liberalization and macroeconomic adjustment, they are also embarked on a significant decentralization of the public sector. The three issues are closely linked.

Strengthening local government is widely viewed as essential to ensuring greater responsiveness and accountability in many infrastructure and service areas that have been dominated from the center in both delivery and financing aspects. Development of political and institutional means to hold local government authorities accountable to their constituents is important because much of the justification for public sector decentralization is based on the premise that many areas of infrastructure and services are provided more efficiently at the local level since beneficiaries can better express their demand for these services, control costs and hold local authorities accountable for their actions.

Decentralization of the public sector requires fundamental reforms in the expenditure and financing responsibilities of local governments in Poland and Romania. Fiscal chaos could ensue if local revenue capacity is not enhanced and intergovernmental fiscal transfers are not controlled. A collapse of local infrastructure and services is likely if local expenditure assignment is not matched with revenue authority and local institutional capacity. Local government reforms must include, therefore, fiscal reforms at the national and local levels and local government institutional strengthening. These reforms also will be crucial to stimulating increased private sector productivity, not only through improved delivery of public infrastructure and services, and a prudent regulatory framework, but also because local governments will be key to implementing an effective policy of property rights through legal cadastre that provide security for the transfer of property.

Local governments will be key implementing institutions for the Bank's pipeline of proposed projects in both countries, primarily in the areas of infrastructure, the social sectors, environment, rural development and poverty alleviation. However, before these decentralizing countries may absorb effectively lending operations, local governments must be strengthened to discharge effectively their new and growing responsibilities. Key areas for institutional strengthening include: local taxation policy and administration (and consistency with national taxation policies); management of local enterprises (e.g. privatization and/or regulation in areas such as water supply and sanitation, transport, solid waste and housing); budgeting, accounting and audits; maintenance programming and implementation; investment planning and evaluation; and procurement practices.

Because decentralization in these countries comes after decades of tight, central control, the pace and scope of the decentralization process are issues of concern for the countries and for the Bank, and all recognize that there is no broadly recognized "road map" for public sector decentralization.

Therefore, the Bank's strategy for assistance to the decentralization process is broad and country-specific, but the short-term strategy is evolving in four key areas: (a) policy dialogue and possible inclusion of local government strengthening measures as part of the program to be supported by adjustment lending; (b) country and regional sector work on local government reform (e.g. regional work in FY91 and local government reform in Poland for FY92); (c) targeting technical assistance on local government reform (e.g. local government component of Infrastructure Technical Assistance Loan to Romania); and (d) highly selective project support through lending operations in areas critical to overall adjustment and reform (e.g. proposed housing project loan to Poland).

need for a more comprehensive strategy, with greater attention to mechanisms such as hearings or surveys, which allow local preferences to be ascertained. In Mauritania, a project helped to establish the institutional framework for the creation of municipalities. In this instance, local elections followed, providing the public with one accountability

mechanism. In Indonesia, an upcoming project provides assistance for (i) strengthening the institutional and human resource capabilities of local governments by increasing the efficiency and effectiveness of previously fragmented training programs, and (ii) strengthening the institutions and coordinating capacities of local government and administration. Other initiatives could focus on strengthening the oversight function of national government. Venezuela has successfully used an executive council (COPRE) to marshal ideas, try out policies and legislation, and develop guidelines and administrative models. Future Bank efforts such as the Africa Municipal Development Program could build on these experiences.

Micro-level Accountability

20. Micro-level accountability can reinforce macro-level accountability when: (i) there is competition, or scope for the public to "**exit**" when dissatisfied with a service. This can have a salutary effect on the agency concerned, through a reduction in its revenues and a related threat to the careers or pay of its staff; (ii) there is participation, so that the public can influence the quality or volume of a service through some form of articulation of preferences or demand. If such "**voice**" makes the public agency more responsive, accountability is enhanced.[1] In the National Irrigation Administration in the Philippines, the exercise of voice resulted in a greatly improved irrigation system (Box 4). Often however, competitive provision is more efficient except where national monopolies or market failure are predominant -- and it is undesirable to regard participation mechanisms as a substitute for (rather than an adjunct to) the availability of alternative providers. In any case, there are inherent problems (free riding, elite dominance, resource diversion) in collective action: the costs and benefits of "voice" options need to be evaluated case by case (Olson, 1965; 1982).

21. There are invariably numerous barriers to exit and voice. Legal and policy-induced barriers are more easily dealt with; natural barriers, such as spatial barriers (e.g. an isolated village can afford only one school) are more difficult to remove. Services that the poor (weak voice) require and for which alternative sources of supply are difficult to find (low exit) will be the most difficult to deal with.

22. ***Exit mechanisms***: There are several possible exit mechanisms, notably deregulation, contracting out of services to multiple private providers, public-private, and public-public competition. The key element is contestability: when incumbents are made to bid for contracts along with outside competitors, they will be more careful about their performance and their terms. Similarly, when regulations favor new entrants, the knowledge of potential entry can mitigate monopolistic behavior on the part of incumbents (Baumol and Lee, 1991). New technologies can be used, where cost effective, to broaden choice and access (e.g. mobile courts, mobile schools and health clinics or the use of VCRs or television for education).

23. ***Voice mechanisms***: Dissemination of information about services can aid the public in demanding greater accountability from service providers. Periodic evaluation of services can exert pressure. For example, a poll of beneficiaries' views on the service or the gathering of data from both beneficiaries and service providers can sometimes be an effective alternative to elaborate participation arrangements. Complaints procedures and institutional mechanisms such as ombudsman are ways of providing voice when there is no need or incentive for collective action. "Hotlines" can be established to help prod response to unsatisfactory services. These mechanisms are in place in some countries, and their effectiveness varies widely: in particular, elites tend to make the most use of

BOX 4
The Philippine Communal Irrigation Program

In May 1982, the World Bank approved a US$72 million loan to the Philippines for a communal irrigation program that would involve the participation of farmer beneficiaries in all phases of the project planning, design, and construction of the system. The project would involve construction or rehabilitation of 144 communal irrigation projects covering about 33,500 hectares in 35 provinces of 11 regions. After completion of a system, the farmers would assume full control of its operation and maintenance.

The project was remarkable in two ways: first, it was one of the most participatory projects ever to involve the Bank. Second, the initiative for the participatory approach came from a government agency, the National Irrigation Administration (NIA), which had been developing and testing the participatory approach for five years.

Before the participatory approach was introduced, nearly all of NIA's professional field staff in charge of communal projects were trained exclusively in technical subjects such as construction, design, and survey. The participatory approach, however, required the addition of staff oriented toward people and trained in building the problem-solving capacities of local people. Consequently, NIA hired community organizers who could work with the farmers to develop irrigation associations.

NIA hired six community organizers for its first participatory project in 1976. By early 1983, the number had expanded to 401. Of that number, 295 worked on communal projects and 106 on national projects. The gradual approach to expanding the program allowed the community organizers to accumulate learning. Organizers who worked on initial projects became the trainers and supervisors for later arrivals.

Evaluations in 1989 concluded that: "participation produced consistently positive results. The canals and structures were viewed by the farmers as more functional and the system was more productive, with greater increases in rice yields and in irrigated area in the dry season. The irrigation associations were more likely to use water distribution methods that assured greater equity of water access to the members and were more likely to use sound financial management practices. They contributed more to construction costs at the time of construction and subsequently paid a greater percentage of their loans due. The costs of achieving the wide range of benefits demonstrated for the participatory projects was only 3% of the total cost of construction."

This program, widely studied around the world as a model of the possibilities of increasing effectiveness and sustainability, is still under way. A new Bank loan in 1988 for the operation and maintenance of the national system (which is distinct from the communal system) provided funds for community organizers and farmer training. Work has begun on a follow-up loan for the communal program.

these services. Consequently, they are most useful to the poor when the service is "non-excludable," like drinking water, roads, or public facilities.

24. Participation of public representatives in decision-making or regulatory bodies is one way of enhancing "voice." Users' representatives, for example, can be appointed to the board of directors of these organizations or hold equity shares of utilities. Where direct participation of users in decision making is difficult or inappropriate, a consultation process can be instituted through public hearing, advisory panels, etc. Legal action by consumer action groups is also a possibility, though not common in developing countries.

Governments and NGOs

25. Some developing countries have witnessed a mushrooming of private voluntary organizations (e.g. India, the Philippines, Bangladesh, Kenya, Zimbabwe, Senegal, Colombia, Mexico, and Chile to name a few), while some other countries clearly have not (e.g. C.A.R. or Malaysia) and depend much more heavily on governmental organizations and initiatives. Various factors contribute to the emergence of a strong voluntary sector, among them culture, level of development, and the stimulus provided by the influx of external NGOs after a natural disaster. A powerful factor clearly is government hostility or encouragement.

26. Government policies determine the enabling environment for NGOs and the roles that they assume. Governments determine in the first instance through rights such as freedom of association, or of speech whether NGOs can function effectively. Regulatory policies -- and fiscal policy -- also affect the environment within which NGOs operate. Precisely because NGOs may be a channel to the poor, or may be advocates on behalf of the poor, NGOs can be used by governments and donors to reach beneficiaries that are otherwise difficult to involve in the flow of project benefits. They can also be called upon to assume roles in the provision of benefits or in communicating between different constituencies. But it is also the case that some governments are suspicious of NGOs precisely because of their advocacy on behalf of the poor. There are, thus, pressures to coopt NGOs and make them extensions of the state.

27. Direct donor funding can be an important means of supporting NGO activities. But it carries with it a number of attendant risks including shifting NGO accountability from their natural constituents to donors, and making them vulnerable to subtle pressures from governments who must approve direct funding of NGOs (Fowler, 1991). The existing literature (mostly sponsored by bilateral donors) shows that NGOs tend to be effective at reaching low-income groups, especially in remote areas, and at working in a relatively participatory way. They tend to be weak in planning and administration. NGOs' most important contribution may not be service delivery but a pilot role for social initiatives urging and developing new approaches which are sometimes replicated on a larger scale. There can be, as a result, synergies between governments and NGOs; governments learn more about the needs of widely dispersed publics while NGOs acquire more effective management skills. The rapidly changing relationship between the State and NGOs needs further research and reflection.

The Bank's Role in Promoting Exit and Voice

28. The Bank is active in promoting deregulation and improving the working of markets in structural adjustment loans, in parastatal reforms and in much of its sector lending. The Bank has, in recent years, also worked to expand participation and the involvement of NGOs in Bank-financed projects. In FY89 and FY90, NGOs were significantly involved in 50 of the projects the Board approved. In some sectors, most notably agriculture and population, NGOs are contributing significantly to effective project implementation. NGO criticism, although sometime unduly harsh, has nevertheless contributed to the redesign or improved implementation of a number of Bank-financed projects.

29. Voice can also be enhanced through **popular participation** in the design and implementation of Bank-financed projects. Bank experience suggests that participation can be important to project success and

BOX 5
Popular Participation and the Bank

"We affirm ... that the economic crisis cannot be resolved ... without the full and effective contribution, creativity and popular enthusiasm of the vast majority of the people."

ARUSHA, 1990

Popular participation is the process by which people, especially disadvantaged people, influence decisions which affect them. The term "popular" refers not only to the absolute poor, but also to a broader range of people who are disadvantaged in terms of wealth, education, ethnicity, or gender. "Participation" means influence on development decisions, not simply involvement in the implementation or benefits of a development activity, although those types of involvement are important and are often encouraged by opportunities for influence.

The World Bank has learned from its experience that popular participation is important for the success of projects economically, environmentally, and socially. The most important lesson has been that popular participation is a question of efficiency, as well as being desirable in its own right. In one study, the Bank evaluated 25 projects five to ten years after completion. Strong beneficiary organizations (an instrument of facilitating participation) proved to be a key factor in determining project sustainability (World Bank, 1985). Another study of 68 Bank-financed projects found that the economic rate of return was twice as high for projects which had been sensitive to local social and cultural realities (Kottak, 1985).

The Bank's experience with participatory projects is limited, but growing. Participatory approaches have most often been adopted in projects designed to help particular communities -- agriculture, especially irrigation, forestry, and livestock; urban development and rural water supply; population, health, and nutrition. Social investment funds are a promising way for governments to support community-initiated micro-projects. A recent review reveals that in virtually every participatory project the Bank has financed, participation has contributed to project effectiveness (World Bank, 1990b). Individuals, households, groups, and communities are more likely to have a stake in, contribute to, and maintain projects which respond to their needs, knowledge, and initiative.

But popular participation is also valuable for bigger projects. The Bank's experience with environmental issues and adjustment loans indicates that public consultation and information sharing can improve the design and build public support for large-scale investments and policy decisions. This approach is working, for instance, in Mexico's Hydroelectric project, India's Upper Krishna Dam project, and Ghana's Private Investment and Sustained Development Promotion Credit.

Operations and PRE are pursuing a modest program of action and learning, supported by SIDA trust-fund resources, designed to strengthen the Bank's support for popular participation where this would contribute to the development effectiveness of Bank-related operations. Learning is being stressed because there are relatively few large-scale participatory development projects in the developing world. It is important to learn in what situations participation is worth the effort, and, in those cases, how the Bank and borrowing governments can effectively promote participation more widely. To date, Bank-supported participatory projects have been the exception rather than the rule, sometimes stemming from the personal commitment of individual task managers.

In most situations, the constraints on popular participation are external to the Bank (the intrinsic difficulties of engaging low-income people in project decisions, for example, and reluctance on the part of some governments). But improvements in income and education, together with increased interest among borrowing member governments, are relaxing external constraints in some situations. While grappling with the problems of making government implementing agencies more people-centered, the learning process is focussing especially on ways the Bank's own operational practices could be more supportive of participatory approaches.

sustainability. It is especially useful for activities focussed on particular communities and dependent on their active cooperation, but it is also relevant to large scale infrastructure projects. Participatory approaches in Bank projects have been tested successfully in sectors (notably, irrigation, forestry, livestock and agricultural credit, urban development and rural water supply, health and nutrition, environment and social investment funds). The Bank has recently embarked on an effort to learn better how to foster popular participation in Bank-supported activities (Box 5).

30. Attention to "exit" and "voice" options at the design stage of relevant Bank-financed service delivery projects will complement the strengthening of internal control systems. The use of such mechanisms, however, will cause accountability to improve only when this leads to a change in the behavior of the service provider -- its efficiency, access, and quality of service, not just its compliance with internal rules. This must be reinforced with incentives that reward responsiveness to users and the wider public.

31. Accountability at the micro-level will, in turn, be sustained only when the government and society at large are concerned and wish to improve it. Comparative information on how different countries perform in respect of key public services can be a powerful tool to generate national and international interest in this area. Selected performance indicators based on good professional judgment can be assembled on these services from as many countries as possible for wide dissemination (including the WDR) (Box 6). It will provide the data for governments, scholars, media and the public at large to see where they stand in respect to the level and quality of their services.

B. THE LEGAL FRAMEWORK FOR DEVELOPMENT

> "The Rule of Law is not a Western idea, nor is it linked up with any economic or social system...As soon as you accept that man is governed by law, and not by whims of men, it is the Rule of Law."[2]

32. The literature on the rule of law is voluminous and the concept lends itself to endless discussions at a jurisprudential level with limited practical relevance. The emphasis here is on a pragmatic view of the rule of law in the context of economic development and Bank operations.

33. The General Counsel has defined the rule of law as "a system based on objective rules which are actually applied and on functioning institutions which ensure the appropriate application of such rules" (Shihata, 1991: 42-43). There is empirical evidence that investment is adversely affected by uncertainty. Investment will not take place and will not succeed without a system which provides a minimum of stability and predictability.

34. Stability and predictability create a climate in which business risk may be rationally assessed and the cost of transactions lowered. In turn, some elements of the rule of law are a necessary condition for stability and predictability. It is primarily this connection of the rule of law with the level of investment and the more efficient use of resources that explains its importance as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself. It is only to the extent that it establishes some of the pre-conditions for economic development that it is legitimate to bring it within the

BOX 6
Improving Accountability and the Environment

The deteriorating quality of air, water and land resources in many developing countries is linked to problems of accountability and capacity. Government decision-makers in charge of natural resource management often contribute to environmental deterioration through poor management decisions. Poor decisions are a function both of inadequate incentives, and of an inability to project the actual effects of well-meant decisions or to evaluate alternative uses of scarce government funds.

Environmental resource management is further complicated by the multi-sectoral nature of many decisions. Water resources, for example, are affected by solid waste systems, storm water drainage, the demands of commercial, household and recreational users, and the requirements of ecological habitats.

Research currently underway in the Bank addresses this problem. The "Service Level Indicators for Capital" (SLIC) research sponsored by the International Economics Department is seeking service level indicators for public facilities (sewerage, water, etc.) and for natural resources, based on measures of quantity, quality and reliability for both users and decision-makers. Included in this research effort is a framework for applying Service Level Indicators through Benefit/Cost analysis. This extends the usefulness of these measures into investment decisions. SLIC creates a bottom-up measure of resource performance, provides an information base which allows users and managers to view how decisions are made and the effects they have, and establishes a transparent accounting framework for government service and natural resource decisions based on the level of services they provide to users. SLIC indicators are currently being formulated in a number of different Urban Development projects in Indonesia.

Service indicators for water resources can be related to the specific uses described above for water resources. Indicator sets for each purpose would be specified by aggregating relevant measures. Service levels for industrial or agricultural water supply users would be based on physical measures; for household water users or recreational users, service levels might be based on total health risk; for ecological habitat, service levels could be the number of viable ecosystems exposed to risk in the river stretch or habitat area.

By identifying and monitoring the specific environmental quality measures identified as important by decision-makers and users, SLIC will improve the effectiveness of infrastructure and natural resource management decisions, and help establish operations and maintenance priorities for public infrastructure. In addition, by measuring these indicators over time, SLIC should be able to establish trends in environmental resource quality, improving natural resource accounting, and defining more precisely the relationship between natural resources and economic development. And as SLIC enables line managers to make better decisions, publicly available service level indicators can also enable users to hold service providers accountable for the level and quality of the services they receive, both from government facilities, and from other providers.

purview of the Bank. The Bank's interest in the rule of law is from the vantage point of development management. As we will see below, the aspects of the rule of law are varied and so are the views about them. Not all have the same bearing on the purposes of the Bank. Moreover, how the legal system operates is highly culture specific and the Bank needs to approach work in this area with a proper understanding of the historical and cultural context.

35. From the great variety of definitions, two major aspects of the rule of law emerge. The first is sometimes called the instrumental notion of the rule of law. It concentrates on the formal elements necessary for a system of

law to exist without judging the content of the laws or their purpose.

36. The second aspect refers to the content of the law and is linked to concepts such as justice (e.g. the element of due process), fairness (the principles of equality) and liberty (civil and political rights). In the view of many, the formal aspect has to be complemented by substantive principles of the rule of law to create a "fair" legal system. In terms of the Bank's work, a "fair" legal system would have to be conducive to balanced development, e.g. a system which facilitates growth and responds to the needs of the poor. These would seem to represent issues the Bank is normally concerned with in its project and policy lending. They are outside the scope of this analysis which focusses on the basic "processes of the formulation and application of rules," (Shihata 1991: 45) and analyzes each of the five elements listed in "Issues of 'Governance'." In so doing, we incorporate the Bank experience so far, and draw conclusions for Bank operations and the relationship of the rule of law with the other elements of governance considered in this paper. The five elements are: (i) a set of rules known in advance; (ii) rules to be actually in force; (iii) mechanisms to ensure application of the rules; (iv) resolution of conflicts through binding decisions of an independent judicial body; and, (v) procedures for amending rules when they no longer serve their purpose.

A Set of Rules Known in Advance

37. This comprises three elements: the existence of rules as a set (denoting coherence), their communication (with accuracy, clarity and effectiveness) and the application of rules only known in advance (non-retroactivity of laws). Communication and coherence are two elements with which the Bank has been concerned. As regards *communication*, many developing countries inherited formal rules for the communication of laws similar to those of the metropolis. Frequently, the obligation of governments to disseminate new laws was and still is limited to their publication in gazettes. The law is available but the citizens have the burden of acquainting themselves with the law.

38. Publication of the official gazettes in many countries has ceased. The Bank has assisted or is in the process of assisting several countries to restart at least publication of the gazette (Box 7). It is also assisting in making the law more accessible and better known within the government itself.[3] However, in many developing countries, large segments of the population are illiterate, the media are ineffective and languages are diverse. Under these circumstances, there are obvious limitations as to how much the law can be known and understood by the average citizen and it is necessary that law be as clear and explicit as it is technically feasible.

39. To the extent that economic policies must be reflected in rules which are to be complied with, governments need to make these rules known through all possible means of communication. Rules are understood here in a broad sense and include legislation, courts' decisions, guidelines, etc. When land is being expropriated, for instance, simple explanatory pamphlets outlining the rights of those affected and explaining how they can exercise those rights should be made available to the population affected. Knowledge by people of their own rights contributes to limiting the arbitrary behavior of government officials and assist in creating the climate of predictability associated with the rule of law.

40. As regards the *coherence* of the rules, when conditioning disbursements in specific Bank operations on the enactment or modification of certain laws, it is essential for the success of the operation that the country implements its own rules. A decree, for

BOX 7
Communication of the Law

MAURITANIA: Development Management Project (Credit 1865 MAU)

The publication of the Mauritanian Official Gazette was done under a contract between the Government of Mauritania and a French printing company located in Bordeaux. This arrangement was however not effective and the Gazette was rarely published. Then the Government of Mauritania, with the assistance of IDA and the French Government, decided to print and publish the Official Gazette domestically. To do so, a contract was awarded to a private printer and the functioning of the Department of the Legislation (Services of the Presidency) was improved within the framework of the above-mentioned IDA Credit. The French Government provided technical assistance in the preparation of the Official Gazette using the French Official Gazette as a model.

The Official Gazette which had not been published for over two years, has now been published in French and Arabic on a monthly basis for the last two and a half years.

GUINEA: Second Economic Management Support Project (Credit 1963 GUI)

The Guinean Official Gazette was experiencing delays of up to two years in the printing of its issues. In order to correct this situation, the Secrétariat Général du Gouvernement (SGG) obtained, as part of this project, US$80,000 from USAID to finance printing of the Official Gazette for two years, and signed a contract with a private printing company to ensure its regular publication. In addition, the contract provided that the backlog caused by the two-year delay in the publication of the Gazette be gradually eliminated.

As of January 1989, the Official Gazette has been published fortnightly. Texts of a general nature and government decrees are published within a month of their signature. The backlog of previously unpublished legislation is being cleared.

The SGG is responsible for the distribution of the Official Gazette within the Government and the subscriptions and sales to public. It is expected that, as revenues from legal notices increase, the Official Gazette will be able to fund itself.

LAO PDR

In 1975 the National Congress of the People's Representative in the Lao People's Republic abolished the former constitution and all existing laws and regulations. In 1989 the government endorsed the establishment of a new economic mechanism, separating the state's administrative and regulatory function from production activities and increasing the role of the private sector. Under a component of a UNDP-funded project supporting the New Economic Mechanism, the Bank will assist the government to prepare and implement key economic and financial legislation, to train lawyers in business law and to establish a center of economic law. As part of such activities the project will make a proposal to the government to establish an official gazette to publish and promulgate new laws and regulations.

instance, should not derogate from legislation. There should be no contradictory statutes. There are, for instance, countries whose constitution forbids private ownership of the means of production. In the context of private sector development operations, the Bank needs to ensure that the operation is based on a sound legal premise (Box 8). In this respect, it would be advisable that, whenever possible, local legal expertise be brought into the picture together with any expertise from abroad as may be needed.

Rules to be Actually in Force

41. It is not enough for a law to be on the books: it has to be applied, it has to be in force in reality and not only in the formal sense, and most important, it has to be complied with. When a law is left in

BOX 8
Legal Inconsistencies in Eastern Europe and Africa

The centralized systems of state planned economies of Eastern European countries face a number of legal problems in their efforts toward economic reform and the development of market economies. Lately, these countries have been introducing reform elements for private sector development. However, contradictions and inconsistencies are often encountered. For example, several countries have started privatization efforts. In this process some have already amended their constitution to make provision for private property rights. Others have not yet changed their constitution to this effect, but, nevertheless, proceed with the privatization effort. In the context of Bank operations an effort should be made to address these issues which can hamper reform. Following are some examples.

In Romania, there has been considerable legislative activity. With regard to private sector development, the law on Restructuring State Economic Units as Autonomous Units and Commercial Companies was passed in September 1990; a draft law on Privatization (currently under consideration) will govern this issue. Other laws under preparation will cover bankruptcy, commercial and company law, foreign investment and small and medium enterprise development (to supersede Law No. 54 defining and permitting small enterprises, which was passed in early 1990). These laws are reducing the role of the government in productive activities while retaining its monitoring functions, introducing private ownership and encouraging foreign investment through joint ventures. The legal framework is, however, operating under the severe constraint of the clearly defined property rights. The Parliament has been given two years from the time of its inception to develop the relevant provisions.

By contrast, in Czechoslovakia, amendments were introduced to the Constitution effective May 1, 1990, recognizing all forms of ownership rights, and providing that they (whether state, cooperative or private) enjoy the same level of protection and that no form of property ownership has a privileged status. A law on Small Privatization was introduced effective December 1, 1990, while a law on Privatization is currently under consideration.

Another example which illustrates the effects of inconsistencies and contradictions in a legal system is the following: the socialist economic system has been protected by the rules of constitutional law, labor law, administrative law, as well as by the rules of criminal law. In the Soviet Union, "undesirable" economic behavior has been controlled through criminal or administrative sanctions for behavior which violates accepted socialist norms and undermines the economic system. There are several articles in the criminal and administrative codes of most republics which criminalize behavior that in a market system is rational and economically desirable. It seems that many of these articles will be eliminated in the next major revision of the codes. In the meantime, however, the existing criminal codes continue to stand and to hamper the economic reform effort. Prosecution under most of these articles continues, with thousands of convictions per year. Even if it is not feasible to amend the codes immediately, steps need to be taken to limit the effect of these provisions on those who wish to engage in new forms of legitimate business.

Although the Eastern European countries are the most striking example, similar examples can be found elsewhere. For instance, Guinea-Bissau is presently amending its Constitution, approved May 16, 1984, as part of a general political transition from a socialist state to a more "capitalist" state. An impediment to developing the private sector is Article 12 of the Constitution, which provides for state ownership of all land (leases are granted to private individuals), minerals, banks, insurance companies, etc. Article 13 also provides for state control of foreign trade and exchange transactions. One of the objectives of the legal technical assistance provided to Guinea under the Second Economic Management Support Project is to coordinate the various donor financed pieces of legislation so that they dovetail as a whole.

abeyance or is not respected, the answer does not necessarily need to be a new law. An analysis of why the old law does not work will avoid placing yet another law on the books.

42. The reasons why laws are ineffective vary greatly. In many developing countries, the fact that many laws are not applied is often related to their inadequacy to the local situation. They had been transplanted from other countries and not adjusted to the local situation. Alternatively, they were not updated to current developments in the countries concerned. For a law to be effective, one has to consider many elements leading to its observance. Such diverse factors as custom, geography, technology, and history play a role in inducing obedience to laws. Because of these factors, the same law and its sanctions in different times and places within different physical and institutional environments will not induce the same behavior. Furthermore, societies evolve and laws may become obsolete. There is a certain inertia in legal systems and they simply may not have been updated to take into account social, business or technological changes.

43. Another obvious reason why laws fail to be applied is the absence of competent administrators of the legal system. The law is not only a set of rules but it encompasses procedures and institutions for implementing these rules. To the extent these are lacking, laws most likely will remain on paper.

44. Donors must be sensitive to the variables which affect the success of the transfer of legal institutions and the application of the laws. They must also be aware of the limitations of sanctions to induce behavioral change. Punishment best enforces already institutionalized law, nudging the occasional deviant into conformity. In many instances, it is more appropriate to use incentives and roundabout measures to achieve results, normally, at lower costs than punishment and to the relief of over-burdened courts.

45. As regards legal institutions, the Bank may assist in improving the efficiency or competence of judicial systems to reduce the costs of economic transactions. In advising governments to adopt new laws, the Bank should be fully aware of implementation constraints. As regards enforcement of the laws, some aspects of it have a clear bearing on economic development and have been the subject of Bank operations; for instance, improvement of tax collection, and changes in security laws to permit financial institutions to foreclose on debt and mortgages (Box 9).

Mechanisms to Ensure Application of the Rules

46. Mechanisms must exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures. The concept of the rule of law requires furthermore that all government officials act within the ambit of the law. State power ought to be exercised under the authority of law. The proper application of the rules by government officials is the essential element of establishing legality and -- in conjunction with the idea of justice -- legitimacy. To act within the law means that the executive branch of the government bases its actions on the statutory power from which government officials derive their authority and that the exercise of such authority is within the boundaries set by the law.

47. Of course, the legislation authorizing government actions cannot prescribe for all circumstances precise and clearly-defined standards. Thus, while the proper application of the rules should ensure predictability, it must always leave some room for flexibility. Further, market competition functions as a limit to public discretionary power. (Citizens can choose private provision over public provision services.) Yet, there are complex choices on how to delegate discretionary power to the bureaucracy. Traditionally, the rule of law called for narrow grants of discretion. But the complexity and variety of

BOX 9
Enforcement

In Guinea under the Private Sector Promotion Credit, the deficient functioning of the judicial system and the legal void on bank sureties has been identified as major constraints for banking activity in the country. Banks are unable "to enforce their rights as creditors through foreclosures or other court-approved actions, due in particular to debtor-judge collusion and rampant corruption" (GUI Report; 5207-55). This operation is a modest start to address these problems and it will be followed by training of the judiciary and legal professions in banking and commercial matters and by improvements in material working conditions.

In Sri Lanka, the Association has been working in two operations in the financial sector to reform the laws allowing financial institutions to foreclose on collateral pledged under loans. Sri Lankan law had prevented direct execution by institutions, who were forced in each case to go to court to get a judgment before they could move against the property. This protection for debtors stemmed from historical concerns about unscrupulous money lenders but did not match the needs of a modern economy. On the advice of the Association the law was changed to permit direct execution. The result is a law which establishes a better balance between the rights and obligations of debtors and creditors.

In the Philippines as part of the Financial Sector Adjustment Loan, the Bank not only advised that the lengthy holding period for repossession by debtors of pledged property be shortened to a more reasonable period, but also that the 1905 bankruptcy law be revised to make it less punitive on debtors and more rehabilitative, in the interests of both creditors and debtors.

issues in modern times have led to increasing delegation of authority to the executive branch based on broad standards, discretion secures flexibility and responsiveness to different situations which could not have been predicted by the legislatures. (For example, environmental legislation often must accord discretion to local public officials.) Discretion represents a counterweight to legal formalism.

48. Discretionary power is not absolute power. Discretion in law is always limited. The most basic guidelines for the exercise of discretion require that any exercise of powers be based on reasons, that these reasons be applied consistently, fairly, and impartially, and that they be intelligibly related to a framework of purposes, policies, principles and rules.

49. As with all exercise of power, there is a need to ensure the respect for these limitations to secure the correct exercise of discretion. Thus, there is a need for mechanisms to ensure the proper application of laws, and rules that regulate how to depart from them. Several different forms of checking administrative action and avoiding the abuse of discretionary power have been adopted in various legal systems ranging from review by independent civil and criminal courts to specialized administrative courts and ombudsmen.

50. In addressing the issue of functioning and effective institutions, the Bank has assisted borrowers to improve their civil service and to establish well-defined administrative structures. Support of civil service reform has concentrated on better training for civil servants, pay structures and the need to ensure that the financial remuneration of civil servants is adequate. The Bank is advising governments on how to improve their administrative decision-making processes and to establish administrative structures which clearly assign authority and responsibility.

51. At times, the proper application of the rules is hampered by an overabundance of -- in some instances -- contradictory or obsolete rules and regulations which overwhelm the bureaucracy. The Bank is assisting countries to review, update and simplify their legal systems.[4] Such reforms of legal systems will improve the administrative capacity of the government to regulate the economy and to reach administrative decisions based on a clear set of new and relevant laws (Box 10).

Conflict Resolution

52. Conflicts in the application of the rules can be resolved through binding decisions of an independent judicial or arbitral body. The existence of an independent judicial or arbitral body which can render binding decisions with respect to conflicts in the application of the rules is an essential element of the rule of law concept. The law loses its conflict-resolving and confidence-inspiring function if there is no independent and credible judicial system which assures that private contractual arrangements are respected and that the law is applied uniformly by the executive. With regard to the first aspect, it is obvious that confidence in the enforceability of agreements and commitments is instrumental to the proper functioning of an economy and the conduct of private economic activities. If there are unreasonable delays and high costs in enforcing laws and agreements between private parties, the efficient conduct of economic activities is hampered. With regard to the second aspect -- i.e. the check on government actions -- it is also evident that a strong judiciary can provide an effective shield against the concentration of arbitrarily exercised executive power.

53. The state of the judiciary in a number of developing countries is precarious. Even in those countries where there is a nominally independent judiciary, the courts are usually overworked and dispute resolution takes a long time. Often, the courts lack proper facilities and there is an urgent need for improving the training of the persons involved in the administration of justice. Despite all this, arbitration proceedings outside the court system are not well-developed.

54. There are several Bank operations under preparation that will assist member governments in the training of judges in economic and business law and may go as far as recommending certain division of labor in the court system so that commercial matters would be handled by specialized courts. (Box 11).

55. In assisting to make the court system more efficient and competent the donors may wish to look beyond the basics of training and of providing adequate physical facilities. For instance, many developed countries also have in the past encountered the problem of a judiciary too unwieldy, expensive and slow to handle disputes. The answer has not necessarily been to improve on the courts but to expand extra-judicial means of settlement by permitting commercial arbitration.[5] Another alternative is to search what caused the growth of disputes by updating or clarifying archaic or uncertain legal situations. The business world has also responded by rationalizing business practices through the development of standard forms and patterns of doing business. The courts themselves may help by mass handling of certain commercial matters, e.g. garnishment and collection of debt. These are areas within the mandate of the Bank in as much as functioning rules and institutions, including an effective dispute-settlement mechanism, are essential for economic development.

Amendment Procedures

56. *There are known procedures for amending the rules when they no longer serve their purpose:* As noted above, the rule of

BOX 10
Reform of the Regulatory Framework

GHANA: Financial Sector Adjustment Credit (Credit 1991 GH)

Banking activities in Ghana have been governed by laws and regulations enacted in the 1960s and early 1970s with a number of amendments and decrees issued on an ad hoc basis since the enactment of the original legislation. Several serious omissions in this body of legislation, together with weak bank supervision, led to the concentration of risk in the portfolios of banks, inadequate capital and reserves, inflated profits and unrecognized loan losses.

In connection with the IDA-financed Financial Sector Adjustment Credit, the Government of Ghana established a committee of legal experts to review the existing legislation, draft the changes necessary to improve the regulatory framework and introduce prudent standards to ensure the viability of the banking system. Risk exposure limits as a percentage of capital have been set on a bank's exposure to a single customer or related group. A minimum capital-adequacy ratio has been established, taking into account the quality of the bank's assets as well as its off-balance-sheet risks. Banking supervisors will have the ability to mandate even a higher capital-adequacy ratio, when, in their opinion, conditions warrant. Banks which do not meet the minimum guidelines are not allowed to pay dividends. New regulations specifying the format and content of audit reports and the minimum scope of audit reviews have been introduced together with uniform accounting and auditing standards and prudent reporting requirements. The accounting standards include guidelines for loan portfolio review and classification, the treatment of interest on non-performing loans, and provisioning for potential loan losses. Monetary penalties for violations of laws and regulations are strengthened and will be periodically revised to serve as a deterrent to illegal and imprudent acts.

POLAND: Structural Adjustment Loan (Loan 3247 POL)

In Poland, the Government's Economic Transformation Program (ETP), pursues structural reform towards the establishment of a market economy. The SAL will support reform initiatives mainly in the areas of: (i) enterprise restructuring, privatization, private sector development, with emphasis on appropriate legislation to define the "rules of the game" (including privatization, demonopolization and competition), the establishment of an adequate institutional framework for enterprise restructuring; (ii) financial sector reform, with emphasis on improved banking regulation and supervision, introduction of adequate accounting and auditing standards, etc. and (iii) social safety.

SRI LANKA: Economic Restructuring Credit (Credit 2128 CE)

The Economic Restructuring Credit (ERC) supports the Government's efforts aimed at stabilizing the economy and implementing structural reforms. In addition to addressing the country's serious internal and external imbalances, the size of the public sector, its claim on resources and the efficiency with which it uses its resources, the ERC also focuses on the development of the private sector through improvements in the existing regulatory framework and incentive system and through transfer to the private sector of activities and assets now being managed by the public sector.

law is instrumental in creating a climate of predictability and stability -- as the antithesis to governmental arbitrariness. Rules that are constantly changing cannot fulfill this function. Neither can rules that are arbitrarily repealed, amended or waived. The perception of arbitrariness and subjectivity is created by ad hoc decisions whereby the creation, amendment or invalidation of laws is undertaken without known and established procedures. Laws created this way will be perceived by those affected as not being enacted through "the right process." Furthermore, it will lead to a general lack of

Box 11
Improving the Judiciary

BANGLADESH: Financial Sector Adjustment Credit (Credit 2152 BD)

The court system in Bangladesh took an average of 10-15 years to dispose of suits brought by financial institutions against defaulting borrowers. The result was that transaction costs were extremely high and collection rates were very low. With the assistance of the Association and the International Monetary Fund, Bangladesh enacted a Financial Loan Courts Act in 1990 which established special commercial courts in the major economic centers of Bangladesh, whereby financial institutions could bring actions against defaulting borrowers and the loans could be adjudicated. Progress, which to date, has been highly favorable, is being monitored under the Financial Sector Adjustment Credit and involves the establishment of courts, appointment of judges and disposal of cases.

obedience to the law beyond the particular rules, and affect the credibility of the whole legal system.

57. The requirement of procedures in place for amending or repealing laws is limited to the existence of such procedures. It is the prerogative of the country concerned -- and outside the mandate of the Bank as stated earlier -- to decide how the legislative process is organized, including whether a separate legislative body should exist. What matters is that the public is aware of the process through which laws can be amended, repealed or waived.

58. In the context of attempts by borrowers to introduce legal reforms, the Bank has stressed the importance of having appropriate procedural rules in place for enacting and/or repealing laws. In order to improve the technical capabilities of the countries concerned in drafting procedural rules and regulations, the assistance financed by the Bank has supported governments' legal offices, i.e. Attorney General, Ministry of Justice, etc., and consisted of training and technical assistance (Laos, Guinea and, under preparation, Angola and Mongolia).

59. The foregoing analysis of the procedural and institutional elements of the rule of law has focussed on their contribution to establishing a "good order" understood as "a system in place, based on abstract *rules* which are actually applied and on functioning *institutions* which ensure the proper application of such rules" (Shihata, 1991: 43). The existence of such a system is needed for economic development; in particular, the economic reform policies introduced by many of the Bank's members and supported through Bank operations cannot be implemented effectively if these reform measures are not translated into workable rules and applied by functioning institutions in a proper and appropriate manner. Thus, the elements of the rule of law discussed above address these processes of the formulation and application of rules and constitute the procedural framework and institutional system which -- if adhered to by the governments concerned -- lead to *stability* and *predictability* and elicit *compliance* with the rules.

60. The rule of law and the various other elements of sound development management are closely interrelated. By simplifying existing rules and limiting discretion in certain decisions the Bank has assisted in reducing the opportunities for corruption. The publicity

that the Bank has insisted on in the administration of certain processes such as procurement has increased transparency in decision-making. Also, the development of communication systems for making the laws known helps in making governmental bureaucracies more accountable.

C. INFORMATION AND TRANSPARENCY

> "Information is now a crucial determinant of the pace of social and economic change."
> *Report of the South Commission (1990: 196)*

61. A competitive market economy requires that economic actors have access to relevant, timely, and reliable information. The less available or credible the information the greater the uncertainty and risk, and therefore the cost, of committing capital or labor. In all countries government is a major source of information, and sets many of the requirements for other providers as well. Information about the economy, about particular market conditions, and about government policies and intentions is all central to private sector calculations, and is either provided by government or greatly influenced by what government requires other entities to make publicly available.

62. Governments have legitimate reasons to withhold some types of information -- on aspects of state security, for example, or where premature disclosure could invite behavior undermining the policy (e.g. changes in exchange rates). Aside from these special cases, three areas are discussed where improved information and greater transparency are beneficial: economic efficiency, transparency as a means of preventing corruption, and the importance of information in the analysis, articulation and acceptance of policy choices.

Information, Transparency and Economic Efficiency

63. Economic efficiency requires that information about government policies and actions be available, that major processes of economic decision-making (for example the budget) are reasonably transparent, and that there is some opportunity for public comment or influence in the process of economic policy-making. This last aspect is of course greatly influenced by a country's government and traditions about political participation and public debate -- questions beyond the Bank's purview. With that limitation in mind, there are three important reasons for greater transparency in policy making as it impacts upon economic efficiency.

64. First, where government economic decision-making is unexamined and uncontestable the dangers of corruption and diversion of public resources (including external assistance) increase. Transparency is not a sufficient condition to control corruption, but it is in most circumstances a necessary one, as will be discussed below.

65. Second, closed decision-making increases the risk of government error -- and of negative reactions. Government's impact on the private sector environment, through an array of influences from monetary and exchange rate policy through taxation and expenditure policies to public procurement, is pervasive and profound. Where decisions in these areas are taken in relative isolation from private-sector reactions, the likelihood of costly mistakes increases -- fiscal policy is a common example. In other instances, governments may be surprised by angry public reactions to the economic consequences of secretly made decisions -- for example, over pricing and subsidies -- when a more open

process of public education and debate might have both improved policy design and eased public acceptance.

66. Third, the efficiency and effectiveness of economic actors, and the competitiveness of markets, requires broadly based access to relevant information. A common problem hindering the development of capital markets, for example, and of equity-based financing in particular, is the lack of clear disclosure rules based on audited accounts of private and public enterprises. Lack of transparency in financial markets often leads to arbitrary and capricious relations between commercial banks and their clients. Without proper accounts and disclosure, neither bank lending nor investment through the capital markets can be based on a firm assessment of credit worthiness. This assessment is necessary to evaluate risk and adequately price the cost of capital to the borrower. The capital market remains circumscribed to a narrow range of firms and instruments protected by either implicit governmental guarantees or by the "reputation" of the most powerful economic groups. A lack of transparency may be especially damaging for banking systems. It can lead to a large accumulation of non-performing assets which would cause bank failure, except for the fact that throughout the developing world deposits are usually explicitly or implicitly guaranteed by the state. Private losses are therefore socialized, as non-competitive risk-taking siphons resources from productive uses to speculative activities.

67. The Bank has been primarily concerned to work with governments to ensure broad awareness and acceptance of economic reform programs (e.g. in the context of structural adjustment operations), and to focus government attention particularly on the impact of its actions on private sector confidence and the business environment. Madagascar's government, on its own initiative, and without Bank involvement, has issued guidelines for openness which represent remarkable progress for a government that leaned towards secrecy not long ago (Box 12).

68. The Bank is also active in several specific areas where transparency is an important issue: in public expenditure decision-making (see PSM paper); in assisting governments to improve public procurement; and, increasingly, in the assessment of environmental impact. Public disclosure of environmental assessments is one instrument that the Bank is encouraging governments to use as a way of ensuring greater accountability and transparency. This is particularly critical in ensuring that people involved in involuntary displacement by development projects (such as the Narmada and Upper Krishna river) are kept fully informed of the results of such assessments. Thus, under the Ecuador Municipal Development and Urban Infrastructure project (FY91) an attempt is made to ensure public review of environmental impact studies of infrastructure projects.

Prevention of Corruption

69. Clearly, the main weapon against corruption is to reduce the opportunities for it to a minimum -- to eliminate economic distortions and administrative controls, and therefore to reduce the scope for illicit arbitrage and bribery, "dash," "speed money" and the like. Transparency in government business has a vital ancillary role. The Bank's involvement in transparency is through its work on public expenditure (transparency of budgets, elimination of "caisse noires"), through its assistance to governments in establishing transparent procurement procedures and conducting environmental assessments.

70. Since central government ministries as principals must -- and should -- delegate to a wide variety of agents the implementation of

BOX 12
Transparency in Government:
The "Ten Commandments" in Madagascar

The following are excerpts from an Official Communication published in the December 18, 1990 issue of the Official Gazette of Madagascar.

FROM: The President of the Democratic Republic of Madagascar

TO: The Prime Minister and Head of Government and the Presidents of Institutions

...

The terms of annexed communication from the Prime Minister...will serve as a rule of conduct and as general guidelines...The Government and other institutions of the Republic are requested to ensure that this is given the widest possible circulation and is applied in both the central and the local public services...

Communications

My own observations and complaints reaching my office lead me to submit the following proposals with a view to establishing a proper code of conduct within the Administration as regards its relations with the public. The principal aim is to improve attitude and behavior in the Administration and to preserve trust between the Administration and the public.

1. The Administration must not be permitted arbitrarily to block correspondence addressed to it.

...

The principle must be that the authority that is addressed must forward the request to the authority with power of decision. The former is free to issue a favorable or unfavorable opinion, but must nonetheless pass the request on. If it believes that the dossier is incomplete, or deficient in some other way, it should inform the applicant and ask him to put matters right; this is particularly important as regards our incentives for investors...

...

2. The Administration should assist the public.

...

3. The Administration should facilitate inquiries by the public.

...

Requests from the public sometimes relate to laws or regulations that contain all the relevant information being sought. The Administration should therefore make leaflets, etc., available to the public...In brief, each agency should make available to the public all the necessary information regarding the activity...Within each agency, a public information unit should be established...

...

4. The Administration must establish and observe set periods for handling requests.

Few laws or regulations stipulate that the Administration must respond within a certain period. As a result, the public is at the mercy of officials and is never certain as to when it will get a reply...Some departments have made efforts to improve this situation by stipulating maximum periods...This practice should be extended to all agencies...

(continued on next page)

policy choices, there are inevitably asymmetries in who has access to quality information. Reporting and monitoring systems can update the information base of principals but there are always opportunities for agents to engage in rent-seeking, or private appropriation of gains to be made from insider information. Monitoring and supervision of these agents is a perennial management concern; making most information a matter of public record is one of the mechanisms for doing so. Guidelines on public information policy generally include criteria for users, rules about time lapses prior to disclosure, and clear rules for access. Precisely because information is scarce, and therefore valuable, information policy needs careful attention.

71. Few areas of government activity are more prone to problems of corruption than

BOX 12
Transparency in Government:
The "Ten Commandments" in Madagascar

(continued)

5. The Administration must have the courage to question certain principles.

(a) The principle that silence is equivalent to a refusal...it is time to stipulate that silence...after a certain period has elapsed, is equivalent to acceptance...

(b) The legal principle of implicit rejection.

It is high time the Administration understood that time is money.

6. The Administration must opt systematically for the automaticity of decisions.

The administration's discretionary power must be reduced to a strict minimum by the publication of clear and precise rules of the game, which it must respect. Regulations and laws that have an impact on the public must move towards this objective, which is also stated as a principle...regarding the conceptual framework for the preparation of laws.

7. The Administration must do away with anonymity.

The myth of the anonymous civil servant is no longer appropriate in a modern administration. The names and positions of agents interacting with the public should appear on nameplates on their doors or be posted on signs in their offices so that people know who they are dealing with. The use of badges could be courteous innovation....

8. No official should have permanent tenure of a position requiring contact with the public. Periodic rotation, even if only within the organization, is strongly urged... The Head of State issued a directive on September 12, 1990 to the effect that enforcement agents should not remain in the same position for more than three years...This measure...should be extended to other officials in contact with the public....

9. The Administration must know how to punish and reward.

There are some good officials and they must be encouraged and rewarded...Poor officials, on the other hand, should be punished and their promotion should be prohibited.

The best way to assess an official that works with the public is to listen to what the public thinks about him. An official, fully documented register could be provided for members of the public to record their complaints or their satisfaction...

10. The Administration must evaluate itself and be open to external audits.

Self-evaluation is carried out by an internal audit unit which each agency must establish to monitor its operations, verify how, and how fast, dossiers are handled and study users' complaints....

that of customs and procurement. Some countries have resorted to correcting the mismanagement of customs by contracting out the customs service to a wholly independent private sector enterprise (Indonesia). Public procurement, on the other hand, is not a self-contained procedure which can be handled in this manner -- though inspection and supervisory services can play a valuable role. Further, procurement is a critical aspect of project and program implementation.

72. Procurement difficulties are symptomatic of problems of government capacity, and of the inherent pressures when large contracts are in play. Since 1983, the Bank has been systematically undertaking country Procurement Assessment Reviews (CPAR) which review public procurement

laws, procedures, and institutions in borrowing countries to identify any fundamental conflict with Bank procurement guidelines, and to decide on acceptability of local procedures for contracts which are appropriate for ICB. The procedures are assessed from the perspective of competition, transparency, disclosure of selection criteria, award to lowest qualified bidder, fair contract conditions, mechanisms for dispute settlement, and an assessment of institutional capability and efficiency in implementing Bank operations.

73. With the advent of adjustment lending, the CPAR has expanded to parastatal and private sector procurement practices and their compatibility with practices in market economies in developed countries. To date, CPARs have been completed for 60 countries with the remainder in the process of being completed; they are updated every four years.

74. Where institutions are weak or procedures inefficient, the loan includes technical assistance components, or support to hire procurement agents. Thus, for example, technical assistance has been provided to improve the institutional framework and introduce more efficient procedures in Uganda and Madagascar. In other cases, new procurement codes have been issued. In the Philippines, action was taken under a Debt Management Loan to streamline overall procurement rules and procedures so as to permit greater delegation of authority to implementing agencies and to establish standards to shorten contract award procedures. Work initiated under this project has been pursued under subsequent projects (the Fifth Highway project) and guidelines acceptable to the Bank are now available for local procurement of goods and consultants. This has facilitated an easing of regulations relating to contractors thereby increasing their willingness once again to accept government contracts.

75. Several countries do not require public bid opening, and permit bargaining even after bids have been opened. The Bank is attempting, in such cases, to review the rationale for existing local procurement regulations rather than simply requiring conformance to Bank guidelines. It is attempting through local seminars and discussions, to focus attention, for example, on the importance of procurement processes to the development of local contracting capacity and pointing to the value for a development perspective, of adopting revised national systems to conform to international norms. In almost all reforming Central and Eastern European countries, institutions were not familiar with local or international competitive bidding. However, these countries are now requesting and showing receptiveness to Bank technical assistance on procurement legislation and procedures (Box 13). In 1990, the Africa region convened a conference on public procurement procedures at which African public officials presented papers along with procurement experts from developed countries on the merits of different approaches to improving the efficiency of public procurement.

Analysis and Dissemination Capacity

76. The collection and dissemination of economic data has been a focus of Bank assistance and advice for a long time, and has included, for example, support for statistical offices, technical assistance where appropriate, and capacity building. Despite these efforts, and the importance of data collection and dissemination, however, adequate economic information has been a casualty of the economic crisis and government stringency, especially in much of Africa. Central Banks which once produced excellent reports on the economy (as in Ghana) have ceased to do so, and government statistical series in many countries have become less timely, reliable, and complete. Given the expanded and more

BOX 13
Changing Procurement Policies and Practices in Eastern Europe

The countries of Eastern and Central Europe (Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia) are rapidly accelerating their transition from centrally planned to market-oriented economies, a process involving profound changes, also in the field of public procurement. They are increasing their externally supported investment project operations, in cooperation with bilateral agencies and international financing institutions. During the past forty years, the countries have performed public procurement through direct allocation of resources, or negotiated contracts. They do not have a recent background in using open, competitive bidding procedures, and vary in their abilities to applying international procurement practices.

The countries lack the requisite public procurement laws and related legal systems, regulations and experienced procurement officers. New and comprehensive legal systems for public procurement are required at all levels of government: national and local, and would ideally apply to all sectors. At the same time, training of procurement personnel would need to be performed on an urgent and massive basis, to implement the new procurement practices. The delays in project implementation caused by inefficient procurement practices may result in opportunity, interest, and inflationary costs of considerable magnitude (10-20% of total project costs).

The World Bank has, at the invitation of several of the countries, advised their senior officials on the requirements for implementing the needed legal and policy changes, and to train involved personnel. Contacts have also been made with multilateral and bilateral agencies which have a direct interest in the issues, with the objective of their participating financially and technically with the Bank in country and regional projects which would address the problems through technical assistance. Financing of such projects could also come from Bank loans, should the countries so request.

sophisticated requirements implied by the Bank's poverty and environment agenda, this is an area deserving more emphasis. China's post-reform Statistical Yearbooks are an example of how substantial breakthroughs can be made in the quality and availability of economic information.

77. The capacity of NGOs and institutions (professional associations, trade unions, business organizations, grass roots groups, research centers, universities and mass media) to articulate the needs of important constituencies, analyze policy requirements and contribute to policy formulation is an important aspect of accountability. Building this capacity is a central aspect of developing an enabling environment for growth. Information must be understood, processed, and used effectively. Capacities need to be developed -- in the universities, in policy research institutes, in economic committees of legislatures where appropriate, and in the media -- to understand information about development issues, and to contribute to broader public education in turn. The African Capacity Building Initiative represents a potential instrument for strengthening the role and capacities of a wide variety of non-governmental institutions. The Bank's External Affairs Department has also done much to improve access to economic information for developing country journalists.

ENDNOTES - Annex I

1. The concepts of "exit" and "voice" which originated in Albert Hirschman's classic work, Exit, Voice and Loyalty (Hirschman, 1970) have been adapted by Samuel Paul in his work for the PRE Working Paper No. 614 on accountability (Paul, 1990).

2. Sir Adetokunbo A. Ademola, Chief Justice of Nigeria, in his address to the Convention on the Rule of Law, organized by the International Commission of Jurists (Lagos, 1961).

3. This is the case of the legal information system included in the Social Sector Management Technical Assistance Project in Argentina (Loan 2984 AR).

4. A practical example is Ghana. The legal and regulatory framework governing private sector activities is being reviewed by the government in order to eliminate obsolete laws and revise other laws to reflect the policy change from a command economy to a free market system. This follows the changes of the regulatory framework for the financial sector which has already led to encouraging results.

5. For example, the Indonesia Report concluded that strengthening the arbitration system and arbitral bodies could improve contract enforcement and avoid some of the constraints in the judicial system.

ANNEX II
TASK FORCE ON GOVERNANCE

Adamolekun, Oladipupo O.	AFTPS
Beckmann, David M.	EXTIE
Bryant, Coralie	PRDPD
Campbell, Tim	LATIE
Chaudry, Shahid A.	LATPS
Dia, Mamadou	AFTIM
Einhorn, Jessica P.	FODDR
Gruss, Hans Jurgen	LEGAF
Harris, Randolph L. P.	CODOP
Heyneman, Stephen Paul	EMTPH
Isenman, Paul	PRDDR
Jones-Carroll, Charlotte	PBDCP
Kohli, Harinder S.	EMTDR
Lacey, Robert Mark	EDICD
Lamb, Geoffrey B.	PRDPD
Landell-Mills, Pierre M.	AFTDR
Lateef, K. Sarwar *	EXTIE
Nankani, Gobind T.	LA1IN
Okonjo-Iweala, Ngozi N.	OPNSV
Pachter, Lisa	EXTIE
Paul, Samuel	CECPS
Pellegrini, Anthony J.	EMTIN
Rigo, Andres	LEGAF
Ritchie, Daniel	ASTDR
Sagasti, Francisco	EXTDR
Schiavo-Campo, Salvatore	AF3CO
Shakow, Alexander	EXTDR
Shirley, Mary M.	CECPS
Socknat, James A.	ASTPH
Wai, Dunstan M.	AFREA
Winkler, Donald R.	LATPS

* Task Manager

Secretarial support to the Task Force was provided by Lynette Alemar (PRDPD), Sonia Benavides (EXTIE), Maria Estrella (EXTIE), Marjorie Pavia (EXTIE) and Amelito Velasco (PRDPD).

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

ROUTING SLIP	DATE: July 24, 1991
NAME	ROOM NO.
Messrs. Isenman and Lateef	
PRDPD staff	

	URGENT		PER YOUR REQUEST
	FOR COMMENT		PER OUR CONVERSATION
	FOR ACTION		SEE MY EMAIL
	FOR APPROVAL/CLEARANCE	◎◎	FOR INFORMATION
	FOR SIGNATURE		LET'S DISCUSS
	NOTE AND CIRCULATE		NOTE AND RETURN

RE: Governance paper

REMARKS:

FROM:	ROOM NO.:	EXTENSION:
Geoff Lamb	S13-119	32544

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: 18-Jul-1991 09:30am

TO: Geoffrey B. Lamb (GEOFFREY B. LAMB)

FROM: Charlotte Jones-Carroll, PBDCP (CHARLOTTE JONES-CARROLL)

EXT.: 30192

SUBJECT: Notes on Governance

Here is my summary of the Governance and PSM discussion, to add to the others you have.

C. SL, PI
PRDPD

Summary of Committee of Whole Discussion of Governance and Public Sector Management Papers - July 16, 1991

Governance

A lively and lengthy discussion on the paper "Managing Development - the Governance Dimension" took place. Because of the paper's moderate, balanced and cautious tone (by the time it reached the EDs' version), it received widespread support, including the recommendations to (i) disseminate the report and EDs' reactions to staff; (ii) continue the broad-based dialogue with borrowers and academics; (iii) carry out further research and (iv) undertake a progress report in the future.

There was some expected polarization between countries which strongly resist any Bank move into political matters (China, Middle East chairs) and countries which want the Bank to be much more proactive than suggested in the paper regarding initiating governance discussions (US, Netherlands, to lesser extent Germany). Most, however, agreed with the paper's emphasis on the need for caution, a low profile, sensitivity and humility in governance issues, as well as the need for country-focus and differentiated response adapted to each situation. Africans and the French were unhappy with the constant mention of Africa in the paper because it implied to them that governance was only a problem in that region (the authors' intent was to highlight the early work on governance in Africa). All agreed governance was a global issue (and many stressed such issues were not absent in Part I countries). The paper's emphasis that corruption was a two-way street permitted many comments on the need for donors to improve their conduct (re protecting commercial interests) and for DAC to push on this. More accountability and transparency from the Bank and predictability from Part I policymakers was also encouraged.

Most EDs argued that governance performance should not become part of conditionality (either for a single loan or for the volume of lending), but that the Bank should use TA and patience in addressing it (I. Shihata joined in preferring TA to address governance). Many highlighted the long-term nature of improving the accountability, predictability and transparency of government. There was a strong inclination toward a selective approach, as counseled in the paper, providing Bank assistance only where country commitment to reform was clear and/or capable local managers existed. No special initiative for governance was endorsed; it was to be integrated into all aspects of Bank assistance. Some (Herfkens, Rehm) thought participation deserved even more attention than given. Collaboration with donors was universally endorsed (Cosgrove saw the Bank taking the lead on this).

I did not see consensus develop on the issues of: (i) Bank competence and authority to address military expenditures (Benhocine, Hosny opposed, Peretz cited G-7 summit as

supporting); (ii) Bank interventions in the judicial system or enforcement of laws (Anglo Africa, Japan, China skeptical; Venezuela, Netherlands supportive), or (iii) Bank as Consultative Group leader being mouthpiece for political conditions of bilaterals (Baijal, Langley = no; Peretz = yes).

In response to inquiries, Mr. Conable agreed to be flexible on the time period before the next review of experience (could be earlier than the two years suggested) and also to keep the task force going in some form to keep attention and a learning process going on (original plan was to transfer leadership of task force to M. Shirley until dissemination stage completed).

Public Sector Management

A thorough discussion of the paper "The Reform of Public Sector Management: Lessons of Experience" followed. The two papers were seen by management and EDs as companions, and indeed the papers cross-referred to one another.

The nature of this paper confused some: it was neither policy paper nor discussion paper. Still, it was generally endorsed as a useful review of experience (although US, Australia wanted more evaluation of results of PSM lending). There was widespread support for the paper's emphasis on the need to review public expenditures altogether (recurrent as well as investment) to have a balanced view of fiscal policy reform needs. Some EDs wished for more treatment of the taxation/revenues side (J. Linn reminded them of the recent paper on tax reform). On civil service reform, the role of severance pay was debated (some thought it too expensive, others just what was needed) and the importance of emergency employment efforts for ex-civil servants was cited (Bolivia example). On public enterprise reform, the sharpest division occured, some (Cosgrove) citing success where privatization takes place and others (Venezuela, China) noting that small capital markets inhibited privatization and made good management, rather than ownership, the crux of the problem.

Technical Assistance was strongly emphasized in the paper and in the CoW as the instrument of choice, but a number of EDs were not happy with lending (PSMTALs) only. They like the IMF's approach of programming direct provision of TA within the budget and Mr. Al-Assaf went so far as to propose reserving net income for a special TA fund. The work of the TA task force was referred to by the presenter and several EDs looked forward to that report (Sevigny, Al Assaf).

Participation and consultation with borrowers/users on project/TA design was praised among the remedial measures proposed in the paper, as was the emphasis on using local consultants. The long-term nature of public sector reform was also widely stressed. The Bank could help, also, by monitoring consultant performance and sharing this information.

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From: Vice President and Secretary

June 26, 1991

Managing Development: The Governance Dimension

A Discussion Paper

1. Attached is a Discussion Paper on "Managing Development: The Governance Dimension." It was prepared by a Task Force on Governance comprising mainly staff of the Operations, Legal, and Policy and Research complexes, which was set up to review issues of governance that lie within the Bank's mandate.

2. This paper will be considered by the Executive Directors meeting as a Committee of the Whole on July 16, 1991.

3. Questions regarding this paper may be addressed to Mr. Lamb (ext. 32544) or Mr. Lateef (ext. 31760).

Distribution:

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MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION

A Discussion Paper

June 25, 1991

MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION*

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* *This paper was prepared by a Task Force with participation from the Operations; Policy, Research and External Affairs; Legal; Corporate Planning and Budget; and Finance Complexes (see Annex II).*

MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION
A DISCUSSION PAPER

EXECUTIVE SUMMARY

(i) This discussion paper is a review of issues of governance that lie within the Bank's mandate. Such an analysis was anticipated in Mr. Shihata's Legal Memorandum of December 21, 1990, discussed at a Board Seminar on April 11, 1991, which set out "a legal framework for the Bank's dealing with this issue". For purposes of this paper, governance is defined as the manner in which power is exercised in the management of a country's economic and social resources for development. The Bank's concern with sound development management extends beyond the capacity of public sector management to the rules and institutions which create a predictable and transparent framework for the conduct of public and private business, and also to accountability for economic and financial performance. Given the limited nature of the Bank's direct operational experience in this area other than that covered under public sector management, this paper defines major concepts, and surveys Bank experience to date. It also highlights some of the issues that have emerged as the Bank addresses a wider range of concerns in this area.

(ii) The Bank's interest in governance arises from its concern for the effectiveness of the development efforts it supports. From this perspective, sound development management, in the broadest sense of the word, is critical to ensuring adequate returns and the efficacy of programs and projects that the Bank finances, and so to the underlying Bank objectives of helping countries reduce poverty and increase sustainable growth. The Bank has a long record of helping countries build the institutions and practices essential to an efficient modern economy, and must continue to set high standards for itself and its borrowers. Its experience provides a number of examples of best practice (some of which are explored in this paper, and some in the accompanying review of work on public sector management) that have been seen to have a demonstrable positive impact on development management in its borrowers.

(iii) The Bank's experience has also shown that when programs and projects appear technically sound but fail to deliver results, the reasons are sometimes attributable to weak institutions, lack of an adequate legal framework, damaging discretionary interventions, uncertain and variable policy frameworks and a closed decision-making process which increases risks of corruption and waste. Much needed legal reforms may come to naught, if laws are not enforced or there are severe delays in the settlement of cases. Privatization efforts may not succeed or be politically sustainable and the supply response to improved pricing policies may not occur unless clear rules and institutions contain transaction costs (i.e. the cost of arranging, monitoring and enforcing contracts). Sophisticated public expenditure reforms may founder if accounting systems are so weak that budgetary policies cannot be implemented or monitored, or when lax procurement encourages corruption which distorts public investment priorities. Public investments may waste resources unless those who will use, and often pay for, the resulting services are involved in their design and operations.

(iv) These examples illustrate a broader point: good governance is central to creating and sustaining an environment which fosters strong and equitable development, and is an essential complement to sound economic policies. Governments play a key role in providing two sets of public goods: the rules to make markets work efficiently, and, more problematically, correcting for market failure. In order to play this role, they need revenues, and "agents" to collect revenues and produce the public goods. This in turn requires systems of accountability, adequate and reliable information, and efficiency in resource management.

(v) Productive institutional arrangements will vary between countries based on their cultural traditions and historic relationships. And they will continue to evolve as the economy grows, becomes more complex and more integrated with international markets. Mature institutional frameworks take a great deal of time, but there is no guarantee that arrangements which are supportive of economic growth and poverty alleviation will, in fact, emerge. The state may behave in a predatory manner or pursue strategies that hinder the development of efficient property rights. Or its agents may behave in an opportunistic manner and indulge in rent-seeking. Good governance is a continuum, and not necessarily unidirectional: it does not automatically improve over time. It is a plant that needs constant tending.

(vi) Recognizing the importance of sound development management, the Bank's emphasis in recent years has shifted rapidly from its own interventions to the overall country context within which those interventions are taking place. In the area of public sector management, attention has shifted from improving management of project-related agencies to more general reform of the civil service and public enterprises, and to the central economic agencies that are responsible for macro-economic policy. A similar broadening of focus is now taking place in such "areas" as accountability and the legal framework.

(vii) *Public sector management* (PSM) issues are addressed in an accompanying paper which reviews experience in selected areas. The primary focus of the Bank's work has been in public expenditure management, civil service reform and parastatal reform. The initial results have been positive, but often in trying circumstances. The effort has been long and arduous, reflecting obstacles of a socio-political nature.

(viii) This paper focusses on three other key dimensions: accountability, the legal framework for development, and information and transparency:

(ix) *Accountability* at its simplest means holding public officials responsible for their actions. Economic objectives of public accountability include congruence between public policy and actual implementation, and the efficient allocation and use of resources. This not only requires systems of financial accountability but also the capacity and willingness to monitor the overall economic performance of the government. At the micro level, the primary concern is with efficiency in the production and delivery of goods and services in the public sector. The Bank has addressed issues of both economic and financial accountability. Its public expenditure work has assisted governments address a range of public resource management issues, and has supported reforms of sector-wide institutions to improve accountability in service delivery. In terms of financial accountability, to improve compliance with accounting and audit covenants, the Bank is assisting some borrowers address country-wide constraints to accounting and auditing through assessments and technical assistance projects. The Bank is

also assisting governments establish adequate oversight and administrative capacity at central and provincial/local levels as they move to decentralize key economic functions of government.

(x) Macro-level accountability can be reinforced at the micro-level both through competition and by enhancing opportunities for participation or other means of articulating the interests of the affected public. The Bank does a great deal to encourage competition through deregulation and contracting out of services, and generally by assisting governments to break up monopolies and barriers to entry. Participation can be encouraged through dissemination of information on services, complaints procedures, and public hearings. The use of local NGOs and the encouragement of beneficiary participation in project design and implementation is encouraged in Bank projects, where appropriate.

(xi) *Predictability and the rule of law:* Predictability implies that rules and regulations are clear and applied even-handedly, and that lines of authority are clear. An efficient civil service helps provide continuity and predictability; Bank PSM work is intended to support these goals. The rule of law is a key element of predictability and stability where business risks may be rationally assessed, transaction costs lowered, and governmental arbitrariness reduced. It is this connection of the rule of law with the more efficient use of resources that justifies its consideration by the Bank. Five basic elements of the rule of law have been identified as relevant to sound economic development and, therefore, to the Bank: (a) there must be a set of rules known in advance; (b) these rules must be actually in force; (c) there must be mechanisms to ensure application of the rules; (d) conflicts must be resolved through binding decisions of an independent judicial body or through arbitration, and (e) there are known procedures for amending the rules when they no longer serve their purpose.

(xii) The Bank has, in recent years, assisted borrowers in ensuring coherence of rules and improved communication; in helping to improve the efficiency of institutions which administer laws of significance to the economy; in the training of judges in commercial law; in encouraging extra-judicial means of settling disputes (e.g. commercial arbitration); and in developing capacity to put in place appropriate procedural rules for enacting and repealing laws. Effective legal reforms require careful preparation, and a thorough understanding of local conditions and the cultural and historical context. With this in view, the Bank has, in a few cases, been carrying out comprehensive reviews of legal systems as they relate to development activity.

(xiii) Adequate and reliable *information* is a precondition for both accountability and the rule of law, and refers to the availability of and access to information from public and private sources, and transparency of decision-making processes. The availability of accurate information about the economy, in general, about market conditions and about the intentions of government critically affects the efficiency and competitiveness of the private sector. Yet, information flows are grossly inadequate in many countries and transparency of decision making low. The Bank has been assisting borrowers improve economic information flows, transparency in budgetary and monetary accounts, and procurement procedures. These measures help to increase the effectiveness of resource use and to reduce corruption and waste.

(xiv) Much of the work described under accountability, rule of law, and information and transparency represents a natural extension of the Bank's work on public sector

management. It is technical in nature and complements other efforts undertaken in economic reforms, such as the elimination of monopolies or removal of controls which help reduce rent-seeking. Indeed, there is much that the Bank routinely does which indirectly contributes to improving economic management.

(xv) However, in undertaking this work, the Bank's role itself is subject to a number of limitations. As an *external* agency, it cannot substitute for the political commitment that governments must bring to reforms in governance. Full ownership is as important in this area as it is in economic policy reforms. The Bank's *legal* mandate provides clear limits to its role, although the legal restrictions help to protect the Bank's reputation for objectivity and technical excellence and its status as an international institution guided solely by concern for economic development and not by any political agenda. The Bank's *past experience* with complex institution building efforts has been mixed, and suggests that it move with caution and absorb the lessons from those experiences. A further limitation arises from *resource constraints*. Work on governance is expensive and time consuming, and is limited by skill availability. However, such work will be handled like all other claims on resources through a determination of priorities within country programs based on need, borrower receptivity, cost, etc. The Bank should, of course, not attempt to take too much on itself, and needs to collaborate with other UN agencies and donors, where possible.

(xvi) Given these constraints, a measured and selective approach is called for. The main elements of this approach are: First, the Bank, through its interventions, needs to continue to exploit opportunities for improving development management, whenever appropriate, through a variety of means including assisting borrowers break up monopolies, removal of controls and other avenues for corruption, beneficiary participation in projects, etc.

(xvii) Second, selectivity is called for in allocating resources and developing work programs. The selectivity needs to be in terms of the choice of countries for specific work on the dimensions of development management outlined above, and in terms of the range of activities the Bank can take on and support at any given time. Such work should only be embarked upon in countries where there is a clear commitment to and need for improving development management along these dimensions. Many of the Bank's borrowers may neither want the Bank to be so involved nor require such assistance. Where there is need but no commitment, such work would waste resources. Similarly, the dimensions of development management the Bank chooses to assist should reflect both the chances of success as well as the Bank's own ability in terms of skills and resources to assist effectively.

(xviii) Third, in countries where the Bank is active in improving development management, it needs to assist in the design of highly differentiated responses, taking account of the country's institutional needs, its political economy, its society, and history. The objective in each case must continue to be to help strengthen the enabling environment for sustainable and equitable development. This requires high quality Economic and Sector Work.

(xix) The emphasis above is on the technical issues of development management. It is important to be aware, however, that a strong emphasis by the Bank on prudent financial management and attention to auditing and accounting or a legal framework suitable for development will tend to bring deeper and more general problems of governance into

sharper relief. Thus, for example, sophisticated systems of financial accounting and auditing may be established but the government may not absorb or use the results to good effect. A legal framework could be created, but arbitrariness or corruption in its implementation could undermine its value. This has already been the experience with sensitive issues of PSM such as civil service reform where political constraints to the success of such work have emerged. Where lack of progress is due not to weaknesses in capacity but to lack of government commitment, the Bank then faces a problem which needs to be reflected in its country strategy and dialogue.

(xx) When political commitment to sound development management is weak, the Bank normally takes up these issues in its dialogue with borrowers while remaining proactive in seeking ways to help the country improve performance in the key areas of concern. This dialogue is supported by economic and sector work, where appropriate. In such a dialogue, governance issues are not discussed in isolation but as an integral part of a government's overall development program. In conducting this dialogue, the level at which issues are discussed is a function of their sensitivity and requires the judgements of senior managers. Technical issues are handled at staff levels, but highly sensitive issues are handled at an appropriately high level (Country Director and above). Donor concerns regarding such lack of political commitment to sound development management are also surfacing increasingly at consultative group meetings. As Chair of these meetings, the Bank would normally inform the country of widely-held donor concerns, particularly when these are likely to affect Bank-assisted programs.

(xxi) When dialogue fails, the Bank's own lending to the country is likely to be affected. Lending levels have long been responsive to issues of development management and performance, and will continue to be so. Judgements of performance are already routinely made for purposes of IDA allocation and in assessing creditworthiness: there is no need for additional criteria to reflect concerns with governance: merely the effective and consistent application of existing criteria based on a greater awareness of the importance of issues of governance for development performance.

(xxii) Given absorptive capacity constraints, and the long-term nature of the development of appropriate institutions and economic decision-making processes, development management concerns need to be integrated into a long-term perspective of a country's development strategy and prospects. As a follow-up to the Long-Term Perspective Study on Sub-Saharan Africa, and the Maastricht conference at which it was discussed, the UNDP and the Bank are assisting interested African countries develop such perspectives. This also implies that some aspects of this work should be supported by investment operations rather than adjustment lending and that long-term capacity building technical assistance is called for.

(xxiii) Such a long-term approach needs to be supplemented by other measures to strengthen implementation capacity. This implies greater efforts at helping build ownership of adjustment programs, a more conscious effort to understand the political and social structure and the customs and laws of its borrowers, the need to foster an "implementation culture" within the Bank and to sensitize staff to the need to handle issues in this area with humility, sensitivity and caution, and the need to encourage participation by beneficiaries, where appropriate, in Bank projects.

(xxiv) Management proposes to disseminate to staff the key messages for the Bank in this paper together with the Board's guidance. A

broad-based dialogue with borrowers, interested academics and others has been initiated in the Africa Region and depending upon this experience, could be extended elsewhere. The Bank's research program in this area needs to develop further. A progress report on the Bank's unfolding experience with governance would be appropriate in two years' time.

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MANAGING DEVELOPMENT: THE GOVERNANCE DIMENSION
A DISCUSSION PAPER

I. INTRODUCTION

Definition and Purpose

1. The Bank's interest in governance arises from its concern for the effectiveness of the development efforts it supports. A general definition of governance is the "exercise of authority, control, management, power of government."[1] A more relevant definition for Bank purposes is "the manner in which power is exercised in the management of a country's economic and social resources for development."[2] The Bank's concern with sound development management thus extends beyond the capacity of public sector management to the rules and institutions which create a predictable and transparent framework for the conduct of public and private business and to accountability for economic and financial performance.

2. Public sector capacity issues are discussed in detail in the accompanying paper, *The Reform of Public Sector Management: Lessons of Experience* (PSM paper) (World Bank, 1991b), and will be referred to only briefly in this paper. The major focus here is on the overall management of resources for development -- with a special emphasis on accountability, the legal framework for development, and information and transparency.

3. In his legal memorandum of December 21, 1990, discussed in a Board seminar on April 11, 1991, the General Counsel set out "a legal framework for the Bank's dealing with this issue as a prelude to any future analysis of the manner in which the Bank may take it on operationally" (Shihata, 1991). Given the limited nature of the Bank's direct operational experience outside the public sector management area, this initial review defines major concepts and surveys Bank experience to date. The paper also cites best practice and highlights issues that have emerged as the Bank addresses a wider range of concerns in this area.

Relevance for the Bank

4. Governance issues are not new to the Bank. As a development institution, the Bank has grappled with these issues from its inception. However, the relatively good growth performance of developing countries between 1965 and 1980 helped conceal the deep-seated problems of governance which affected the efficient use of resources and retarded adjustment efforts to respond to a changing external environment. By the beginning of the 1980s, as growth decelerated sharply and the developing world was adversely affected by a severe worsening in the terms of trade, the emergence of a climate of relative scarcity began to expose governance issues in many countries. At the same time, it was becoming increasingly clear that investment lending could not achieve its objectives in the absence of an appropriate policy environment.

5. Structural adjustment lending and related public sector management (PSM) reforms aimed at creating an enabling environment for growth. Their focus was on reducing the area of government intervention in incentive policies, on the more efficient use of public resources and on reducing fiscal deficits, thereby indirectly addressing those

governance issues which affected the management of resources. Despite some encouraging success with adjustment lending and public sector reforms, the enabling environment is still deficient in many cases. Improvement in the efficacy of Bank-supported investments and policy reforms thus depends in such cases, on further improvements in the institutional framework for development management.

6. For some of the Bank's borrowers, the effectiveness of both adjustment and investment operations is impeded by factors which contribute to poor development management. These include weak institutions, lack of an adequate legal framework, weak financial accounting and auditing systems, damaging discretionary interventions, uncertain and variable policy frameworks and closed decision- making which increases risks of corruption and waste. There are examples of countries where corruption has adversely affected development. In those countries, pervasive patronage in government has perverted public investment choices to finance white elephants, usually by contracting excessive foreign debt. Monopolies were sanctioned and allocated to friends of those in power, at great economic cost to the nation. There are also examples where good progress in policy reforms has been offset by uncertainties in the investment climate. In some countries which have made good progress in establishing realistic relative prices, the expected private sector response has been inhibited by inconsistent behavior towards business by some government agencies, by inconsistencies between new government policies and the existing legal framework, or by discrimination against certain ethnic groups with strong business communities. In Eastern Europe, the lack of a legal framework conducive to private sector development is a severe impediment to privatization and new investment. In some Latin American countries, rapid decentralization has outstripped systems of accountability and civil service institutions at provincial and local government level, fuelling already unsustainable fiscal deficits.

7. The Africa Region was the first to articulate the Bank's concerns in its Long-Term Perspective Study on Sub-Saharan Africa (LTPS) (World Bank, 1989) in a frank discussion of the "crisis of governance".[3] The LTPS proved a stimulus to the debate now underway in both developing and developed countries on issues of governance in general, and in the Bank, as it relates to economic development. Another stimulus has been the rapid political changes in Eastern Europe, Latin America and parts of Asia and Africa. These changes have been accompanied by changes in the role of the state to reflect a greater preoccupation with the creation of an enabling environment for development, larger responsibilities for the private sector, a reduction in direct government involvement in production and commercial activity and the devolution of power from the center to lower levels of government. These changes have usually been associated with difficult economic reforms and macro-economic adjustment requiring considerable skill on the part of governments in developing a political consensus around these reforms. By its function, the Bank is intimately involved in this broad reform process and governments are increasingly turning to it to address a much broader range of economic management issues, including the legal framework and systems of procurement and financial accountability.

8. Bilateral donors have been increasingly sensitive to public criticism of concessional aid flows to governments which lack democracy, have a poor human rights record, or are seen to be corrupt, and have been pursuing a broader governance agenda through political channels.

9. The Bank's mandate, as laid down in its Articles of Agreement as applied in practice, is the promotion of sustainable economic and social development. Its concern for governance must be driven by that mandate. The General Counsel's memorandum identified five aspects of governance that are beyond the Bank's mandate: the Bank cannot be influenced by the political character of a member; it cannot interfere in the partisan politics of the member; it must not act on behalf of donor countries in influencing the member's political orientation or behavior; it cannot be influenced in its decisions by political factors that do not have a preponderant economic effect; and its staff should not build their judgments on the possible reactions of a particular Bank member or members. This memorandum then suggested that governance may be relevant to the Bank's work if it is addressed in terms of having good order and discipline in the management of a country's resources. In this respect, the General Counsel considered the need for rules and institutions and mentioned, by way of illustration, a number of areas that may fall within the Bank's mandate such as civil service reform, legal reform, accountability for public funds and budget discipline (Shihata, 1991: 47-54).

10. Section II of this paper describes the nature of the governance problem from the Bank's perspective. Section III summarizes key dimensions of governance and the Bank's experience with each dimension. (Three of these dimensions -- accountability, the legal framework for development, and information and transparency -- are discussed in greater detail in Annex I.) Section IV discusses the role of the Bank. Section V discusses implications for Bank practice; and Section VI outlines next steps.

II. THE NATURE OF THE PROBLEM

The Role of Governments

11. Even in societies that are highly market-oriented, only governments can provide two sorts of public goods: rules to make markets work efficiently, and in some cases, corrective interventions where there are market failures. With respect to rules, without the institutions and supportive framework of the State to create and enforce the rules, to establish law and order, and to ensure property rights, production and investment will be deterred and development hindered (Eggertson, 1990). This is because high "transaction costs" (i.e., the cost of arranging, monitoring and enforcing contracts) would inhibit such activities. Compensation for market failure is more problematic. Governments in the 1970s relied on this rationale to rush into unwise policies and investments, although often their own policy interventions were responsible for market failures and the investments did not yield adequate returns. Governments now increasingly recognize the need for more restraint and for taking "market-friendly" steps to deal with problems. In addition, the State must play a key role in ensuring the provision of services such as education, health, and essential infrastructure, particularly when such services are directed at the poor and are not forthcoming from the private sector. A well-educated labor force and adequate infrastructure are fundamental to the quality of private investment.

12. However, to finance such expenditures, the state needs revenues. The state also needs "agents" who will collect taxes from the public and produce and deliver essential services (such as education and health, and a legal framework).[4] This, in

turn, requires systems of accountability -- accountability within government and from the government to those to whom it delivers services. For the system to work, adequate and reliable information flows are essential. Without it, the rules are not known, accountability is low, and uncertainties excessive. Thus, accountability, publicly known rules, information and transparency are all key elements of sound development management. Moreover, the institutional framework needed to provide these public goods must be managed efficiently.

13. Productive institutional arrangements will vary between countries, based on their cultural traditions and historic relationships. And they will continue to evolve as the economy grows and becomes more complex and more integrated with international markets. Mature institutional frameworks take a great deal of time to develop, but there is no guarantee that arrangements which are supportive of economic growth and poverty alleviation will, in fact, emerge. The state may behave in a predatory manner or pursue strategies that hinder property rights. Its agents may behave in an opportunistic manner and indulge in "rent-seeking". Why do some states behave differently from others? What are the conditions that permit success? The historical evidence is far from clear. However, institutional economists, like Douglass North, argue that institutions, defined as "the rules of the game in a society" (North, 1990: 3),[5] determine the performance of economies. Efficient institutions emerge when there are built-in incentives to create and enforce property rights, defined in the broadest sense. The example most often cited is that of the contrasting paths pursued by England and Spain in the seventeenth century, when both countries faced severe fiscal crises. The path pursued by England led to a burst of innovative activity; that of Spain led to a decline of such activity. Thus, to quote North:

> "In England, Parliament created the Bank of England and a fiscal system in which expenditures were tied to tax revenues. The consequent financial revolution not only finally put the government on a sound financial basis, but laid the ground for the development of the private capital market. More secure property rights, the decline of mercantilist restrictions, and the escape of textile firms from urban guild restrictions combined to provide expanding opportunities for firms in domestic and international markets. Both the growing markets and the patent law encouraged the growth of innovative activity....
>
> In Spain, repeated bankruptcies between 1557 and 1647 were coupled with desperate measures to stave off disaster. War, the church, and administering the complex bureaucratic system provided the major organizational opportunities in Spain and in consequence the military, priesthood, and the judiciary were rewarding occupations. The expulsion of the Moors and Jews, rent ceilings on land and price ceilings on wheat, confiscations of silver remittances to merchants in Seville (who were compensated with relatively worthless bonds called juros) were symptomatic of the disincentives to productive activity" (North, 1990: 114-115).

14. Such historical contrasts illustrate the importance to development of the "underlying institutional characteristics" of societies. Institutional economists point out that in order to understand better why these characteristics are different in different societies, we need to know more about the interaction between culture and formal rules and institutions.

15. The role of culture in shaping institutions and rules is an area of some contention in academic circles. Some argue that the importance of cultural divergences diminishes as the market economy progressively transforms society. Others, citing Japan, stress that norms and values of consensus and reciprocity may soften the impersonal nature of the market, and that national cultures impart a long-term, culturally specific shape to the legal and other institutions that support the functioning of the market. These two views are not necessarily inconsistent; the issue is one of degree.

16. The current debate on governance, therefore, needs to take account of cultural differences.[6] The concepts that are discussed in this paper mean different things to different cultures. The concept of "contract", which is at the heart of accountability and the rule of law, carries implicit the notion that rights and obligations incurred at a given point of time through an abstract legal device -the contract - will be honored at a later point of time by all parties concerned. Some cultures may have different conceptions of the relative importance of contractual agreements in relation to other rights and obligations. These may include, for example, strong and binding ethnic or kinship ties. Social norms may affect, for example, attitudes towards evading taxes or what constitutes conflict of interest.

17. The spread of political and legal systems modelled on Western traditions may lead to the simultaneous existence of two sets of norms and institutions for dealing with broadly defined rights and obligations, with Western notions of the rule of law, private property rights and contracts superimposed on ideas such as "consensus", "communal property" and "reciprocity", which have evolved over long periods of time in many non-Western cultural settings. While these different ways of anchoring social rights and obligations may or may not hamper the functioning of modern economic institutions, such as the market, it is important to be aware of them when pursuing policy reforms and institution building.

When Governance Fails

18. The institutional characteristics for managing development, thus, vary widely among countries and do not permit easy generalization. Nor is it practical to attempt a taxonomy, classifying states, say, by different governance characteristics. This complexity arises from the unique imprint of history, geography and culture on each country's institutions and rules, and the multidimensional nature of governance as a concept. Thus, each country is at a different level of political, economic and social development reflecting a wide array of historical, geographic and cultural factors. A number of the Bank's borrowers have been relatively successful in creating the institutions and rules that promote broad-based economic development. Some others are on their way to doing so, while yet others still labor under severe political, institutional and economic constraints on better government performance. What is said in this paper about government performance must be applied to individual countries in their context.

19. But poor governance is readily recognizable. The key symptoms are, inter alia:

- failure to make a clear separation between what is public and what is private, hence, a tendency to direct public resources for private gain;
- failure to establish a predictable framework of law and government behavior conducive to development, or arbitrariness in the application of rules and laws;

- the existence of excessive rules, regulations, licensing requirements, etc., which impede the functioning of markets and encourage rent-seeking;
- priorities inconsistent with development, resulting in a misallocation of resources;
- excessively narrowly-based or non-transparent decision making.

20. Such "problems" may be due to lack of capacity or to volition, or both, and may be of varying severity. However, it is when they are sufficiently severe and act in tandem that they create an environment that is hostile to development. In such circumstances, the authority of governments over their peoples tends to be progressively eroded. This reduces compliance with decisions and regulations. Governments then tend to respond through populist measures or, as in some authoritarian regimes, they resort to coercion. Either way, the economic cost can be high, including a diversion of resources to internal security, and escalating corruption. Poor development performance can in turn contribute to poor governance by further eroding the confidence of citizens in their governments, and causing governments to behave insecurely.

21. The absence of good governance has proved to be particularly damaging to the "corrective intervention" role of government. Programs for poverty alleviation and environmental protection, for example, can be totally undermined by a lack of public accountability, corruption and the "capture" of public services by elites. Funds intended for the poor may be directed to the benefit of special interest groups, and the poor may have inadequate access to legal remedies. Similarly, the enforcement of environmental standards, which benefit the population as a whole but which may be costly to powerful industrial and commercial groups, can be emasculated by poor governance. Industrial emissions standards, forest protection policies and guidelines for the incorporation of environmental concerns into public expenditure decisions may be worth little more than the paper they are written on unless rules are clear, information is available to the public, and government officials are accountable. In the case of the environment, problems are magnified by difficulties of monitoring and enforcement, which enable official government policies to be ignored.

22. Among the underlying causes of poor development management is the level of economic, human and institutional development. Lack of an educated and trained manpower and weak institutions can substantially reduce the capacity of countries to provide sound development management. Poverty and illiteracy make poor governance more possible. This is not, though, to suggest that development automatically brings good governance; nor to imply that sound economic management is not possible in poor countries. There are a number of Asian counter-examples, both authoritarian and democratic. It is simply that poverty, illiteracy and weak institutions make the task of good development management much more complicated and problematic.

23. Pervasive corruption is particularly damaging to development. Corruption occurs in all countries and in many different forms. It tends to thrive when resources are scarce, and governments, rather than markets, allocate them; when civil servants are underpaid; when rules are unreasonable or unclear; when controls are pervasive and regulations excessive; and when disclosure and punishment are unlikely. Although there have been isolated instances of governments being both corrupt and successful at promoting development, in general, corruption weakens the ability of governments to carry out their

functions efficiently. "Bribery, nepotism, venality and lack of dedication to duty," notes the 1991 WDR, "can cripple administration and dilute equity from the provision of government services, and thus also undermine social cohesiveness" (World Bank, 1991a). Graft on a large scale is not possible without collusion with private companies or foreign suppliers, with officials of foreign governments sometimes turning a blind eye, – a problem of international governance.

24. Other causes of poor development management are a high degree of concentration of political power and the colonial inheritance. On the positive side, many former colonies inherited systems of financial accountability, an independent civil service, and a legal framework. However, since these were imported from outside, they have not always taken root. Colonial rule implied accountability to the colonial power, rather than to citizens; it thus sometimes destroyed indigenous systems of accountability.

25. Colonial rule has sometimes bequeathed standing armies, thus, diverting resources away from development and making fragile civilian governments prone to military coups and related political instability. The 1991 WDR estimates that since 1948, there has, on average, been one coup attempt per developing country every five years (World Bank, 1991a: 7.2). Colonially imposed frontiers have sometimes led to border disputes and ethnic strife. During the Cold War, such strife has, on occasion, been fuelled by arms exports to the rival factions/states.

26. These symptoms and causes of poor governance are not unique to any particular form of government. The 1991 WDR examined the evidence on the relative performance records of democracies and authoritarian regimes and noted that the democratic-authoritarian distinction itself "fails to explain whether or not countries initiate reform, implement it effectively, or survive its political fall-out" (World Bank, 1991a: 7.11). Authoritarian regimes were just as likely to yield to the interests of narrow constituencies. The report concluded that "there was no evidence to support the view that authoritarian governments, on average, show greater promise for achieving rapid growth" (p.16). Moving beyond growth to social development, the report notes that some studies suggest that for a given level of income, "improvements in social indicators are associated with freedom and liberty" (7.11).

27. In sum, governance is a continuum, and not necessarily unidirectional: it does not automatically improve over time. It is a plant that needs constant tending. Citizens need to demand good governance. Their ability to do so is enhanced by literacy, education and employment opportunities. Governments need to prove responsive to those demands. Neither of these can be taken for granted. Change occurs sometimes in response to external or internal threats. It also occurs through pressures from different interest groups, some of which may be in the form of populist demands. While donors and outsiders can contribute resources and ideas to improve governance, for change to be effective, it must be rooted firmly in the societies concerned, and cannot be imposed from outside.

III. DIMENSIONS OF GOVERNANCE

28. As indicated in the foregoing discussion, there are four key dimensions of governance that are of relevance to the Bank's work: capacity and efficiency issues in public sector management, accountability, predictability and the legal framework for development, and information. These are now discussed in turn (See Annex I for a more

detailed discussion of accountability, the legal framework for development, and information and transparency).

(a) Improving Public Sector Management

29. When the capacity of the public sector to manage the economy and deliver public services is weak, the prospects for development are poor. The public sector in many developing countries has been characterized by uneven revenue collection, poor expenditure control and management, a bloated and underpaid civil service, a large parastatal sector that provides poor returns on the scarce public funds invested in it and weaknesses in the capacity of core economic agencies to design and implement policies that would address these problems. Not only does this state of affairs contribute to large fiscal deficits requiring adjustment measures, but it also progressively erodes the capacity of the state to provide economic and social services.

30. The Bank's involvement in this area, till the 1980s, was overwhelmingly in the institutional development of the agencies implementing Bank-financed projects. With the introduction of adjustment lending, the Bank began to focus on improvements in overall public sector management, and the improvement of sector-wide institutions and service delivery. Within this dimension, three areas have received primary attention in the 1980s: public expenditure management, civil service reform, and parastatal reform. Within public expenditure management, the emphasis has been on assisting borrowers improve public investment programming and the budget process. Less advanced have been efforts to improve the execution and monitoring of public expenditure programs. Under civil service reform, in the short term, the emphasis has been on cost-containment measures; in the medium term, on strengthening personnel management and the effectiveness and efficiency of public agencies. In the management of public enterprises, the Bank has been assisting borrowers rationalize the size of the public enterprise sector, privatize, restructure, or liquidate public companies, as appropriate, improve the competitiveness of the policy environment, and clarify the relationship between the central government and public enterprises with a view to increasing the returns on the government's investment in the sector. The core agencies for key sectors and for national economic management have been assisted to strengthen management of these reform programs and to give greater priority to and to increase efficiency in the delivery of social services. Decentralization and tax reform are other areas where the Bank has supported government efforts to improve public sector efficiency (as noted in the Tax Reform Policy Paper).

31. The accompanying PSM paper provides a review of selected issues and concludes that initial results have been positive, often in trying circumstances. The effort has been long and arduous, reflecting obstacles of a socio-political nature. In public expenditure management, imperfect accountability has gone hand in hand with weak institutional capacity. In civil service reform, there is a shift in emphasis to improved personnel management. In all cases, the need for strong political commitment is noted. It is particularly difficult to ensure commitment to reforms over time. Tensions between economic benefits and political costs are typical of reforms in this area.

(b) Accountability

32. Accountability, at its simplest, means holding public officials responsible for their actions. How this happens varies widely from country to country, depending upon cultural traditions, history, political institutions, administrative capacities and the public's access to and use of information. For the

Bank, accountability must be seen from the viewpoint of development management. At a broad level, economic objectives of public accountability include congruence between public policy and actual implementation, and the efficient allocation and use of public resources. This not only requires systems of financial accountability, but also the capacity and willingness to monitor the overall economic performance of the government. At the micro level, the primary concern is comparable efficiency in investment and in the production and delivery of goods and services in the public sector.

33. The Bank has addressed issues of both economic and financial accountability. As noted above, public expenditure reviews have focussed on the efficiency of resource use in public investment programs, in the parastatals sector, in the social sectors, and more recently, in employment and wage issues in civil services. This has led frequently to the identification of reforms including the removal of white elephants from public investment programs, privatization, restructuring and closure of state enterprises, reallocation of resources in favor of primary health and primary education, and the removal of "ghost workers" and rationalization of employment levels in the public sector. Through sector adjustment or investment loans, the Bank also assists reforms of sector-wide institutions, with a view to improving the efficiency and accountability of institutions responsible for service delivery. In the area of overall economic performance monitoring, the Bank's Operations Evaluation Department (OED) has for long advised planning and performance ministries on monitoring and evaluation functions. Greater attention to this issue is also being paid under PSM projects.

34. In the area of financial accountability, the Bank has tended to focus on project implementation agencies. However, compliance with accounting and audit covenants has often been disappointing, reflecting weaknesses in country-wide accountability mechanisms. To address this problem, the Bank has been pursuing a three-pronged strategy: (i) improving borrower incentives to comply with accounting and audit covenants; (ii) encouraging a more systematic review of auditing and accounting issues during project preparation; and (iii) strengthening borrower capacity through country-wide reviews of accounting and auditing. For example, accounting and auditing functions are being strengthened in Ghana, Madagascar, Mauritania and Indonesia. The LAC Region has been actively helping governments strengthen agencies critical to accountability and transparency, such as tax and customs officers, Central Banks and the offices of Controller-Generals. Accountability assessments are also underway in some countries. To be effective, such reviews need to focus on the processes by which audited reports are reviewed and action taken to deal with the corruption and waste identified.

35. Decentralization is sometimes seen as the means of reducing an overload of central government responsibilities by relying on local decision making, micro-level accountability and through participation of beneficiaries in the design and monitoring of service deliveries. However, decentralization must be managed with care if it is not to result in fiscal imbalances, wastage and corruption due to a lack of adequate oversight from national authorities, weak administrative capacity at local levels and the risk of capture of institutions by local elites. Both in Latin America and Eastern Europe, the Bank has been active in assisting with the rapid decentralization proceeding in those regions, mainly through technical assistance for the strengthening of local governments and for ensuring fiscal and financial accountability. In Mauritania, an institutional framework for the creation of municipalities is being established.

36. Micro-level accountability can sometimes reinforce macro-level accountability through competition or the provision of alternatives, that is, opportunities for "exit", or by enhancing opportunities for participation, public comment or complaint, or other forms of "voice".[7] Exit mechanisms include deregulation, contracting out, public-public and public-private competition. The Bank has encouraged exit through deregulation and contracting out of services in various projects and generally by encouraging break-up of local or national monopolies. Voice can be encouraged through dissemination of information on services, complaint procedures, public hearings, public feedback on development activities and services, representation on boards, participation by beneficiaries in the design of projects, and the encouragement of local NGOs which are able to reach poor or marginal groups who would otherwise be voiceless. Popular participation in project design and implementation has been shown to have a significant positive effect on the efficacy of projects. Inevitably, however, there are some attendant risks that need to be factored in when pursuing these means (see paras. 19, 25 and 26 in Annex I). NGOs were involved in 50 Bank-financed projects in each of the past two fiscal years, compared to 15 projects in FY88. Some 20 projects, with exceptionally participatory approaches, are being studied by an Operations-PRE learning group in an exercise designed to draw lessons from Bank experience with popular participation. The Philippines Communal Irrigation Project remains a particularly good example of successful beneficiary participation on a large scale producing consistently good results. Best practice consists of a systematic effort during project preparation to explore, where appropriate, opportunities to enhance competition and participation.

(c) Predictability and the Legal Framework for Development

37. Predictability implies "standard operating procedures, institutionalized rules, non-personalized decision making and modest levels of discretion and regularized procedures for establishing and implementing policies" (Brautigam, 1991). In systems with high predictability, rules and regulations are clearly promulgated and generally and consistently applied, and lines of authority are clear. The civil service provides a measure of continuity. In most countries, predictability is imperfect. The Bank's concern is to support the continued evolution towards ensuring at least a minimum level of predictability. The Bank is increasingly involved in assisting its borrowers to improve the quality and efficiency of the civil service which, when successful, will help enhance predictability (see the PSM paper).

38. A sound legal framework for development, a further key element of predictability, is an area of focus in this paper. The General Counsel defined the rule of law in terms of a "system based on objective rules, which are actually applied, and on functioning institutions, which ensure the appropriate application of such rules." Reforms proposed by the Bank, he argued, "cannot be effective in the absence of a system which translates them into workable rules and makes sure they are complied with" (Shihata, 1991: 42-43). Such a system is needed to create a climate of stability and predictability, where business risks may be rationally assessed, transaction costs lowered, and governmental arbitrariness reduced. It is this connection of the rule of law with the more efficient use of resources that justifies its consideration by the Bank as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself; it is only to the extent that it establishes a set of preconditions for development that it comes within the purview

of the Bank. The elements of the rule of law are varied. Not all have the same bearing on the purposes of the Bank. The following basic elements have been identified by the General Counsel:

39. ***There must be a set of consistent rules known in advance.*** The Bank is assisting former socialist economies and others to ensure that new economic measures are not in conflict with existing laws or constitutional provisions. More can be done by most governments to communicate laws effectively and to explain to citizens the content of legislation. The Bank is assisting some borrowers in this area.

40. ***These rules must actually be in force.*** Laws are frequently ineffective or are not applied because they are perceived as obsolete or irrelevant, or because enforcement capacity is inadequate. The underlying reasons for non-compliance with the rules are manifold; some borrowers (with Bank assistance) are analyzing the causes and improving the efficiency and competence of the institutions which administer the laws.

41. The ***application of the rules*** requires flexibility and executive branch discretion to deal with diverse situations. To avoid abuse of that discretion requires systems of review. Some countries have independent or specialized courts or ombudsmen; civil service reform will also address the underlying causes of abuse. Rationalization of obsolete rules and regulations, by updating and simplifying legal systems, is being attempted with Bank assistance.

42. To assure a business environment conducive to investment and commercial activity, ***conflicts must be resolved through binding decisions of an independent judicial body or through arbitration.*** Confidence in the enforceability of agreements and commitments is critical to the proper functioning of an economy. The Bank is beginning to be active in this area with several operations under preparation that will assist borrowers train judges in economic and business fields and handle commercial matters in specialized courts. Other dispute settlement measures such as commercial arbitration can also be useful.

43. Finally, ***there should exist known procedures for amending the rules when they no longer serve their purpose.*** When laws are changed arbitrarily and subjectively without recourse to established procedures, they lack acceptance and invite evasion. While it is outside the Bank's mandate to determine what legislative process should be in place to amend laws, the Bank is assisting in a modest way in training and technical assistance for the offices of the Attorney General, Ministry of Justice, etc. in areas relating to development management.

44. The Bank's experience shows that effective legal reforms require careful preparation and a thorough knowledge of local conditions, and the cultural and historical context. Legal sectoral reviews in Indonesia and Cote d'Ivoire, and reviews of the legal frameworks for financial operations in the Philippines, Guinea and Senegal have enabled the Bank to assist borrowers tailor rules and the strengthening of institutions to country circumstances. It is also important to recognize, as noted in para. 16, that attention must be paid to local circumstances and traditions.[8]

(d) Information and Transparency

45. Adequate and reliable information refers to the availability of and access to information from public and private sources, and the transparency of decision-making processes. These are vital to both

accountability and the rule of law. Their absence provides opportunities for deception, unfair or inequitable treatment and corruption. The Bank's interest in information is once again derived from and limited to their impact on development management.

46. The availability of accurate information critically affects the efficiency and competitiveness of the private sector: information about the economy, in general, about conditions in particular markets, and about the intentions and actions of government itself are crucial to private sector's calculation of risk and potential reward. Governments need to raise the quality of the information they themselves provide and to ensure that the private sector also discloses essential information. Capital market development, for example, is hindered when public and private enterprises are not compelled to publish audited accounts; likewise without transparency in the financial systems, capital and financial markets remain circumscribed to a narrow range of firms and instruments, and the soundness of the banking system remains at risk. An efficient market economy needs openness in this sense: openness is also strengthened, conversely, by a competitive economy, where there are many sources of information and where economic signals (such as prices) carry rich and relatively undistorted information.

47. Transparency of decision making is a safeguard against corruption, wastage and the abuse of executive authority. Competition and deregulation, the removal of unnecessary controls, clear rules and disclosure are important first steps. Many countries have sophisticated and strict laws against corruption, but these are not always enforced. The Bank has been assisting borrowers remove unnecessary controls and to reduce regulations, improve domestic and external procurement procedures and make budgets and Central Bank accounts more transparent. Where corruption has been pervasive, more drastic measures may be called for, such as Indonesia's use of the SGS to manage its customs services.

48. Corruption is a two-way street. Donors have an important responsibility to ensure that their national commercial considerations do not undermine good economic management in the developing world. Encouraging governments to develop sound public investment programs and respecting the priorities established is an important contribution that donors can make. A document entitled "Good Procurement Practices for Official Development Assistance" was prepared by the OECD's Development Assistance Committee (DAC) in consultation with the Bank. More recently, through a DAC Working Party on Financial Aspects of Development Assistance, a greater effort is being made to ensure that competition for contracts under donor-financed projects is not a source of corruption and does not contribute to distorted investment priorities. The intention is to ensure greater transparency and fair trade practices through a common band of concessionality levels, more open procurement procedures for large projects, an upper income limit for tied aid, ICB procedures, etc. Project preparation through joint appraisals and cofinancing with multilateral development banks, including the World Bank, is seen as one way to ensure sound investments and consistency with country priorities. When such cofinancing is not possible, the DAC has proposed that donors look to the Bank for advice on the appropriateness of proposed bilaterally financed large projects in the particular country economic situation. A consensus has yet to be reached on these proposals.

49. Budgets in developing countries often lack transparency. Revenues are sometimes diverted to special accounts outside the budgetary framework. Transactions with

parastatals are obscured. A number of expenditure items are off-budget. Military expenditures often escape scrutiny, avoid accountability expenditure control and auditing, in part because of the reluctance of civilian financial managers to question military procurement. High pressure salesmanship reinforced by generous trade credits in this area, as in others, can contribute to waste and corruption.

50. The Bank has been active in assisting governments to improve the transparency of budgets mainly through its public expenditure work. In undertaking such work, its main concern is that the country has systems of expenditure decision making and financial accountability that ensures that all expenditures, including military expenditures, are properly assessed and prioritized, that they are transparent, and that they are subject to expenditure controls and auditing. The Bank's focus is to assist borrowers to ensure that the overall size of public expenditures is not excessive in relation to resource availability and that adequate resources are allocated to economic and social sectors, and within these to programs that direct key services to the poor in a cost-effective manner. Its interest in military expenditures is because of its crowding-out effect on development spending.

51. Availability of information and transparency may lower uncertainty and transaction costs, but will not, by itself, bring about greater accountability in the absence of organizations and mechanisms that analyze and disseminate information. The mass media, in particular, play a key role here. The African Capacity Building Initiative is an example of the potential role of donors in strengthening the analytical and research capacities of institutions in developing countries. Long-term training/twinning arrangements -- whether these are formal institutional connections or the informal evolution of relations, like those of certain universities in the developed world with close links to the economic establishments in certain developing countries -- can play a key role.

IV. THE ROLE OF THE BANK

Key Elements of an Approach

52. Governance is a concern for the Bank for two sets of reasons. First, *from a broader perspective*, both history (see Section II) and the Bank's own experience show that good governance, in the sense that it has been used above, is central to creating and sustaining an enabling environment for development.

53. Second, *from the Bank's perspective*, as noted in Section I, sound development management is inextricably linked with the returns to and the efficacy of investments that the Bank helps finance and so to the Bank's underlying objectives of helping countries reduce poverty and increase sustainable growth.

54. The Bank has a long record of helping countries build the institutions and practices essential to an efficient and modern economy and must continue to set high standards for itself and its borrowers. Section III in this paper and Annex I cite the many ways in which borrowers are being assisted in improving development management. The Bank's concern here arises not merely from the impact of such assistance on country performance but also, as a financial institution, such assistance is part of sound portfolio management.

55. Until recently, in such areas as accountability and the legal framework, the Bank has tended to focus its attention narrowly on its own intervention rather than on the country context within which those

interventions were taking place. Thus, the Bank insists, in all cases, on proper systems of audited accounts for its project entities but has not often focussed on the constraints within which the overall system of financial accountability was operating. It has often encouraged borrowers to introduce new laws and regulations (e.g. trade and investment legislation) without always examining whether the legal system as a whole is operational and whether laws will be implemented effectively. This has changed rapidly in recent years. Just as Bank public sector management work has broadened from strengthening project-related agencies to a broader concern with overall civil service and parastatal reforms, similar shifts are now taking place in these other areas in a few countries. This is evident from the following illustrative list of activities being pursued in different Regions of the Bank.

Accountability

(a) ***At the macro level:***

- *Strengthening accounting* in the public sector, focussing on a range of actions, depending on country situation and need such as the availability of comprehensive and timely information, classification of expenditures in a manner consistent with budget and programs, appropriate analysis for decision making, comparison of budget and actual results, improving the organization and responsibility for accounting in the finance ministry, and legal requirements for financial reporting. (paras. 6-11 in Annex I)

- *Auditing reforms* to enable appropriate independence of the audit organization specified in the legal structure, greater attention to "value for money" auditing, and improvements in the educational system and professional training. (paras. 13-14 in Annex I)

- *Country-wide accountability assessments and projects* have been undertaken in Madagascar, Indonesia and Bolivia along the above lines. (para. 11 in Annex I)

- *Decentralization*: Assisting governments to establish or strengthen systems of financial accountability as they devolve financial power to local authorities. (paras. 16-19 in Annex I)

(b) ***At the sector level:***

- Strengthening the capacity and accountability of ministries and institutions that develop policies, establish expenditure priorities and oversee the delivery of essential services.

(c) ***At the micro level:***

- Assessment of *choice and participation options* in the design and preparation of projects producing and delivering services. (paras. 20-24 and 28-31 in Annex I)

- Encouraging *beneficiary participation* where appropriate, in the design and implementation of Bank projects, based on lessons drawn from the ongoing Operations-PRE study of Bank experience with popular participation. (Box 5 in Annex I)

- Selective and focussed use of *local NGOs* to enhance service delivery and ensure that the voice of the poor is heard in project design. (paras. 25-27 in Annex I)

Legal Framework for Development

- *Legal reforms*, including better communication of laws, ensuring consistency of laws, addressing constraints to implementation of laws, updating legal systems, training of the judiciary in business and economic laws, and encouraging extra-judicial alternatives when legal systems are overburdened, such as commercial arbitration and other dispute settlements mechanisms. (paras. 32-60 in Annex I)

- *Legal Sector Reviews*, undertaken at the request of borrowers, with a view to removing impediments to private sector activity.

Information and Transparency

- *Transparency*: Assisting governments improve the transparency of budgets and public expenditure programs; assisting with the preparation of environmental assessments and encouraging borrowers to share these with those affected by projects; assisting improve domestic and external procurement (Box 13 in Annex I and paras. 71-75) mechanisms and institutions to ensure competition, transparency (including disclosure of selection criteria), and fair contract conditions in public procurement etc.

- *Economic and social information:* Assisting governments improve the collection and dissemination of economic and social data. (paras. 76, Annex I)

- *Analysis and dissemination capacity:* Strengthening the capacity to understand, process and use information. The Africa Capacity Building Initiative will contribute to this process as well as long-term twinning/training arrangements. The training of economic journalists to raise the level of public awareness and policy debate may also yield returns. (para.76-77, Annex I)

56. Much of the above work represents a natural extension of the Bank's work on public sector management. It is, like the PSM work, technical in nature and complements other efforts undertaken in economic reforms, such as elimination of monopolies, deregulation or removal of controls to contribute to good economic management and reduce opportunities for rent-seeking. Indeed, there is much that the Bank has been doing routinely which indirectly contributes to good governance.

Limitations of the Bank's Role

57. In undertaking such work, the Bank faces some inherent limitations: those of any external agency, of its legal mandate, of its comparative advantage, and of the skills and resources available to it. First, as an external agency, the Bank cannot substitute for the political commitment that governments must bring to reforms in this area. Outsiders can assist and advise, but unless governments are committed to reform, changes that are brought about will not be sustainable. Full ownership of reforms is as important in this area as it is with economic policy reforms.

58. Second, the Bank's legal mandate clearly delimits its areas of concern. By way of illustration, the Bank may support government efforts at decentralization. It may, through its economic and sector work make a persuasive case for or against decentralization of particular functions. But the decision to decentralize is one that only

governments can take. Similarly, the Bank is rightly concerned with financial and economic accountability, but political accountability is outside its mandate. Similarly, the Bank may assist in strengthening local governments; it may not, however, have conditionality requiring local government elections. With regard to the legal framework for development, the Bank's concern is with its procedural and institutional aspects. The substantive elements of such a framework have political connotations that may sometimes lie outside the Bank's mandate. Here the General Counsel's memorandum provides clear general guidance, although such distinctions can, sometimes, be difficult to make in practice. It is important to note the underlying motivations behind the restrictions in the Articles of Agreement. These restrictions help to protect the Bank's reputation for technical excellence and objectivity and its status as an international institution that is guided solely by its concern for economic development and not by any political agenda of its own.

59. Third, the Bank's past experience provides a counsel of caution. The accompanying PSM paper is evidence that work in this area is likely to prove difficult and not yield quick results. The Bank's early experience with integrated rural development projects in the 1970s taught many valuable lessons. These projects were ambitious ventures into the public sector and social engineering. Of the many lessons learned from that experience, some reinforce the need for the exercise of care and humility in tackling problems of governance. The lessons include the need for a more differentiated approach between regions, countries and project type; the need for strong government commitment at an early stage; the need for training and retraining Bank staff to meet the complex needs of these projects; the need for long-term institution building and for avoiding project institutional arrangements that lead to frequent conflict with other parts of national and local governments; emphasis on developing human capital rather than quick physical implementation: the realization that expatriate technical assistance is a poor substitute for developing local capability. There were also other important lessons not directly related to governance involving the incentive frameworks, the role of the private sector and over-optimism on the availability of profitable technical packages.

60. Finally, work on development management and institution building is expensive and time consuming. However, such work will be handled like all other claims on budget resources, through a determination of priorities within existing country programs, based on need, borrower receptivity, etc. As noted below (para. 64), selectivity would be important in terms of countries and the range of activities to be pursued. The Bank should, of course, not attempt to take too much on itself. There are UN and other agencies who have experience in some relevant areas, which the Bank can tap through collaboration and its aid coordination function. Given that the rationale for the Bank's involvement in governance is that it helps improve the effectiveness of its programs and projects, and not as a new line of business, high quality work and improved Bank practices in this broad area should help the Bank to move further towards an "implementation culture", leading over the longer run, to increased cost efficiencies for the Bank itself and greater effectiveness of Bank interventions.

61. The skill-mix problem also raises difficulties. Many governance concerns can and are being addressed by various specialists in the broad PSM field, although experienced auditors, accountants, lawyers, tax specialists, management specialists and the like, are generally in short supply in the Bank. The LAC region has gradually built up a range of new skills through judicious hiring and use of consultants. Consultants can play an

important role; Bank staff need to ensure though that consultants are sensitive to the Bank's institutional concerns. Here again, the Bank needs to assist borrowers to draw on skills in other agencies, but recognize that there will nevertheless be significant trade-offs.

V. IMPLICATIONS FOR BANK PRACTICE

62. Bank actions relating to the governance dimension of development would be chosen selectively from the following range of options depending upon country circumstances and needs, the state of the dialogue with the borrower, and budgetary constraints:

- *Assisting* governments in reforms that they have identified or assisting them to identify reforms when they have asked for such assistance. The Bank is already experiencing a growing demand for technical assistance in support of a legal and procurement framework in Africa and Eastern Europe and strengthening decentralization in Latin America.

- *Persuading* governments through dialogue and economic and sector work of the need for reforms. Institutional and public sector management assessments and public expenditure reviews and financial accountability and legal sector reviews in Africa and Asia are examples of how this has begun to happen.

- *Crafting* country lending strategies and levels to take account of the impact of governance issues on development performance.

- *Helping* countries deal with the especially complex issues of poverty and the environment (see para. 21 above), where the quality of governmental performance is particularly important.

- *Projecting* a long-term vision of an enabling environment, as in the 1991 WDR but at country level, and supporting such fundamental ingredients as universal literacy, expanded primary education, better information on development issues and a supportive environment for a growing private sector.

- *Improving* implementation performance through greater efforts at assisting borrowers build ownership of adjustment programs, understanding the political and social structure of the country as well as its laws and customs, and increasing attention to fostering an "implementation culture" in the Bank, including greater emphasis on beneficiary participation in project design.

As a practical matter, given differing country circumstances as well as budgetary and staff constraints, a ***measured and selective approach*** must be pursued. The main elements of this approach are set out and some of the actions outlined above are elaborated, in the paragraphs that follow.

63. First, the Bank, through its interventions, should continue to exploit opportunities for improving development management, whenever appropriate, through a variety of means including assisting borrowers break up monopolies, removal of controls and other avenues for corruption, beneficiary participation in projects, etc.

64. Second, selectivity is necessary in allocating budgetary resources and developing work programs. The selectivity needs to be in terms of the choice of countries for specific work on the key dimensions of development management outlined above, and in terms of the range of activities the Bank can take on and support at any given time. Such work can only be embarked upon in countries where there is a clear commitment to and need for improving development management along these dimensions. Many of the Bank's borrowers may neither want the Bank to be so involved nor require such assistance. Where there is need but no commitment, such work would waste resources. Similarly, the dimensions of development management the Bank chooses to assist should reflect both the chances of success from such an involvement as well as the Bank's own ability in terms of skills and resources to assist effectively.

65. Third, in countries where the Bank is active in improving the governance dimension of development management, it needs to assist in the design of highly differentiated responses, taking account of the country's institutional needs, its political economy, its society, and history. The objective in each case must continue to be to help strengthen the enabling environment for sustainable and equitable development. This requires high quality analysis, usually as part of appropriate Economic and Sector Work.

Country Strategy and Implementation Issues

66. It is important to note in this context that a strong emphasis by the Bank on prudent financial management and attention to auditing and accounting or a legal framework suitable for development will tend to surface deeper and more general problems of governance. Thus, for example, sophisticated systems of financial accounting and auditing may be established but the government may not absorb or use the results to good effect. A legal framework could be created, but arbitrariness or corruption in its implementation could undermine its value. This has already been the experience with sensitive issues of PSM such as civil service reform where political constraints to the success of such work have emerged. Where lack of progress is due not to weaknesses in capacity but to lack of government commitment, the Bank then faces a problem which needs to be reflected in its country strategy and dialogue.

67. When political commitment to sound development management is weak, the Bank normally takes up these issues in its dialogue with borrowers while remaining proactive in seeking ways to help the country improve performance in some of the key areas. This dialogue is supported by economic and sector work, where appropriate. In such a dialogue, governance issues are not discussed in isolation but as an integral part of a government's overall development program. In conducting this dialogue, the level at which issues are discussed is a function of their sensitivity and requires the judgements of senior managers. Technical issues are handled at staff levels, but sensitive issues are handled at an appropriately high level (Country Director and above).

68. The issue of political commitment to sound development management is also surfacing increasingly at consultative group meetings. The General Counsel's legal memorandum noted that the Bank should not act as the agent of donor countries at these meetings. As Chair of these meetings, it is normal for the Bank to inform the country of widely-held donor concerns, particularly when these would affect Bank-assisted programs.

69. When dialogue fails, the Bank's own lending to the country is likely to be affected. Lending levels have long been responsive to issues of development management and

development performance, and will continue to be so. Judgments of performance are already routinely made for purposes of IDA allocation and in assessing creditworthiness. This involves judgments about the quality of development management as it relates to growth and to poverty reduction, consistent with the policy paper on poverty (World Bank, 1990e). There is no need for additional criteria to reflect concerns with governance: merely the effective and consistent application of existing criteria based on a greater awareness of the importance of issues of governance for development performance.

70. *Poverty and the environment* are two critical areas of country strategy which present particular challenges of governance. The Bank needs to pay attention to the equity as well as cost-effectiveness of social expenditures in its poverty assessments and public expenditure reviews, including addressing questions of the adequacy of social safety nets (especially important in middle-income countries). The legal framework can also greatly influence the access of disadvantaged groups, such as women or landless people, to public services and economic opportunities. On environmental matters, even non-interventionist governments face relatively extensive requirements for administrative and regulatory decision making, much of it discretionary, in areas -- like forest policy or pollution control -- where property rights are uncertain and market processes, therefore, cannot easily produce a socially desirable outcome. The Bank is considering how these inherent difficulties can be overcome and potentially abusive discretionary powers curbed for example, by separating surveillance from administrative responsibility. WDR 1992 will discuss some of these issues of environmental policy and governance.

71. Given absorptive capacity constraints, and the long-term nature of the task of developing appropriate institutions and the strengthening of budgetary decision making and accountability, development management concerns must be integrated, where appropriate and relevant, into a long-term perspective of a country's development strategy and prospects. In the Africa Region, as a follow-up to the Long-Term Perspective Study on Sub-Saharan Africa and the Maastricht conference which discussed it, the UNDP and the Bank, with assistance from the Netherlands Government, are assisting interested African countries to develop such perspectives. The objective, in this case, is to use the exercise to help develop a national consensus on development objectives and instruments, and to put government adjustment programs within the framework of a long-term development strategy aimed at poverty reduction and consistent with environmental concerns. Countries elsewhere may wish to consider a similar approach. For the Bank, this means taking a longer-term view of its own interventions to assist borrowers improve economic management, recognizing that quick results may be unrealistic, and focussing on human and institutional capacity development. This also implies that some aspects of this work should be supported by investment operations rather than with adjustment lending. Carefully designed long-term technical assistance is also appropriate.

72. This long-term approach would reinforce efforts underway to strengthen ownership of adjustment programs. The technical complexity of the preparatory work on *adjustment operations* and the speed with which borrowers require resource transfers, sometimes leave insufficient time for adequate dialogue and can cause the Bank to contribute to programs whose ownership is weak and that are then seen to be externally imposed. In an ideal world, sufficient preparation time would permit a better understanding of the political economy of the country, and through a more

intensive and extensive dialogue, greater ownership and understanding of the program by the borrower is assured. However, governments and Bank staff frequently do not have that luxury. Governments often delay adjustment and come to the Bank for assistance on adjustment when they are facing a serious crisis. There is, then, an inherent conflict between the need for quick support of sensitive policy reforms and the need to build ownership and understanding of the program. Moreover, greater ownership comes after a program begins to show results. It, nevertheless, remains important to ensure that operations are designed, taking into account, the political economy of the country. It is also important to ensure that ownership of the program, however narrow at the start, is genuine, and is broadened over time. At the same time, the strength and integrity of adjustment programs must be protected.

73. Beyond adjustment lending, fostering an "*implementation culture*" requires attention to good governance in the design of projects, as well as a deliberate focus on implementation. Best practice includes simple project design, discourages creation of autonomous project implementation units, encourages use of existing structures to implement projects, increases supervision, suggests prior action and conditionality rather than delayed dated covenants, recommends recruitment of key staff well before effectiveness and pays special attention to the fiscal effects of projects. All of these recommendations, coming more and more sharply into focus in Bank operations, are instances of the approaches to good development management discussed in this paper.

74. *Beneficiary participation* is, in many instances, an important component of institutionalizing an implementation-oriented approach as well as a means of improving the effectiveness of particular projects. The Bank, as noted, is attempting to spread best practice in this area. This will require skills in organizing participatory processes, mediating conflicting points of view while achieving results in a timely manner. In some cases, it means identifying intermediaries through which the Bank can work. It may also mean working with local NGOs; in other instances, this may mean searching for special skills in local sociologists, development managers, anthropologists or consultants who can be brought into projects for particular aspects of project work. Timetables may sometimes need to be adjusted in order to accomodate this labor intensive work – often at the beginning of the project cycle. The Bank's learning process on popular participation is addressing these issues (Box 5, Annex I).

Implications for Research

75. Much of the Bank's current policy and research work in public sector management bears on "governance" issues. For example, studies underway examine ways to introduce greater public accountability in public finance and in civil service management, while work on regulatory institutions and on the political economy of adjustment also addresses some of the questions discussed in this paper. Much uncharted territory remains, and current work could be extended in several directions.

76. One such is further research on the rule of law, to explore the minimal juridical conditions for broad-based development. For example, in areas such as contract enforcement, employment and tenancy transactions, recourse against public agencies and judicial independence, is there relatively consistent and culture-neutral experience on which countries can base their own efforts? Another important area is the accountability of public agencies, where it would be useful to evaluate the wide variety of mechanisms and models available. These include contracting

out of services to private providers (on which some work is in progress), decentralization of provision and/or finance, ombudsman mechanisms, "customer-driven" service systems and others. Further research could follow up some of the findings of WDR 1991 to explore the two-way relationship over time between economic growth and changes in governance.

V. CONCLUSION

77. Management proposes to proceed with the following:

(i) Dissemination to the staff of the key messages for the Bank in this paper together with the Board's guidance.

(ii) A broad-based dialogue with borrowers, interested academics and others, has begun in the Africa Region, and depending upon this experience, could be extended elsewhere;

(iii) A research program along the lines discussed in paras. 75-76.

(iv) A progress report to the Board on the Bank's ongoing experience with governance issues in about two years' time.

ENDNOTES

1. Webster's Unabridged Dictionary

2. Governance, in general, has three distinct aspects: (i) the form of political regime (parliamentary/presidential, military/civilian, authoritarian/democratic); (ii) the processes by which authority is exercised in the management of a country's economic and social resources; and (iii) the capacity of governments to design, formulate, and implement policies, and, in general, to discharge government functions. The first aspect clearly falls outside the Bank's mandate. The Bank's focus is, therefore, on the second and third aspects.

3. This discussion was itself partly prompted by criticisms of early drafts of the LTPS from African reviewers who felt this issue needed to be aired.

4. This gives rise to the so-called "Principal-Agent" problem which relates to how the Principal can most effectively induce the Agent to act the way the Principal would like. There is a growing body of literature on "Agency theory." See Eisenhardt, 1989.

5. North draws an important distinction between institutions and organizations. "Institutions, together with the standard constraints of economic theory, determine the opportunities in a society. Organizations are created to take advantage of those opportunities; as the organizations evolve, they alter the institutions" (North, 1990: 7).

6. Lucien Pye argues persuasively that "culture is not a matter of the rule of the irrational as opposed to objective rational behavior, for the very character of rational judgements varies with time and place. Common sense exists in all cultures, but it is not the same from culture to culture. Sentiments about change, judgements about utility, expectations as to what different forms of power can and cannot accomplish are all influenced by cultural dispositions....People cling to their cultural ways not because of some vague feeling for their historical legacies and traditions, but because their culture is part and parcel of their personalities" (Pye, 1985).

7. The concepts of "exit" and "voice", which originated in Albert Hirschman's classic work, Exit, Voice and Loyalty (Hirschman, 1970), have been adapted by Samuel Paul to the issue of accountability (Paul, 1991).

8. For example, under a Bank-supported Madagascar Environment Program - The Land and Rural Resources Directorate (DPRA), a public titling agency, for which the Bank has been a lead donor, has been struggling unsuccessfully for some time with formal legal arrangements which would ensure that disadvantaged people who invest in land, will have access to future benefits from their investments. Having failed the formal legal way to do this, they pursued a different course. A survey of the current, traditional land tenure system is under way to understand traditional rights and control mechanisms, and to understand how investment decisions are made and benefits derived. This survey, which is highly participatory, builds on people's knowledge of the land around their communities and of the rights and obligations traditionally allocated to groups and individuals. Once this survey is completed, it is planned that the DPRA will set up village discussions in which individual rights will be agreed upon for a specified period and verbal community consensus will sanctify these rights. This community agreement will be updated on a regular basis every few years. The results of the village discussions, and the community agreements about individual rights that follow, will be included in reports to be given the status of official (legal) documents.

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ANNEX I
KEY DIMENSIONS OF GOVERNANCE

A. ACCOUNTABILITY

> "[Accountability] is found where rulers readily delegate authority, where subordinates confidently exercise their discretion, where the abuse of power is given its proper name, and is properly punished under a rule of law which stands above political faction."
>
> *John Lonsdale (1986)*

The Nature and Scope of Accountability

1. Accountability, at its simplest, means holding public officials responsible for their actions. Political leaders are ultimately responsible to their populations for government actions and this means that there has to be accountability within government. How this happens varies widely in different countries, depending upon cultural characteristics, history, political institutions, administrative capacities and the public's access to and use of information. At a broad level, economic objectives of public accountability include ensuring congruence between public policy and actual implementation, and the efficient allocation and use of public resources. This not only requires systems of financial accountability, but also the capacity and willingness of governments to monitor their overall economic performance. At the micro level, the primary concern is similar efficiency in investment and in the production and delivery of goods and services in the public sector.

2. Accountability is important throughout the economic system, not just within government. Governments also have an important role to play in ensuring accountability in the private sector, through company and securities legislation, competitive policy, and regulatory oversight. As the state sheds many productive investments in developing countries, this function becomes particularly important.

3. Public accountability involves three inter-related groups: (i) the general public and particularly recipients of public services, who are interested in service providers being accountable to them; (ii) political leaders and supervisors of service providers, who would like the service providers to be accountable to them for a mixture of public policy and private/parochial interests; and (iii) the service providers themselves, with objectives and interests often different from the first two.

4. The phenomenon of "capture" of public services and resources by relatively narrow special interests is an ever-present problem in all countries. It is made worse by monopoly, and also by limited capacity of the public to demand *and* monitor good performance, especially since it is often hard to measure the benefits of public services. These factors make improvements in public accountability an especially complex and difficult undertaking.

5. The historical evolution of accountability reveals three features. First, micro-level accountability has become more important as the role of the state has expanded and made it impossible to apply broad political accountability to all the myriad actions of modern government. Second, the focus in

public accountability tends to be on inputs, especially public expenditure, rather than on outputs or impacts, which are often diverse and complex to measure. Third, except for legal accountability for government action in some countries, accountability has mostly been by internal administrative controls by political leaders, government agencies and bureaucrats acting as proxies for the public. But hierarchical control is often ineffective, especially when collusion between supervisory and subordinate personnel is likely. Micro-level accountability, remains critical, especially in ensuring government responsiveness to the views and needs of the "publics" for which services are intended.

Macro-Level Accountability

6. There are two key aspects of macro-level accountability that are particularly relevant: financial accountability, and accountability for overall economic performance.

Financial accountability involves:

(i) A properly functioning government accounting system for effective expenditure control and cash management;

(ii) An external audit system which reinforces expenditure control by exposure and sanctions against misspending and corruption;

(iii) Mechanisms in place to review and act on the results of audits and to ensure that follow-up action is taken to remedy problems identified.

7. Without a well-functioning system of financial accountability, government efficiency is poor, and the probability of corruption increases greatly. Corruption is clearly an issue of concern not only because of potential misuse of external resources (including the Bank's) but also because it generally reduces the efficiency of resource use (Box 1).

8. The Bank has historically focussed on financial accountability, especially in the context of investment projects. As is the experience of other donors, compliance with accounting and auditing covenants has been uneven. The problems encountered in these areas are not project specific but are symptomatic of weaknesses in country-wide financial accountability. The need for improved financial accountability at the national level is of particular relevance in countries where the Bank is undertaking adjustment lending and is, in effect, providing substantial resources directly to government budgets.

9. To address this issue, the Bank is pursuing in selected countries a three-pronged strategy. First, it is trying to *improve borrower performance* through stricter enforcement and the introduction of penalties for non-compliance. The penalties include not extending closing dates, conditioning further processing of loans to compliance with requirements on past loans and suspending disbursements.

10. Second, it is trying to *encourage more systematic review of auditing and accounting capacities and needs during project preparation*, and encouraging greater contracting out for project accounting and audit services.

11. Third, it is helping to *strengthen borrower capacity* through country-wide reviews of auditing and accounting systems, and following up with assistance. In Ghana and Madagascar, Economic Management Support Projects aim to remedy deficiencies in public financial management in those

BOX 1
Reflections on Corruption

Corruption is the misuse of power for personal gain. Many people, anywhere, can be tempted to misuse power for personal gain, if permitted to do so at no cost or risk to themselves. Thus, corruption occurs in all countries in many different forms. It tends to emerge and increase in any country when inequalities are acute, resources scarce, rules unclear, disclosure and punishment unlikely, and upward mobility is restricted. Efforts to reduce its incidence need first to identify the *kind* of corruption (graft, bribery, theft, conflict of interest, nepotism, bias, or favoritism), its *frequency* (pervasive, occasional, or intermittent), and its *perpetrators* (contractors, public officials, political elite, businessmen, foreign suppliers).

The causes of corruption relate to political and economic conditions within the society and their linkages to problems in the world economy (Theobald, 1990: 10-11; 161-169). As such, causes are as complex as types of corruption are varied. While distinguishing between symptoms and causes is important, sometimes symptomatic relief provides opportunities for needed social and economic change leading to more lasting "cures". For example, bribery of public officials allocating essential licenses can be mitigated by clear rules, disclosure, and effective enforcement. Further, the amount of licensing can be reduced with clear rules. The longer-term measure of civil service reform adds more long lasting relief. Only over time, and with major policy reform, can improved economic performance increase economic opportunities and thereby provide the environment and context for diminished corruption. Yet, every generation has to make its own struggle against its resurgence.

Competition, clear rules, and disclosure are important first steps. Many countries have sophisticated and strict laws addressing corruption. Yet the existence of legislation alone is insufficient. The problem may lie with a lack of dependable enforcement. Simultaneously with enacting legislation, the strength and independence of the judiciary has to be secured (see para. 51).

Many political leaders in countries with serious poverty have amassed extraordinary fortunes. Foreign exchange reserves were transferred to foreign bank accounts. Such abuse, needless to say, adversely effects economic development. It unleashes cynicism which corrodes public trust – and signals to others to do likewise. Private wealth accumulated through abuse of power amidst public squalor undermines legitimacy. Yet, graft on this large scale is not possible without collusion between major private corporations and public agencies. Often the "commissions" are paid by foreigners – foreign contractors, companies, or consultants. Sometimes such activity is associated with foreign aid. Foreign companies argue that bribery is but one of the costs of doing business in a country. Financing necessarily flows through different agencies; a percentage "take" off the top is considered a fee by some, a kickback by others.

What, if anything, can donors do in these circumstances? In part, the recommendation for countries is also true for donors – *reduce the number of unnecessary regulations, and rely more on market forces; ensure that laws are observed; insist upon meeting procurement and contracting standards; upon meeting audit requirements, study audit reports; pay attention to the manner in which disbursements are handled.* Even with these safeguards, the problems are daunting. Aid coordination provides another venue for flagging the importance of supervision, audits, and attention to disbursement processes. Audits may be required, and not always performed, or where performed, they may not be read. Project supervision is difficult to maintain in the best of circumstances; when donor agencies are pressed to do more with fewer people, supervision suffers.

(continued on next page)

countries. The projects would clear the backlog of government accounts and introduce new accounting methods and software to improve the accuracy and timeliness of financial data. Similarly, the Development Management Project in Mauritania helped to establish the Office of Auditor-General. Audit systems in the banking sector are being

BOX 1
Reflections on Corruption

(continued)

Corruption is a two-way street. Donors have responsibility to ensure that commercial considerations do not undermine good economic management in developing countries. Encouraging governments to develop sound public investment programs and respecting the priorities established is an important contribution donors can make. In this regard, the Development Assistance Committee (DAC) of the OECD, in consultation with the Bank, has prepared a document entitled "Good Procurement Practice for Official Development Assistance". More recently through an OECD/DAC Working Party on Financial Aspects of Development Assistance a greater effort is also being made to ensure that competition for contracts under donor-financed projects is not a source of corruption and does not contribute to distorted investment priorities. The intention is to ensure greater transparency and fair trade practices through a common band of concessionality levels, more open procurement procedures for large projects, upper income limit for tied aid, more transparency in large projects, e.g. through ICB procedures and mandatory consultation, etc. Project preparation through joint appraisals and cofinancing with multilateral development banks including the World Bank is seen as one way to ensure sound investments. When such cofinancing is not possible, the DAC has proposed that donors look to the Bank for advice on the appropriateness of proposed bilaterally financed large projects in the particular country situation. A consensus has yet to be reached on these proposals.

Some observers have also suggested that one of the next steps may be to have donors more fully exchange information with one another about companies, contractors, or consulting groups which have been identified as having participated in graft, bribery, or other corrupt behavior. This 'blacklisting' of corrupt companies or contractors by donors would provide a useful disincentive for these practices.

reformed in Poland and Algeria, while Poland has also requested technical advice on audits and evaluations of government programs and accounts. In January 1990, the Africa Region set itself a target of 12 projects or project components aimed at strengthening financial management capabilities of borrowers through FY92. The Asia Region established a Task Force on Auditing which also suggested the need for a more comprehensive approach to the problem. In Indonesia, the Bank is supporting a comprehensive Accountancy Development Project (Box 2). These country-level reviews need to focus on coverage, timeliness and quality of financial control of projects and public expenditures, but also take account of legislative or other review of government policies and programs and of public access to information.

12. ***Accountability for Economic Performance***: The Bank has also addressed issues of economic accountability. As described in the Public Sector Management (PSM) paper, public expenditure reviews have focussed on the efficiency of resource use in public investment programs, in the parastatals sector, in the social sectors, and more recently, in employment and wage issues in civil services. This has led frequently to the identification of reforms including the removal of white elephants from public investment programs, privatization, restructuring and closure of state enterprises where appropriate, reallocation of resources in favor of primary health and primary education, and the removal of "ghost workers" and rationalization of employment levels in the public sector.

BOX 2
Indonesia-Accountancy Development Project

Indonesia's government accounting practice had changed little since the 1864 Dutch Financial Administration Act. Finding that they could not cope with the increasing complexity of government financial transactions, the government requested Bank support for an accountancy project. Budget reports and financial statements did not provide a comprehensive view of the financial situation and were often delayed. It took three years before government expenditures for a given period were reported to Parliament.

In the private sector, the accounting system had fallen behind other skills required in industry and commerce. The shortage of trained accountants and managers who could produce and use accounting information was severe. The professional body of accountants – the Indonesian Institute of Accountants – was relatively young and lacked detailed accounting and auditing standards to guide the profession, a code of ethics and disciplinary processes to regulate it.

The Bank-financed accountancy development project will address all these areas by:

- improving accounting practices in the public sector by supporting the introduction of modernized government accounting;
- improving accounting practices in the private sector by supporting the development of technical standards and a code of ethics for the accountancy profession;
- supporting the government's program to raise the quality of accounting faculties and to prepare for future expansion of accountancy education and training; and,
- improving the legislation on accounting, auditing and disclosure requirements.

The modernization of government accounting is being carried out with the use of local and foreign specialists who are assisting in the design of a uniform chart of accounts and a clear and specific classification of expenditures. Similar changes in accounting practices will be adopted by public enterprises and by lower levels of government.

With regard to private sector accounting, the World Bank will support the Indonesian Institute of Accountants to continue the Certified Accountant's professional education. Accounting principles and auditing standards will be formulated for more consistent financial reporting by commercial and industrial businesses and a code of ethics will be developed.

In accounting education, the Bank will finance programs for personnel development, procurement of teaching equipment and materials, research, fellowships to train accounting teachers, and loan programs for institutions and students. The improved quality of accounting programs in universities and institutions will permit expansion of accountancy enrollments and increase the supply of accounting professionals.

The proposed project will be implemented over five and half years. Its total cost is US$162.5 million, of which the Bank loan will finance US$112.0 million.

Increasing attention is being paid to strengthen the capacity of governments to monitor and evaluate their own economic performance, including issues of resource use.

13. In some industrial countries (and a few developing countries), a current wave of PSM reforms seeks to raise the efficiency with which public resources are used by giving public managers greater freedom to run their operations but substantially increasing their accountability through objectives, specific targets and performance monitoring. There has also been an attempt to link such

efficiency concerns to broader notions of performance in implementing government policy objectives. This accountability is sometimes reflected in contracts, programs or memoranda of understanding. A number of developing countries have adopted the use of such memoranda in the context of parastatal reforms, which are then negotiated by heads of government departments and chief executives of public enterprises. These have had mixed results, particularly when undertaken with inadequate preparation or discussion. This is accompanied by a movement away from a single year to a medium-term budgetary framework that provides managers with a stable resource stream. Alongside this, accounting systems and internal auditing are being strengthened, with increased emphasis on cash management and, in some cases, accrual accounting. The audit function is now being widened to include not only financial probity but also "Value-For-Money" (VFM) audits.

14. The applicability of these innovations to developing countries will vary. Some of the Bank's borrowers are probably ready for reforms along the lines described above. However, in most countries, the basic accounting and auditing systems are not in place. Greater autonomy to managers must be linked to improvements in financial information systems. Similarly, only when financial audit systems are functioning well can "Value For Money" auditing be considered.

15. Governments could do more to strengthen the overall monitoring and evaluation function, currently largely donor driven and project specific. Yet in many countries, departments are required by legislation to prepare annual reports on their activities. Some countries have performance monitoring ministries. OED has tried to encourage these activities, and more work under PSM projects is under way. This will need to be a gradual process, given the competing claims on resources.

Decentralization: The Macro-Micro Linkage

16. Decentralization is an increasingly common phenomenon in Latin America, Asia and Eastern Europe. In theory, it can lead to significant improvements in efficiency and effectiveness by reducing overloading of central government functions and improving access to decision making and participation at lower levels of government, for example, by improved service design, user financing targeting and delivery (See Box 3).

17. However, if not carefully managed, decentralization can lead to a deterioration in the use and control of resources, especially in the short term. National goals can be seriously distorted by local governments and scarce resources diverted to misuse. Moreover, radical decentralization can seriously weaken the capacity of the central government to manage the economy through fiscal and monetary means. In the late 1980s, Argentina's provincial governments were responsible for the largest and fastest-growing portion of the public sector deficit. Apart from the potential damage done to macroeconomic stability and expenditure efficiency, resources are arguably more open to capture by elite groups at the local level than at national levels.

18. Perhaps, the most serious problem is weak administrative capacity at local levels, leading to waste and corruption. The poorest local authorities, whose constituents stand to gain the most from improved delivery and targeting of social services, are precisely those least able to manage increased responsibilities.

19. The Bank's present approach to decentralization and local government development relies heavily on financial tools to

BOX 3
Decentralization in Poland and Romania

As Poland and Romania pursue political liberalization and macroeconomic adjustment, they are also embarked on a significant decentralization of the public sector. The three issues are closely linked.

Strengthening local government is widely viewed as essential to ensuring greater responsiveness and accountability in many infrastructure and service areas that have been dominated from the center in both delivery and financing aspects. Development of political and institutional means to hold local government authorities accountable to their constituents is important because much of the justification for public sector decentralization is based on the premise that many areas of infrastructure and services are provided more efficiently at the local level since beneficiaries can better express their demand for these services, control costs and hold local authorities accountable for their actions.

Decentralization of the public sector requires fundamental reforms in the expenditure and financing responsibilities of local governments in Poland and Romania. Fiscal chaos could ensue if local revenue capacity is not enhanced and intergovernmental fiscal transfers are not controlled. A collapse of local infrastructure and services is likely if local expenditure assignment is not matched with revenue authority and local institutional capacity. Local government reforms must include, therefore, fiscal reforms at the national and local levels and local government institutional strengthening. These reforms also will be crucial to stimulating increased private sector productivity, not only through improved delivery of public infrastructure and services, and a prudent regulatory framework, but also because local governments will be key to implementing an effective policy of property rights through legal cadastre that provide security for the transfer of property.

Local governments will be key implementing institutions for the Bank's pipeline of proposed projects in both countries, primarily in the areas of infrastructure, the social sectors, environment, rural development and poverty alleviation. However, before these decentralizing countries may absorb effectively lending operations, local governments must be strengthened to discharge effectively their new and growing responsibilities. Key areas for institutional strengthening include: local taxation policy and administration (and consistency with national taxation policies); management of local enterprises (e.g. privatization and/or regulation in areas such as water supply and sanitation, transport, solid waste and housing); budgeting, accounting and audits; maintenance programming and implementation; investment planning and evaluation; and procurement practices.

Because decentralization in these countries comes after decades of tight, central control, the pace and scope of the decentralization process are issues of concern for the countries and for the Bank, and all recognize that there is no broadly recognized "road map" for public sector decentralization.

Therefore, the Bank's strategy for assistance to the decentralization process is broad and country-specific, but the short-term strategy is evolving in four key areas: (a) policy dialogue and possible inclusion of local government strengthening measures as part of the program to be supported by adjustment lending; (b) country and regional sector work on local government reform (e.g. regional work in FY91 and local government reform in Poland for FY92); (c) targeting technical assistance on local government reform (e.g. local government component of Infrastructure Technical Assistance Loan to Romania); and (d) highly selective project support through lending operations in areas critical to overall adjustment and reform (e.g. proposed housing project loan to Poland).

ensure efficiency, including cost recovery for municipal services. An upcoming study on decentralization in LAC countries suggests the need for a more comprehensive strategy, with greater attention to mechanisms such as hearings or surveys, which allow local preferences to be ascertained. In Mauritania, a project helped to establish the institutional

framework for the creation of municipalities. In this instance, local elections followed, providing the public with one accountability mechanism. In Indonesia, an upcoming project provides assistance for (i) strengthening the institutional and human resource capabilities of local governments by increasing the efficiency and effectiveness of previously fragmented training programs, and (ii) strengthening the institutions and coordinating capacities of local government and administration. Other initiatives could focus on strengthening the oversight function of national government. Venezuela has successfully used an executive council (COPRE) to marshal ideas, try out policies and legislation, and develop guidelines and administrative models. Future Bank efforts such as the Africa Municipal Development Program could build on these experiences.

Micro-level Accountability

20. Micro-level accountability can reinforce macro-level accountability when: (i) there is competition, or scope for the public to "exit" when dissatisfied with a service. This can have a salutary effect on the agency concerned, through a reduction in its revenues and a related threat to the careers or pay of its staff; (ii) there is participation, so that the public can influence the quality or volume of a service through some form of articulation of preferences or demand. If such "voice" makes the public agency more responsive, accountability is enhanced.[1] In the National Irrigation Administration in the Philippines, the exercise of voice resulted in a greatly improved irrigation system (Box 4). Often however, competitive provision is more efficient except where national monopolies or market failure are predominant -- and it is undesirable to regard participation mechanisms as a substitute for (rather than an adjunct to) the availability of alternative providers. In any case, there are inherent problems (free riding, elite dominance, resource diversion) in collective action: the costs and benefits of "voice" options need to be evaluated case by case (Olson, 1965; 1982).

21. There are invariably numerous barriers to exit and voice. Legal and policy-induced barriers are more easily dealt with; natural barriers, such as spatial barriers (e.g. an isolated village can afford only one school) are more difficult to remove. Services that the poor (weak voice) require and for which alternative sources of supply are difficult to find (low exit) will be the most difficult to deal with.

22. ***Exit mechanisms***: There are several possible exit mechanisms, notably deregulation, contracting out of services to multiple private providers, public-private, and public-public competition. The key element is contestability: when incumbents are made to bid for contracts along with outside competitors, they will be more careful about their performance and their terms. Similarly, when regulations favor new entrants, the knowledge of potential entry can mitigate monopolistic behavior on the part of incumbents (Baumol and Lee, 1991). New technologies can be used, where cost effective, to broaden choice and access (e.g. mobile courts, mobile schools and health or the use of VCRs or television for education).

23. ***Voice mechanisms***: Dissemination of information about services can aid the public in demanding greater accountability from service providers. Periodic evaluation of services can exert pressure. For example, a poll of beneficiaries' views on the service or the gathering of data from both beneficiaries and service providers can sometimes be an effective alternative to elaborate participation arrangements. Complaints procedures and institutional mechanisms such as ombudsman are ways of providing voice when there is no need or incentive for collective action.

BOX 4
The Philippine Communal Irrigation Program

In May 1982, the World Bank approved a US$72 million loan to the Philippines for a communal irrigation program that would involve the participation of farmer beneficiaries in all phases of the project planning, design, and construction of the system. The project would involve construction or rehabilitation of 144 communal irrigation projects covering about 33,500 hectares in 35 provinces of 11 regions. After completion of a system, the farmers would assume full control of its operation and maintenance.

The project was remarkable in two ways: first, it was one of the most participatory projects ever to involve the Bank. Second, the initiative for the participatory approach came from a government agency, the National Irrigation Administration (NIA), which had been developing and testing the participatory approach for five years.

Before the participatory approach was introduced, nearly all of NIA's professional field staff in charge of communal projects were trained exclusively in technical subjects such as construction, design, and survey. The participatory approach, however, required the addition of staff oriented toward people and trained in building the problem-solving capacities of local people. Consequently, NIA hired community organizers who could work with the farmers to develop irrigation associations.

NIA hired six community organizers for its first participatory project in 1976. By early 1983, the number had expanded to 401. Of that number, 295 worked on communal projects and 106 on national projects. The gradual approach to expanding the program allowed the community organizers to accumulate learning. Organizers who worked on initial projects became the trainers and supervisors for later arrivals.

Evaluations in 1989 concluded that: "participation produced consistently positive results. The canals and structures were viewed by the farmers as more functional and the system was more productive, with greater increases in rice yields and in irrigated area in the dry season. The irrigation associations were more likely to use water distribution methods that assured greater equity of water access to the members and were more likely to use sound financial management practices. They contributed more to construction costs at the time of construction and subsequently paid a greater percentage of their loans due. The costs of achieving the wide range of benefits demonstrated for the participatory projects was only 3% of the total cost of construction."

This program, widely studied around the world as a model of the possibilities of increasing effectiveness and sustainability, is still under way. A new Bank loan in 1988 for the operation and maintenance of the national system (which is distinct from the communal system) provided funds for community organizers and farmer training. Work has begun on a follow-up loan for the communal program.

"Hotlines" can be established to help prod response to unsatisfactory services. These mechanisms are in place in some countries, and their effectiveness varies widely: in particular, elites tend to make the most use of these services. Consequently, they are most useful to the poor when the service is "non-excludable," like drinking water, roads, or public facilities.

24. Participation of public representatives in decision-making or regulatory bodies is one way of enhancing "voice." Users' representatives, for example, can be appointed to the board of directors of these organizations or hold equity shares of utilities. Where direct participation of users in decision making is difficult or inappropriate, a consultation process can be instituted through public hearing, advisory panels, etc. Legal action by

consumer action groups is also a possibility, though not common in developing countries.

Governments and NGOs

25. Some developing countries have witnessed a mushrooming of private voluntary organizations (e.g. India, the Philippines, Bangladesh, Kenya, Zimbabwe, Senegal, Colombia, Mexico, and Chile to name a few), while some other countries clearly have not (e.g. C.A.R. or Malaysia) and depend much more heavily on governmental organizations and initiatives. Various factors contribute to the emergence of a strong voluntary sector, among them culture, level of development, and the stimulus provided by the influx of external NGOs after a natural disaster. A powerful factor clearly is government hostility or encouragement.

26. Government policies determine the enabling environment for NGOs and the roles that they assume. Governments determine in the first instance through rights such as freedom of association, or of speech whether NGOs can function effectively. Regulatory policies -- and fiscal policy -- also affect the environment within which NGOs operate. Precisely because NGOs may be a channel to the poor, or may be advocates on behalf of the poor, NGOs can be used by governments and donors to reach beneficiaries that are otherwise difficult to involve in the flow of project benefits. They can also be called upon to assume roles in the provision of benefits or in communicating between different constituencies. But it is also the case that some governments are suspicious of NGOs precisely because of their advocacy on behalf of the poor. There are, thus, pressures to coopt NGOs and make them extensions of the state.

27. Direct donor funding can be an important means of supporting NGO activities. But it carries with it a number of attendant risks including shifting NGO accountability from their natural constituents to donors, and making them vulnerable to subtle pressures from governments who must approve direct funding of NGOs (Fowler, 1991). The existing literature (mostly sponsored by bilateral donors) shows that NGOs tend to be effective at reaching low-income groups, especially in remote areas, and at working in a relatively participatory way. They tend to be weak in planning and administration. NGOs' most important contribution may not be service delivery but a pilot role for social initiatives urging and developing new approaches which are sometimes replicated on a larger scale. There can be, as a result, synergies between governments and NGOs; governments learn more about the needs of widely dispersed publics while NGOs acquire more effective management skills. The rapidly changing relationship between the State and NGOs needs further research and reflection.

The Bank's Role in Promoting Exit and Voice

28. The Bank is active in promoting deregulation and improving the working of markets in structural adjustment loans, in parastatal reforms and in much of its sector lending. The Bank has, in recent years, also worked to expand participation and the involvement of NGOs in Bank-financed projects. In FY89 and FY90, NGOs were significantly involved in 50 of the projects the Board approved. In some sectors, most notably agriculture and population, NGOs are contributing significantly to effective project implementation. NGO criticism, although sometime unduly harsh, has nevertheless contributed to the redesign or improved implementation of a number of Bank-financed projects.

29. Voice can also be enhanced through popular participation in the design and implementation of Bank-financed projects.

BOX 5
Popular Participation and the Bank

"We affirm ... that the economic crisis cannot be resolved ... without the full and effective contribution, creativity and popular enthusiasm of the vast majority of the people."

ARUSHA, 1990

Popular participation is the process by which people, especially disadvantaged people, influence decisions which affect them. The term "popular" refers not only to the absolute poor, but also to a broader range of people who are disadvantaged in terms of wealth, education, ethnicity, or gender. "Participation" means influence on development decisions, not simply involvement in the implementation or benefits of a development activity, although those types of involvement are important and are often encouraged by opportunities for influence.

The World Bank has learned from its experience that popular participation is important for the success of projects economically, environmentally, and socially. The most important lesson has been that popular participation is a question of efficiency, as well as being desirable in its own right. In one study, the Bank evaluated 25 projects five to ten years after completion. Strong beneficiary organizations (an instrument of facilitating participation) proved to be a key factor in determining project sustainability (World Bank, 1985). Another study of 68 Bank-financed projects found that the economic rate of return was twice as high for projects which had been sensitive to local social and cultural realities (Kottak, 1985).

The Bank's experience with participatory projects is limited, but growing. Participatory approaches have most often been adopted in projects designed to help particular communities -- agriculture, especially irrigation, forestry, and livestock; urban development and rural water supply; population, health, and nutrition. Social investment funds are a promising way for governments to support community-initiated micro-projects. A recent review reveals that in virtually every participatory project the Bank has financed, participation has contributed to project effectiveness (World Bank, 1990b). Individuals, households, groups, and communities are more likely to have a stake in, contribute to, and maintain projects which respond to their needs, knowledge, and initiative.

But popular participation is also valuable for bigger projects. The Bank's experience with environmental issues and adjustment loans indicates that public consultation and information sharing can improve the design and build public support for large-scale investments and policy decisions. This approach is working, for instance, in Mexico's Hydroelectric project, India's Upper Krishna Dam project, and Ghana's Private Investment and Sustained Development Promotion Credit.

Operations and PRE are pursuing a modest program of action and learning, supported by SIDA trust-fund resources, designed to strengthen the Bank's support for popular participation where this would contribute to the development effectiveness of Bank-related operations. Learning is being stressed because there are relatively few large-scale participatory development projects in the developing world. It is important to learn in what situations participation is worth the effort, and, in those cases, how the Bank and borrowing governments can effectively promote participation more widely. To date, Bank-supported participatory projects have been the exception rather than the rule, sometimes stemming from the personal commitment of individual task managers.

In most situations, the constraints on popular participation are external to the Bank (the intrinsic difficulties of engaging low-income people in project decisions, for example, and reluctance on the part of some governments). But improvements in income and education, together with increased interest among borrowing member governments, are relaxing external constraints in some situations. While grappling with the problems of making government implementing agencies more people-centered, the learning process is focussing especially on ways the Bank's own operational practices could be more supportive of participatory approaches.

Bank experience suggests that participation can be important to project success and sustainability. It is especially useful for activities focussed on particular communities and dependent on their active cooperation, but it is also relevant to large scale infrastructure projects. Participatory approaches in Bank projects have been tested successfully in sectors (notably, irrigation, forestry, livestock and agricultural credit, urban development and rural water supply, health and nutrition, environment and social investment funds). The Bank has recently embarked on an effort to learn better how to foster popular participation in Bank-supported activities (Box 5).

30. Attention to "exit" and "voice" options at the design stage of relevant Bank-financed service delivery projects will complement the strengthening of internal control systems. The use of such mechanisms, however, will cause accountability to improve only when this leads to a change in the behavior of the service provider -- its efficiency, access, and quality of service, not just its compliance with internal rules. This must be reinforced with incentives that reward responsiveness to users and the wider public.

31. Accountability at the micro-level will, in turn, be sustained only when the government and society at large are concerned and wish to improve it. Comparative information on how different countries perform in respect of key public services can be a powerful tool to generate national and international interest in this area. Selected performance indicators based on good professional judgment can be assembled on these services from as many countries as possible for wide dissemination (including the WDR) (Box 6). It will provide the data for governments, scholars, media and the public at large to see where they stand in respect to the level and quality of their services.

B. THE LEGAL FRAMEWORK FOR DEVELOPMENT

> "The Rule of Law is not a Western idea, nor is it linked up with any economic or social system...As soon as you accept that man is governed by law, and not by whims of men, it is the Rule of Law."[2]

32. The literature on the rule of law is voluminous and the concept lends itself to endless discussions at a jurisprudential level with limited practical relevance. The emphasis here is on a pragmatic view of the rule of law in the context of economic development and Bank operations.

33. The General Counsel has defined the rule of law as "a system based on objective rules which are actually applied and on functioning institutions which ensure the appropriate application of such rules" (Shihata, 1991: 42-43). There is empirical evidence that investment is adversely affected by uncertainty. Investment will not take place and will not succeed without a system which provides a minimum of stability and predictability.

34. Stability and predictability create a climate in which business risk may be rationally assessed and the cost of transactions lowered. In turn, some elements of the rule of law are a necessary condition for stability and predictability. It is primarily this connection of the rule of law with the level of investment and the more efficient use of resources that explains its importance as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself. It is only to the extent that it establishes some of the pre-conditions for economic development

BOX 6
Improving Accountability and the Environment

The deteriorating quality of air, water and land resources in many developing countries is linked to problems of accountability and capacity. Government decision-makers in charge of natural resource management often contribute to environmental deterioration through poor management decisions. Poor decisions are a function both of inadequate incentives, and of an inability to project the actual effects of well-meant decisions or to evaluate alternative uses of scarce government funds.

Environmental resource management is further complicated by the multi-sectoral nature of many decisions. Water resources, for example, are affected by solid waste systems, storm water drainage, the demands of commercial, household and recreational users, and the requirements of ecological habitats.

Research currently underway in the Bank addresses this problem. The "Service Level Indicators for Capital" (SLIC) research sponsored by the International Economics Department is seeking service level indicators for public facilities (sewerage, water, etc.) and for natural resources, based on measures of quantity, quality and reliability for both users and decision-makers. Included in this research effort is a framework for applying Service Level Indicators through Benefit/Cost analysis. This extends the usefulness of these measures into investment decisions. SLIC creates a bottom-up measure of resource performance, provides an information base which allows users and managers to view how decisions are made and the effects they have, and establishes a transparent accounting framework for government service and natural resource decisions based on the level of services they provide to users. SLIC indicators are currently being formulated in a number of different Urban Development projects in Indonesia.

Service indicators for water resources can be related to the specific uses described above for water resources. Indicator sets for each purpose would be specified by aggregating relevant measures. Service levels for industrial or agricultural water supply users would be based on physical measures; for household water users or recreational users, service levels might be based on total health risk; for ecological habitat, service levels could be the number of viable ecosystems exposed to risk in the river stretch or habitat area.

By identifying and monitoring the specific environmental quality measures identified as important by decision-makers and users, SLIC will improve the effectiveness of infrastructure and natural resource management decisions, and help establish operations and maintenance priorities for public infrastructure. In addition, by measuring these indicators over time, SLIC should be able to establish trends in environmental resource quality, improving natural resource accounting, and defining more precisely the relationship between natural resources and economic development. And as SLIC enables line managers to make better decisions, publicly available service level indicators can also enable users to hold service providers accountable for the level and quality of the services they receive, both from government facilities, and from other providers.

that it is legitimate to bring it within the purview of the Bank. The Bank's interest in the rule of law is from the vantage point of development management. As we will see below, the aspects of the rule of law are varied and so are the views about them. Not all have the same bearing on the purposes of the Bank. Moreover, how the legal system operates is highly culture specific and the Bank needs to approach work in this area with a proper understanding of the historical and cultural context.

35. From the great variety of definitions, two major aspects of the rule of law emerge. The first is sometimes called the instrumental notion of the rule of law. It concentrates on the formal elements necessary for a system of

law to exist without judging the content of the laws or their purpose.

36. The second aspect refers to the content of the law and is linked to concepts such as justice (e.g. the element of due process), fairness (the principles of equality) and liberty (civil and political rights). In the view of many, the formal aspect has to be complemented by substantive principles of the rule of law to create a "fair" legal system. In terms of the Bank's work, a "fair" legal system would have to be conducive to balanced development, e.g. a system which facilitates growth and responds to the needs of the poor. These would seem to represent issues the Bank is normally concerned with in its project and policy lending. They are outside the scope of this analysis which focusses on the basic "processes of the formulation and application of rules," (Shihata 1991: 45) and analyzes each of the five elements listed in "Issues of 'Governance'." In so doing, we incorporate the Bank experience so far, and draw conclusions for Bank operations and the relationship of the rule of law with the other elements of governance considered in this paper. The five elements are: (i) a set of rules known in advance; (ii) rules to be actually in force; (iii) mechanisms to ensure application of the rules; (iv) resolution of conflicts through binding decisions of an independent judicial body; and, (v) procedures for amending rules when they no longer serve their purpose.

A Set of Rules Known in Advance

37. This comprises three elements: the existence of rules as a set (denoting coherence), their communication (with accuracy, clarity and effectiveness) and the application of rules only known in advance (non-retroactivity of laws). Communication and coherence are two elements with which the Bank has been concerned. As regards *communication*, many developing countries inherited formal rules for the communication of laws similar to those of the metropolis. Frequently, the obligation of governments to disseminate new laws was and still is limited to their publication in gazettes. The law is available but the citizens have the burden of acquainting themselves with the law.

38. Publication of the official gazettes in many countries has ceased. The Bank has assisted or is in the process of assisting several countries to restart at least publication of the gazette (Box 7). It is also assisting in making the law more accessible and better known within the government itself.[3] However, in many developing countries, large segments of the population are illiterate, the media are ineffective and languages are diverse. Under these circumstances, there are obvious limitations as to how much the law can be known and understood by the average citizen and it is necessary that law be as clear and explicit as it is technically feasible.

39. To the extent that economic policies must be reflected in rules which are to be complied with, governments need to make these rules known through all possible means of communication. Rules are understood here in a broad sense and include legislation, courts' decisions, guidelines, etc. When land is being expropriated, for instance, simple explanatory pamphlets outlining the rights of those affected and explaining how they can exercise those rights should be made available to the population affected. Knowledge by people of their own rights contributes to limiting the arbitrary behavior of government officials and assist in creating the climate of predictability associated with the rule of law.

40. As regards the *coherence* of the rules, when conditioning disbursements in specific Bank operations on the enactment or modification of certain laws, it is essential for the success of the operation that the country implements its own rules. A decree, for

BOX 7
Communication of the Law

MAURITANIA: Development Management Project (Credit 1865 MAU)

The publication of the Mauritanian Official Gazette was done under a contract between the Government of Mauritania and a French printing company located in Bordeaux. This arrangement was however not effective and the Gazette was rarely published. Then the Government of Mauritania, with the assistance of IDA and the French Government, decided to print and publish the Official Gazette domestically. To do so, a contract was awarded to a private printer and the functioning of the Department of the Legislation (Services of the Presidency) were improved within the framework of the above-mentioned IDA Credit. The French Government provided technical assistance in the preparation of the Official Gazette using the French Official Gazette as a model.

The Official Gazette which had not been published for over two years, has now been published in French and Arabic on a monthly basis for the last two and a half years.

GUINEA: Second Economic Management Support Project (Credit 1963 GUI)

The Guinean Official Gazette was experiencing delays of up to two years in the printing of its issues. In order to correct this situation, the Secrétariat Général du Gouvernement (SGG) obtained, as part of this project, US$80,000 from USAID to finance printing of the Official Gazette for two years, and signed a contract with a private printing company to ensure its regular publication. In addition, the contract provided that the backlog caused by the two-year delay in the publication of the Gazette be gradually eliminated.

As of January 1989, the Official Gazette has been published fortnightly. Texts of a general nature and government decrees are published within a month of their signature. The backlog of previously unpublished legislation is being cleared.

The SGG is responsible for the distribution of the Official Gazette within the Government and the subscriptions and sales to public. It is expected that, as revenues from legal notices increase, the Official Gazette will be able to fund itself.

LAO PDR

In 1975 the National Congress of the People's Representative in the Lao People's Republic abolished the former constitution and all existing laws and regulations. In 1989 the government endorsed the establishment of a new economic mechanism, separating the state's administrative and regulatory function from production activities and increasing the role of the private sector. Under a component of a UNDP-funded project supporting the New Economic Mechanism, the Bank will assist the government to prepare and implement key economic and financial legislation, to train lawyers in business law and to establish a center of economic law. As part of such activities the project will make a proposal to the government to establish an official gazette to publish and promulgate new laws and regulations.

instance, should not derogate from legislation. There should be no contradictory statutes. There are, for instance, countries whose constitution forbids private ownership of the means of production. In the context of private sector development operations, the Bank needs to ensure that the operation is based on a sound legal premise (Box 8). In this respect, it would be advisable that, whenever possible, local legal expertise be brought into the picture together with any expertise from abroad as may be needed.

Rules to be Actually in Force

41. It is not enough for a law to be on the books: it has to be applied, it has to be in force in reality and not only in the formal sense, and most important, it has to be complied with. When a law is left in

BOX 8
Legal Inconsistencies in Eastern Europe and Africa

The centralized systems of state planned economies of Eastern European countries face a number of legal problems in their efforts toward economic reform and the development of market economies. Lately, these countries have been introducing reform elements for private sector development. However, contradictions and inconsistencies are often encountered. For example, several countries have started privatization efforts. In this process some have already amended their constitution to make provision for private property rights. Others have not yet changed their constitution to this effect, but, nevertheless, proceed with the privatization effort. In the context of Bank operations an effort should be made to address these issues which can hamper reform. Following are some examples.

In Romania, there has been considerable legislative activity. With regard to private sector development, the law on Restructuring State Economic Units as Autonomous Units and Commercial Companies was passed in September 1990; a draft law on Privatization (currently under consideration) will govern this issue. Other laws under preparation will cover bankruptcy, commercial and company law, foreign investment and small and medium enterprise development (to supersede Law No. 54 defining and permitting small enterprises, which was passed in early 1990). These laws are reducing the role of the government in productive activities while retaining its monitoring functions, introducing private ownership and encouraging foreign investment through joint ventures. The legal framework is, however, operating under the severe constraint of the clearly defined property rights. The Parliament has been given two years from the time of its inception to develop the relevant provisions.

By contrast, in Czechoslovakia, amendments were introduced to the Constitution effective May 1, 1990, recognizing all forms of ownership rights, and providing that they (whether state, cooperative or private) enjoy the same level of protection and that no form of property ownership has a privileged status. A law on Small Privatization was introduced effective December 1, 1990, while a law on Privatization is currently under consideration.

Another example which illustrates the effects of inconsistencies and contradictions in a legal system is the following: the socialist economic system has been protected by the rules of constitutional law, labor law, administrative law, as well as by the rules of criminal law. In the Soviet Union, "undesirable" economic behavior has been controlled through criminal or administrative sanctions for behavior which violates accepted socialist norms and undermines the economic system. There are several articles in the criminal and administrative codes of most republics which criminalize behavior that in a market system is rational and economically desirable. It seems that many of these articles will be eliminated in the next major revision of the codes. In the meantime, however, the existing criminal codes continue to stand and to hamper the economic reform effort. Prosecution under most of these articles continues, with thousands of convictions per year. Even if it is not feasible to amend the codes immediately, steps need to be taken to limit the effect of these provisions on those who wish to engage in new forms of legitimate business.

Although the Eastern European countries are the most striking example, similar examples can be found elsewhere. For instance, Guinea-Bissau is presently amending its Constitution, approved May 16, 1984, as part of a general political transition from a socialist state to a more "capitalist" state. An impediment to developing the private sector is Article 12 of the Constitution, which provides for state ownership of all land (leases are granted to private individuals), minerals, banks, insurance companies, etc. Article 13 also provides for state control of foreign trade and exchange transactions. One of the objectives of the legal technical assistance provided to Guinea under the Second Economic Management Support Project is to coordinate the various donor financed pieces of legislation so that they dovetail as a whole.

abeyance or is not respected, the answer does not necessarily need to be a new law. An analysis of why the old law does not work will avoid placing yet another law on the books.

42. The reasons why laws are ineffective vary greatly. In many developing countries, the fact that many laws are not applied is often related to their inadequacy to the local situation. They had been transplanted from other countries and not adjusted to the local situation. Alternatively, they were not updated to current developments in the countries concerned. For a law to be effective, one has to consider many elements leading to its observance. Such diverse factors as custom, geography, technology, and history play a role in inducing obedience to laws. Because of these factors, the same law and its sanctions in different times and places within different physical and institutional environments will not induce the same behavior. Furthermore, societies evolve and laws may become obsolete. There is a certain inertia in legal systems and they simply may not have been updated to take into account social, business or technological changes.

43. Another obvious reason why laws fail to be applied is the absence of competent administrators of the legal system. The law is not only a set of rules but it encompasses procedures and institutions for implementing these rules. To the extent these are lacking, laws most likely will remain on paper.

44. Donors must be sensitive to the variables which affect the success of the transfer of legal institutions and the application of the laws. It must also be aware of the limitations of sanctions to induce behavioral change. Punishment best enforces already institutionalized law, nudging the occasional deviant into conformity. In many instances, it is more appropriate to use incentives and roundabout measures to achieve results, normally, at lower costs than punishment and to the relief of over-burdened courts.

45. As regards legal institutions, the Bank may assist in improving the efficiency or competence of judicial systems to reduce the costs of economic transactions. In advising governments to adopt new laws, the Bank should be fully aware of implementation constraints. As regards enforcement of the laws, some aspects of it have a clear bearing on economic development and have been the subject of Bank operations; for instance, improvement of tax collection, and changes in security laws to permit financial institutions to foreclose on debt and mortgages (Box 9).

Mechanisms to Ensure Application of the Rules

46. Mechanisms must exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures. The concept of the rule of law requires furthermore that all government officials act within the ambit of the law. State power ought to be exercised under the authority of law. The proper application of the rules by government officials is the essential element of establishing legality and -- in conjunction with the idea of justice -- legitimacy. To act within the law means that the executive branch of the government bases its actions on the statutory power from which government officials derive their authority and that the exercise of such authority is within the boundaries set by the law.

47. Of course, the legislation authorizing government actions cannot prescribe for all circumstances precise and clearly-defined standards. Thus, while the proper application of the rules should ensure predictability, it must always leave some room for flexibility. Further, market competition functions as a limit to public discretionary power. (Citizens can choose private provision over public provision services.) Yet, there are complex choices on how to delegate discretionary power to the bureaucracy. Traditionally, the rule of law called for narrow grants of discretion. But the complexity and variety of

BOX 9
Enforcement

In Guinea under the Private Sector Promotion Credit, the deficient functioning of the judicial system and the legal void on bank sureties has been identified as major constraints for banking activity in the country. Banks are unable "to enforce their rights as creditors through foreclosures or other court-approved actions, due in particular to debtor-judge collusion and rampant corruption" (GUI Report; 5207-55). This operation is a modest start to address these problems and it will be followed by training of the judiciary and legal professions in banking and commercial matters and by improvements in material working conditions.

In Sri Lanka, the Association has been working in two operations in the financial sector to reform the laws allowing financial institutions to foreclose on collateral pledged under loans. Sri Lankan law had prevented direct execution by institutions, who were forced in each case to go to court to get a judgment before they could move against the property. This protection for debtors stemmed from historical concerns about unscrupulous money lenders but did not match the needs of a modern economy. On the advice of the Association the law was changed to permit direct execution. The result is a law which establishes a better balance between the rights and obligations of debtors and creditors.

In the Philippines as part of the Financial Sector Adjustment Loan, the Bank not only advised that the lengthy holding period for repossession by debtors of pledged property be shortened to a more reasonable period, but also that the 1905 bankruptcy law be revised to make it less punitive on debtors and more rehabilitative, in the interests of both creditors and debtors.

issues in modern times have led to increasing delegation of authority to the executive branch based on broad standards, discretion secures flexibility and responsiveness to different situations which could not have been predicted by the legislatures. (For example, environmental legislation often must accord discretion to local public officials.) Discretion represents a counterweight to legal formalism.

48. Discretionary power is not absolute power. Discretion in law is always limited. The most basic guidelines for the exercise of discretion require that any exercise of powers be based on reasons, that these reasons be applied consistently, fairly, and impartially, and that they be intelligibly related to a framework of purposes, policies, principles and rules.

49. As with all exercise of power, there is a need to ensure the respect for these limitations to secure the correct exercise of discretion. Thus, there is a need for mechanisms to ensure the proper application of laws, and rules that regulate how to depart from them. Several different forms of checking administrative action and avoiding the abuse of discretionary power have been adopted in various legal systems ranging from review by independent civil and criminal courts to specialized administrative courts and ombudsmen.

50. In addressing the issue of functioning and effective institutions, the Bank has assisted borrowers to improve their civil service and to establish well-defined administrative structures. Support of civil service reform has concentrated on better training for civil servants, pay structures and the need to ensure that the financial remuneration of civil servants is adequate. The Bank is advising governments on how to improve their administrative decision-making processes and to establish administrative structures which clearly assign authority and responsibility.

51. At times, the proper application of the rules is hampered by an overabundance of -- in some instances -- contradictory or obsolete rules and regulations which overwhelm the bureaucracy. The Bank is assisting countries to review, update and simplify their legal systems.[4] Such reforms of legal systems will improve the administrative capacity of the government to regulate the economy and to reach administrative decisions based on a clear set of new and relevant laws (Box 10).

Conflict Resolution

52. Conflicts in the application of the rules can be resolved through binding decisions of an independent judicial or arbitral body. The existence of an independent judicial or arbitral body which can render binding decisions with respect to conflicts in the application of the rules is an essential element of the rule of law concept. The law loses its conflict-resolving and confidence-inspiring function if there is no independent and credible judicial system which assures that private contractual arrangements are respected and that the law is applied uniformly by the executive. With regard to the first aspect, it is obvious that confidence in the enforceability of agreements and commitments is instrumental to the proper functioning of an economy and the conduct of private economic activities. If there are unreasonable delays and high costs in enforcing laws and agreements between private parties, the efficient conduct of economic activities is hampered. With regard to the second aspect -- i.e. the check on government actions -- it is also evident that a strong judiciary can provide an effective shield against the concentration of arbitrarily exercised executive power.

53. The state of the judiciary in a number of developing countries is precarious. Even in those countries where there is a nominally independent judiciary, the courts are usually overworked and dispute resolution takes a long time. Often, the courts lack proper facilities and there is an urgent need for improving the training of the persons involved in the administration of justice. Despite all this, arbitration proceedings outside the court system are not well-developed.

54. There are several Bank operations under preparation that will assist member governments in the training of judges in economic and business law and may go as far as recommending certain division of labor in the court system so that commercial matters would be handled by specialized courts. (Box 11).

55. In assisting to make the court system more efficient and competent the donors may wish to look beyond the basics of training and of providing adequate physical facilities. For instance, many developed countries also have in the past encountered the problem of a judiciary too unwieldy, expensive and slow to handle disputes. The answer has not necessarily been to improve on the courts but to expand extra-judicial means of settlement by permitting commercial arbitration.[5] Another alternative is to search what caused the growth of disputes by updating or clarifying archaic or uncertain legal situations. The business world has also responded by rationalizing business practices through the development of standard forms and patterns of doing business. The courts themselves may help by mass handling of certain commercial matters, e.g. garnishment and collection of debt. These are areas within the mandate of the Bank in as much as functioning rules and institutions, including an effective dispute-settlement mechanism, are essential for economic development.

BOX 10
Reform of the Regulatory Framework

GHANA: Financial Sector Adjustment Credit (Credit 1991 GH)

Banking activities in Ghana have been governed by laws and regulations enacted in the 1960s and early 1970s with a number of amendments and decrees issued on an ad hoc basis since the enactment of the original legislation. Several serious omissions in this body of legislation, together with weak bank supervision, led to the concentration of risk in the portfolios of banks, inadequate capital and reserves, inflated profits and unrecognized loan losses.

In connection with the IDA-financed Financial Sector Adjustment Credit, the Government of Ghana established a committee of legal experts to review the existing legislation, draft the changes necessary to improve the regulatory framework and introduce prudent standards to ensure the viability of the banking system. Risk exposure limits as a percentage of capital have been set on a bank's exposure to a single customer or related group. A minimum capital-adequacy ratio has been established, taking into account the quality of the bank's assets as well as its off-balance-sheet risks. Banking supervisors will have the ability to mandate even a higher capital-adequacy ratio, when, in their opinion, conditions warrant. Banks which do not meet the minimum guidelines are not allowed to pay dividends. New regulations specifying the format and content of audit reports and the minimum scope of audit reviews have been introduced together with uniform accounting and auditing standards and prudent reporting requirements. The accounting standards include guidelines for loan portfolio review and classification, the treatment of interest on non-performing loans, and provisioning for potential loan losses. Monetary penalties for violations of laws and regulations are strengthened and will be periodically revised to serve as a deterrent to illegal and imprudent acts.

POLAND: Structural Adjustment Loan (Loan 3247 POL)

In Poland, the Government's Economic Transformation Program (ETP), pursues structural reform towards the establishment of a market economy. The SAL will support reform initiatives mainly in the areas of: (i) enterprise restructuring, privatization, private sector development, with emphasis on appropriate legislation to define the "rules of the game" (including privatization, demonopolization and competition), the establishment of an adequate institutional framework for enterprise restructuring; (ii) financial sector reform, with emphasis on improved banking regulation and supervision, introduction of adequate accounting and auditing standards, etc. and (iii) social safety.

SRI LANKA: Economic Restructuring Credit (Credit 2128 CE)

The Economic Restructuring Credit (ERC) supports the Government's efforts aimed at stabilizing the economy and implementing structural reforms. In addition to addressing the country's serious internal and external imbalances, the size of the public sector, its claim on resources and the efficiency with which it uses its resources, the ERC also focuses on the development of the private sector through improvements in the existing regulatory framework and incentive system and through transfer to the private sector of activities and assets now being managed by the public sector.

Amendment Procedures

56. *There are known procedures for amending the rules when they no longer serve their purpose:* As noted above, the rule of law is instrumental in creating a climate of predictability and stability -- as the antithesis to governmental arbitrariness. Rules that are constantly changing cannot fulfill this function. Neither can rules that are arbitrarily repealed, amended or waived. The perception of arbitrariness and subjectivity is created by ad hoc decisions whereby the creation,

Box 11
Improving the Judiciary

BANGLADESH: Financial Sector Adjustment Credit (Credit 2152 BD)

The court system in Bangladesh took an average of 10-15 years to dispose of suits brought by financial institutions against defaulting borrowers. The result was that transaction costs were extremely high and collection rates were very low. With the assistance of the Association and the International Monetary Fund, Bangladesh enacted a Financial Loan Courts Act in 1990 which established special commercial courts in the major economic centers of Bangladesh, whereby financial institutions could bring actions against defaulting borrowers and the loans could be adjudicated. Progress, which to date, has been highly favorable, is being monitored under the Financial Sector Adjustment Credit and involves the establishment of courts, appointment of judges and disposal of cases.

amendment or invalidation of laws is undertaken without known and established procedures. Laws created this way will be perceived by those affected as not being enacted through "the right process." Furthermore, it will lead to a general lack of obedience to the law beyond the particular rules, and affect the credibility of the whole legal system.

57. The requirement of procedures in place for amending or repealing laws is limited to the existence of such procedures. It is the prerogative of the country concerned -- and outside the mandate of the Bank as stated earlier -- to decide how the legislative process is organized, including whether a separate legislative body should exist. What matters is that the public is aware of the process through which laws can be amended, repealed or waived.

58. In the context of attempts by borrowers to introduce legal reforms, the Bank has stressed the importance of having appropriate procedural rules in place for enacting and/or repealing laws. In order to improve the technical capabilities of the countries concerned in drafting procedural rules and regulations, the assistance financed by the Bank has supported governments' legal offices, i.e. Attorney General, Ministry of Justice, etc., and consisted of training and technical assistance (Laos, Guinea and, under preparation, Angola and Mongolia).

59. The foregoing analysis of the procedural and institutional elements of the rule of law has focussed on their contribution to establishing a "good order" understood as "a system in place, based on abstract *rules* which are actually applied and on functioning *institutions* which ensure the proper application of such rules" (Shihata, 1991: 43). The existence of such a system is needed for economic development; in particular, the economic reform policies introduced by many of the Bank's members and supported through Bank operations cannot be implemented effectively if these reform measures are not translated into workable rules and applied by functioning institutions in a proper and appropriate manner. Thus, the elements of the rule of law discussed above address these processes of the formulation and application of rules and constitute the procedural framework and institutional system which -- if adhered to by the governments concerned -- lead to *stability* and *predictability* and elicit *compliance* with the rules.

60. The rule of law and the various other elements of sound development management are closely interrelated. By simplifying existing rules and limiting discretion in certain decisions the Bank has assisted in reducing the opportunities for corruption. The publicity that the Bank has insisted on in the administration of certain processes such as procurement has increased transparency in decision-making. Also, the development of communication systems for making the laws known helps in making governmental bureaucracies more accountable.

C. INFORMATION AND TRANSPARENCY

> "Information is now a crucial determinant of the pace of social and economic change."
>
> *Report of the South Commission (1990: 196)*

61. A competitive market economy requires that economic actors have access to relevant, timely, and reliable information. The less available or credible the information the greater the uncertainty and risk, and therefore the cost, of committing capital or labor. In all countries government is a major source of information, and sets many of the requirements for other providers as well. Information about the economy, about particular market conditions, and about government policies and intentions is all central to private sector calculations, and is either provided by government or greatly influenced by what government requires other entities to make publicly available.

62. Governments have legitimate reasons to withhold some types of information -- on aspects of state security, for example, or where premature disclosure could invite behavior undermining the policy (e.g. changes in exchange rates). Aside from these special cases, three areas are discussed where improved information and greater transparency are beneficial: economic efficiency, transparency as a means of preventing corruption, and the importance of information in the analysis, articulation and acceptance of policy choices.

Information, Transparency and Economic Efficiency

63. Economic efficiency requires that information about government policies and actions be available, that major processes of economic decision-making (for example the budget) are reasonably transparent, and that there is some opportunity for public comment or influence in the process of economic policy-making. This last aspect is of course greatly influenced by a country's government and traditions about political participation and public debate -- questions beyond the Bank's purview. With that limitation in mind, there are three important reasons for greater transparency in policy making as it impacts upon economic efficiency.

64. First, where government economic decision-making is unexamined and uncontestable the dangers of corruption and diversion of public resources (including external assistance) increase. Transparency is not a sufficient condition to control corruption, but it is in most circumstances a necessary one, as will be discussed below.

65. Second, closed decision-making increases the risk of government error -- and of negative reactions. Government's impact on the private sector environment, through an array of influences from monetary and exchange rate policy through taxation and expenditure policies to public procurement, is pervasive and profound. Where decisions in these areas are taken in relative isolation from

private-sector reactions, the likelihood of costly mistakes increases -- fiscal policy is a common example. In other instances, governments may be surprised by angry public reactions to the economic consequences of secretly made decisions -- for example, over pricing and subsidies -- when a more open process of public education and debate might have both improved policy design and eased public acceptance.

66. Third, the efficiency and effectiveness of economic actors, and the competitiveness of markets, requires broadly based access to relevant information. A common problem hindering the development of capital markets, for example, and of equity-based financing in particular, is the lack of clear disclosure rules based on audited accounts of private and public enterprises. Lack of transparency in financial markets often leads to arbitrary and capricious relations between commercial banks and their clients. Without proper accounts and disclosure, neither bank lending nor investment through the capital markets can be based on a firm assessment of credit worthiness. This assessment is necessary to evaluate risk and adequately price the cost of capital to the borrower. The capital market remains circumscribed to a narrow range of firms and instruments protected by either implicit governmental guarantees or by the "reputation" of the most powerful economic groups. A lack of transparency may be especially damaging for banking systems. It can lead to a large accumulation of non-performing assets which would cause bank failure, except for the fact that throughout the developing world deposits are usually explicitly or implicitly guaranteed by the state. Private losses are therefore socialized, as non-competitive risk-taking siphons resources from productive uses to speculative activities.

67. The Bank has been primarily concerned to work with governments to ensure broad awareness and acceptance of economic reform programs (e.g. in the context of structural adjustment operations), and to focus government attention particularly on the impact of its actions on private sector confidence and the business environment. Madagascar's government, on its own initiative, and without Bank involvement, has issued guidelines for openness which represent remarkable progress for a government that leaned towards secrecy not long ago (Box 12).

68. The Bank is also active in several specific areas where transparency is an important issue: in public expenditure decision-making (see PSM paper); in assisting governments to improve public procurement; and, increasingly, in the assessment of environmental impact. Public disclosure of environmental assessments is one instrument that the Bank is encouraging governments to use as a way of ensuring greater accountability and transparency. This is particularly critical in ensuring that people involved in involuntary displacement by development projects (such as the Narmada and Upper Krishna river) are kept fully informed of the results of such assessments. Thus, under the Ecuador Municipal Development and Urban Infrastructure project (FY91) an attempt is made to ensure public review of environmental impact studies of infrastructure projects.

Prevention of Corruption

69. Clearly, the main weapon against corruption is to reduce the opportunities for it to a minimum -- to eliminate economic distortions and administrative controls, and therefore to reduce the scope for illicit arbitrage and bribery, "dash," "speed money" and the like. Transparency in government business has a vital ancillary role. The Bank's involvement in transparency is through its work on public expenditure (transparency of budgets, elimination of "caisse noires"), through its assistance to governments in

BOX 12
Transparency in Government:
The "Ten Commandments" in Madagascar

The following are excerpts from an Official Communication published in the December 18, 1990 issue of the Official Gazette of Madagascar.

FROM: The President of the Democratic Republic of Madagascar
TO: The Prime Minister and Head of Government and the Presidents of Institutions

...

The terms of annexed communication from the Prime Minister...will serve as a rule of conduct and as general guidelines...The Government and other institutions of the Republic are requested to ensure that this is given the widest possible circulation and is applied in both the central and the local public services...

Communications

My own observations and complaints reaching my office lead me to submit the following proposals with a view to establishing a proper code of conduct within the Administration as regards its relations with the public. The principal aim is to improve attitude and behavior in the Administration and to preserve trust between the Administration and the public.

1. The Administration must not be permitted arbitrarily to block correspondence addressed to it.

...

The principle must be that the authority that is addressed must forward the request to the authority with power of decision. The former is free to issue a favorable or unfavorable opinion, but must nonetheless pass the request on. If it believes that the dossier is incomplete, or deficient in some other way, it should inform the applicant and ask him to put matters right; this is particularly important as regards our incentives for investors...

...

2. The Administration should assist the public.

...

3. The Administration should facilitate inquiries by the public.

...

Requests from the public sometimes relate to laws or regulations that contain all the relevant information being sought. The Administration should therefore make leaflets, etc., available to the public...In brief, each agency should make available to the public all the necessary information regarding the activity...Within each agency, a public information unit should be established...

...

4. The Administration must establish and observe set periods for handling requests.

Few laws or regulations stipulate that the Administration must respond within a certain period. As a result, the public is at the mercy of officials and is never certain as to when it will get a reply...Some departments have made efforts to improve this situation by stipulating maximum periods...This practice should be extended to all agencies...

(continued on next page)

establishing transparent procurement procedures and conducting environmental assessments.

70. Since central government ministries as principals must -- and should -- delegate to a wide variety of agents the implementation of policy choices, there are inevitably asymmetries in who has access to quality information. Reporting and monitoring systems can update the information base of principals but there are always opportunities for agents to engage in rent-seeking, or private appropriation of gains to be made from insider information. Monitoring and supervision of these agents is a perennial management concern; making most information a matter of public record is one of the mechanisms for doing so. Guidelines on public information policy generally include criteria for users,

BOX 12
Transparency in Government:
The "Ten Commandments" in Madagascar

(continued)

5. The Administration must have the courage to question certain principles.

(a) The principle that silence is equivalent to a refusal...it is time to stipulate that silence...after a certain period has elapsed, is equivalent to acceptance...

(b) The legal principle of implicit rejection.

It is high time the Administration understood that time is money.

6. The Administration must opt systematically for the automaticity of decisions.

The administration's discretionary power must be reduced to a strict minimum by the publication of clear and precise rules of the game, which it must respect. Regulations and laws that have an impact on the public must move towards this objective, which is also stated as a principle...regarding the conceptual framework for the preparation of laws.

7. The Administration must do away with anonymity.

The myth of the anonymous civil servant is no longer appropriate in a modern administration. The names and positions of agents interacting with the public should appear on nameplates on their doors or be posted on signs in their offices so that people know who they are dealing with. The use of badges could be courteous innovation....

8. No official should have permanent tenure of a position requiring contact with the public. Periodic rotation, even if only within the organization, is strongly urged... The Head of State issued a directive on September 12, 1990 to the effect that enforcement agents should not remain in the same position for more than three years...This measure...should be extended to other officials in contact with the public....

9. The Administration must know how to punish and reward.

There are some good officials and they must be encouraged and rewarded...Poor officials, on the other hand, should be punished and their promotion should be prohibited.

The best way to assess an official that works with the public is to listen to what the public thinks about him. An official, fully documented register could be provided for members of the public to record their complaints or their satisfaction...

10. The Administration must evaluate itself and be open to external audits.

Self-evaluation is carried out by an internal audit unit which each agency must establish to monitor its operations, verify how, and how fast, dossiers are handled and study users' complaints....

rules about time lapses prior to disclosure, and clear rules for access. Precisely because information is scarce, and therefore valuable, information policy needs careful attention.

71. Few areas of government activity are more prone to problems of corruption than that of customs and procurement. Some countries have resorted to correcting the mismanagement of customs by contracting out the customs service to a wholly independent private sector enterprise (Indonesia). Public procurement, on the other hand, is not a self-contained procedure which can be handled in this manner -- though inspection and supervisory services can play a valuable role. Further, procurement is a critical aspect of project and program implementation.

72. Procurement difficulties are symptomatic of problems of government capacity, and of the inherent pressures when large contracts are in play. Since 1983, the Bank has been systematically undertaking country Procurement Assessment Reviews (CPAR) which review public procurement laws, procedures, and institutions in borrowing countries to identify any fundamental conflict with Bank procurement guidelines, and to decide on acceptability of local procedures for contracts which are appropriate for ICB. The procedures are assessed from the perspective of competition, transparency, disclosure of selection criteria, award to lowest qualified bidder, fair contract conditions, mechanisms for dispute settlement, and an assessment of institutional capability and efficiency in implementing Bank operations.

73. With the advent of adjustment lending, the CPAR has expanded to parastatal and private sector procurement practices and their compatibility with practices in market economies in developed countries. To date, CPARs have been completed for 60 countries with the remainder in the process of being completed; they are updated every four years.

74. Where institutions are weak or procedures inefficient, the loan includes technical assistance components, or support to hire procurement agents. Thus, for example, technical assistance has been provided to improve the institutional framework and introduce more efficient procedures in Uganda and Madagascar. In other cases, new procurement codes have been issued. In the Philippines, action was taken under a Debt Management Loan to streamline overall procurement rules and procedures so as to permit greater delegation of authority to implementing agencies and to establish standards to shorten contract award procedures. Work initiated under this project has been pursued under subsequent projects (the Fifth Highway project) and guidelines acceptable to the Bank are now available for local procurement of goods and consultants. This has facilitated an easing of regulations relating to contractors thereby increasing their willingness once again to accept government contracts.

75. Several countries do not require public bid opening, and permit bargaining even after bids have been opened. The Bank is attempting, in such cases, to review the rationale for existing local procurement regulations rather than simply requiring conformance to Bank guidelines. It is attempting through local seminars and discussions, to focus attention, for example, on the importance of procurement processes to the development of local contracting capacity and pointing to the value for a development perspective, of adopting revised national systems to conform to international norms. In almost all reforming Central and Eastern European countries, institutions were not familiar with local or international competitive bidding. However, these countries are now requesting and showing receptiveness to Bank technical assistance on procurement legislation and procedures (Box 13). In 1990, the Africa region convened a conference on public procurement procedures at which African public officials presented papers along with procurement experts from developed countries on the merits of different approaches to improving the efficiency of public procurement.

Analysis and Dissemination Capacity

76. The collection and dissemination of economic data has been a focus of Bank assistance and advice for a long time, and has included, for example, support for statistical offices, technical assistance where appropriate, and capacity building. Despite these efforts, and the importance of data collection and dissemination, however, adequate economic information has been a casualty of the

BOX 13
Changing Procurement Policies and Practices in Eastern Europe

The countries of Eastern and Central Europe (Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia) are rapidly accelerating their transition from centrally planned to market-oriented economies, a process involving profound changes, also in the field of public procurement. They are increasing their externally supported investment project operations, in cooperation with bilateral agencies and international financing institutions. During the past forty years, the countries have performed public procurement through direct allocation of resources, or negotiated contracts. They do not have a recent background in using open, competitive bidding procedures, and vary in their abilities to applying international procurement practices.

The countries lack the requisite public procurement laws and related legal systems, regulations and experienced procurement officers. New and comprehensive legal systems for public procurement are required at all levels of government: national and local, and would ideally apply to all sectors. At the same time, training of procurement personnel would need to be performed on an urgent and massive basis, to implement the new procurement practices. The delays in project implementation caused by inefficient procurement practices may result in opportunity, interest, and inflationary costs of considerable magnitude (10-20% of total project costs).

The World Bank has, at the invitation of several of the countries, advised their senior officials on the requirements for implementing the needed legal and policy changes, and to train involved personnel. Contacts have also been made with multilateral and bilateral agencies which have a direct interest in the issues, with the objective of their participating financially and technically with the Bank in country and regional projects which would address the problems through technical assistance. Financing of such projects could also come from Bank loans, should the countries so request.

economic crisis and government stringency, especially in much of Africa. Central Banks which once produced excellent reports on the economy (as in Ghana) have ceased to do so, and government statistical series in many countries have become less timely, reliable, and complete. Given the expanded and more sophisticated requirements implied by the Bank's poverty and environment agenda, this is an area deserving more emphasis. China's post-reform Statistical Yearbooks are an example of how substantial breakthroughs can be made in the quality and availability of economic information.

77. The capacity of NGOs and institutions (professional associations, trade unions, business organizations, grass roots groups, research centers, universities and mass media) to articulate the needs of important constituencies, analyze policy requirements and contribute to policy formulation is an important aspect of accountability. Building this capacity is a central aspect of developing an enabling environment for growth. Information must be understood, processed, and used effectively. Capacities need to be 0developed -- in the universities, in policy research institutes, in economic committees of legislatures where appropriate, and in the media -- to understand information about development issues, and to contribute to broader public education in turn. The African Capacity Building Initiative represents a potential instrument for strengthening the role and capacities of a wide variety of non-governmental institutions. The Bank's External Affairs Department has also done much to improve access to economic information for developing country journalists.

ENDNOTES

1. The concepts of "exit" and "voice" which originated in Albert Hirschman's classic work, Exit, Voice and Loyalty (Hirschman, 1970) have been adapted by Samuel Paul in his work for the PRE Working Paper No. 614 on accountability (Paul, 1990).

2. Sir Adetokunbo A. Ademola, Chief Justice of Nigeria, in his address to the Convention on the Rule of Law, organized by the International Commission of Jurists (Lagos, 1961).

3. This is the case of the legal information system included in the Social Sector Management Technical Assistance Project in Argentina (Loan 2984 AR).

4. A practical example is Ghana. The legal and regulatory framework governing private sector activities is being reviewed by the government in order to eliminate obsolete laws and revise other laws to reflect the policy change from a command economy to a free market system. This follows the changes of the regulatory framework for the financial sector which has already led to encouraging results.

5. For example, the Indonesia Report concluded that strengthening the arbitration system and arbitral bodies could improve contract enforcement and avoid some of the constraints in the judicial system.

ANNEX II
TASK FORCE ON GOVERNANCE

Adamolekun, Oladipupo O.	AFTPS
Beckmann, David M.	EXTIE
Bryant, Coralie	PRDPD
Campbell, Tim	LATIE
Chaudry, Shahid A.	LATPS
Dia, Mamadou	AFTIM
Einhorn, Jessica P.	FODDR
Gruss, Hans Jurgen	LEGAF
Harris, Randolph L. P.	CODOP
Heyneman, Stephen Paul	EMTPH
Isenman, Paul	PRDDR
Jones-Carroll, Charlotte	PBDCP
Kohli, Harinder S.	EMTDR
Lacey, Robert Mark	EDICD
Lamb, Geoffrey B.	PRDPD
Landell-Mills, Pierre M.	AFTDR
Lateef, K. Sarwar *	EXTIE
Nankani, Gobind T.	LA1IN
Okonjo-Iweala, Ngozi N.	OPNSV
Pachter, Lisa	EXTIE
Paul, Samuel	CECPS
Pellegrini, Anthony J.	EMTIN
Rigo, Andres	LEGAF
Ritchie, Daniel	ASTDR
Sagasti, Francisco	EXTDR
Schiavo-Campo, Salvatore	AF3CO
Shakow, Alexander	EXTDR
Shirley, Mary M.	CECPS
Socknat, James A.	ASTPH
Wai, Dunstan M.	AFREA
Winkler, Donald R.	LATPS

* Task Manager

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THE WORLD BANK
POLICY, RESEARCH AND EXTERNAL AFFAIRS
PRE COMMITTEE

Minutes of the Meeting of May 29, 1991

Present

Committee	Others
Messrs. W. Thalwitz, *Chairman*	Messrs./Mmes. C. Bryant, PRDPD
H. Bachmann, MIGPA	A. Farzin, PRDPD
S. Husain, LACVP	R. Harris, CODOP
P. Isenman, PRDDR	A. Khanna, EXC
B. Kavalsky, FRM	G. Lamb, PRDPD
R. Picciotto, CPBVP	K. Larrecq, FRM
V. Rajagopalan, PRSVP	S. Lateef, EXTIE
I. Shihata, LEGVP	B. Liebenthal, PRDRA
L. Summers, DECVP	J. Linn, CECDR
T. Thahane, SECGE	J. Nellis, CECPS
	S. Paul, CECPS
	A. Shakow, EXTDR
	Z. Shalizi, PRDPM

Two papers were under review: "Reform of Public Sector Management: Lessons of Experience" and "Governance for Development: Discussion Paper and Background Paper."

PUBLIC SECTOR MANAGEMENT: LESSONS OF EXPERIENCE

Introduction

Mr. Thalwitz opened the discussion indicating that the agenda would be followed. On this paper in particular he wanted views on the breadth of treatment on the three topics covered within and their contribution to the changing role of the state -- the last question in the agenda.

The first speaker commended the paper, saying that staff will find it useful. Queried about whether the points made on corruption were problematical, he said no. Another member commented that he wondered why there was little or no discussion of the underlying causes of the problems these reforms were intended to address. He added that he thought that if we were to help the private sector one had to improve the quality of government given the need for an enabling environment, infrastructure, quality of services, and legal framework. In contrast to the first speaker, he did take exception to the discussion of corruption, preferring the more even handed

discussion in the governance paper. In regard to privatization, he was not comfortable with saying that privatization is necessary -- which is quite different from saying, as in the past, that it is advisable. If a parastatal is making large profits for government, why should it be privatized? In regard to earmarking (p.15), further research is needed. There are also legal implications. Sometimes in the push by the Bank for cost recovery, one gets into earmarking which in some countries is legally proscribed. He also suggested dropping the quote on p. 28 indicating that it could unnecessarily cause the country concerned harm.

Another member then commented that there was a bit of a disconnect between the first chapters and chapter 5. Chapter 5 should also include a discussion of embedded technical assistance as well as the technical assistance implications of all three areas discussed in the paper. The issue of institutional development is big and significant; trust funds are not directed to that issue. The Bank needs a clearer institutional development strategy within country strategies. In regard to the discussion of privatization, there needs to be more attention to the need for prior effective public enterprise reform. Others demurred, querying why governments should be counseled to invest in reform of enterprises that were targeted for sale. Another speaker added that there are differing views about this issue and perhaps the paper should reflect the competing perspectives. He added that the issue of private-public sector relationships was well covered in the WDR; a perspective that could usefully be reflected here.

Turning again to the issue of corruption, a member noted that development comes to a halt when rent taking creates obstacles to access and entry. The challenge for donors is how to eliminate occasions for corruption. Another pointed out, however, that while recommendations often point back to international competitive bidding, some aspects of government procurement are traditionally exempted from ICB, e.g. the arms trade is exempted and nowhere would there be support for arms trade to be included in ICB.

A participant commended the modesty of the paper. He added that paras. 2.19 - 2.25 (on budgeting, auditing, and strengthening budget procedures) were essentially without a conclusion unless the Chief Economist has something more to offer on how to make inter-sectoral trade-offs. Public expenditure reviews encounter this issue; once one has identified the white elephants, what guidance can there be about intersectoral trade-offs. In regard to privatization, one of the lessons of recent past work is that the idea of an intermediate step in commercialization is not necessary. These enterprises should quickly be subject to the discipline of the market.

Responding to comments, it was noted that this was a deliberately modest paper given the problems encountered by the earlier institutional development paper. Revisions could strengthen the links to private sector development. On the other hand, this is not a paper on privatization -- there will be a forthcoming paper on divestiture. This paper is about lessons for successful public sector restructuring. There is always a risk that once an enterprise has been successfully restructured, it can still go off the rails, thus that necessary to keep the gains on track, or to enhance the durability of restructuring must receive more attention. Mr. Thalwitz suggested the

language -- "privatization may be necessary to lock in some of the advances and improvements made in public enterprise reform."

The respondent added that the paper stayed away from resource pleading, but noted that an earlier version had said more about resource constraints which are severe in this area. Another commentator added that the Bank need not provide the labor. The response was that the Bank is currently not devoting the minimum essential resources to get the job done. That is among the reasons why we should not talk about doing more of the micro-level interventions since even on the major macro work, there are not sufficient resources.

GOVERNANCE FOR DEVELOPMENT

Introduction

Mr. Thalwitz said that he wanted the committee to address the questions on the agenda. He added that the paper was fully debated in the preceding OVP meeting, and he wanted those views to be expressed here as well. As a contentious subject, it is likely to be debated in the PC.

The first speaker said that he would try to be constructive. His first problem with the paper is its very title -- governance is an emotive topic -- and he would prefer more use of the terms management, or better yet, economic management. The difference is that in changing the rhetoric, the stage is set for politicizing the institution. When one gets into the substance of these issues -- capacity, accountability, predictability and rule of law, and openness -- there is little problem. Indeed, his objections with the paper are when it moves from the specific to the more general discussion. Take for example, the points made in para. 38 -- these are tractable goals in smaller countries in, for example, many African countries. But these issues are not as readily tractable in large countries such as India, China, Brazil or Mexico. Further any policy paper has to start with the Bank's successes and failures. The Bank has had failures in integrated rural development (IRD) lending. In the case of IRD, the effort was to cater to all the socio-economic environment, but as it turned out this elegant concept was next to impossible to operationalize. The resulting failure came about because of the hubris underpinning it, as in this case. While the paper claims humility, it is basically not humble in objectives. He added that a discussion paper going to the Board is also not the place to discuss Bank processes and procedures. Similarly, he would prefer that all references to human rights be eliminated.

As a procedural matter, another speaker pointed out this paper follows on the earlier paper by Mr. Shihata, and the Board has asked for it. In some ways he found the suggestion of a more narrowly conceived paper attractive. There are some executive directors who are groping for a handle for a more political paper which should be resisted. Providing a paper is the best minimal defense. Intellectually, however, we should only take on what we know we can handle. He queried whether the paper was to go to a COW or a seminar.

Mr. Thalwitz said that he was not concerned about the bureaucratic issues of whether it was a COW or not. Nor was he convinced that changing the name would solve the issue.

Another member said that he appreciated the effort people drafting the paper had gone through. Some readers, he added, will invariably say you've gone too far; others, that this does not go far enough. Some language changes might be necessary (especially more discussion of economic management). It is concerning that some junior level staff may want to resume the mantle of the "white man's burden." He suggested that the paper say that while governance in general may be defined as including the elements denoted (in the current draft), it might go on to say that from the Bank's perspective the concern of this paper will be with "the way in which a country manages its resources." That the broader issues may be subsumed under the concept of different economic regimes. He added that caution is necessary in the discussion on openness -- as that has very different connotations for different audiences.

This paper, a speaker noted, was particularly difficult to write. He wondered about a different approach -- whether, in short, it should not be a state of the art paper in political economy. It might then argue that both voice and exist need to be strengthened to achieve better governance. There was here too little sense of the complexity. He thought that section three should analyze Bank experience in the past more than it does currently.

Mr. Thalwitz strongly disagreed, saying that it would be inappropriate to build an entire edifice. A state of the art political economy paper was the opposite of that which had been proposed by other speakers and around which there might be more consensus -- of narrowing and delimiting the concept of governance to economic management and the Bank's role therein. He indicated that real caution was essential around this exercise because of the larger political forces surrounding it; that the paper may have too much conceptual material already. This is a Board paper; they would want a theoretical political economy paper. In regard to the issues of evidence and review of Bank experience -- it was understandable that this schedule precluded such a complete review for this paper. But that will have to be done before the second paper mentioned in the last paragraph.

Commenting again on the difficulty inherent in writing this paper, another participant noted that the discussion in the meeting had focused less on the substance of the paper than on how to express the central ideas. On substance, this paper successfully captured an emerging consensus, including issues previously neglected. When it came to Bank strategy, however, it was in effect saying to the Board "trust us" to work through the implications on a country by country, subject by subject, case by case basis. This was unlikely to be accepted without further explanation. He went on to recommend deleting para. 152 (reference to IDA allocations) in the background paper; as well as references to "egregious" in the text generally.

Mr. Thalwitz said that para. 4 (discussion paper) in referring to people's dissatisfaction with governance as a factor leading to radical political change is stated too strongly. That, on the other hand, he found paras 37, through 40 (Discussion paper) brilliant. These are saying that

there is no available single yardstick for measuring performance, and yet, once that's admitted, when poor performance becomes pervasive the problems are obvious to many. Herein lies part of the answer to the concern with governance as the rubric under which this work goes forward. There is more here than narrow economic management; one cannot capture it with that nomenclature alone. Beyond that there is a question of public policy, of capriciousness which results in under utilizing a country's resources.

Yes, another noted, this is true. Mobutu's Zaire is the ultimate example. Still having used the word governance, let's move on to use then the term economic management of resources in order to distance ourselves from the most political aspects of governance.

The author summed up saying that most of the points could easily be handled. He would try to check that each time the word governance is used, it is necessary and used appropriately; that the discussion of Bank procedures was there in order to point to instances when we risk being part of the problem; that references to human rights will be removed. In regard to evidence and Bank experience, he added that he had looked at OED studies for material but found little that was directed at questions of governance.

Mr. Thalwitz said that while this paper could come out with a design based on observations that are not yet codified into evidence, that will not be possible for subsequent papers on this topic such as that referred to in the concluding paragraph. He added that the complex operational issue is when does the moment come when the Bank must be expected to react to problems of an egregious nature -- for example pervasive corruption?

A member noted there had been two instances when senior management decided development was no longer possible. When corruption becomes very widespread, development is stalemated, and the Bank will need to stop lending.

Is this the line to be drawn -- widespread rentseeking? If there are other abuses, are they sufficient cause to draw that line? Countries are also shareholders hence denying them resources is a problem. But the major purpose of this paper is not about when to stop lending; it is about crafting the content of good economic management for the large number of intermediate cases.

A member noted that in the two hour discussion, no mention had been made of loans not made to China (a case which had received much press attention). The reply was that shareholders can make such political decisions; senior management cannot. Mr. Thalwitz added that by many criteria the Chinese would not fit the cases under discussion -- their management of economic resources is not in question since they are still achieving 7 percent growth.

A member guiding the paper expressed thanks for the extensive participation of OPN and LEG in producing the paper. The changes requested would be made; as a result the PC meeting would probably be deferred by a week.

OFFICE MEMORANDUM

DATE: May 24, 1991

TO: See distribution below

FROM: Geoffrey Lamb, Chief, PRDPD

EXTENSION: 32544

SUBJECT: Agenda for May 29 PRE Committee discussion of the papers on "Reform of Public Sector Management: Lessons of Experience" and "Governance for Development: Discussion Paper and Background Paper"

1. The Comittee will consider these two papers at its meeting of May 29 (2:30 p.m., room D-1204). The papers will also be considered in tandem in both the PC and the Board.

PUBLIC SECTOR MANAGEMENT

2. This paper is essentially a review of the main themes of Bank work in public sector management over the last ten years or so, since public sector became an explicit and organizationally distinct focus of Bank work. Does the paper give a full and balanced picture of what the Bank has done in the field over this period?

3. The "lessons of experience" which the paper draws are of three types: very general conclusions (e.g. that public sector management reform is complex and takes a long time), very specific conclusions (e.g. that state enterprise performance can be substantially improved without changes in ownership, but that privatization probably becomes necessary in many cases in order to lock in efficiency gains), and conclusions about the use of Bank instruments (e.g. proposals for improving technical assistance for PSM, or a tentative recommendation to go the route of projects rather than adjustment operations for sustained PSM reform). Are these lessons of experience sufficiently sharply drawn to provide staff, management and Board with adequate guidance about directions for the "next generation" of PSM activities?

4. The paper sets out basically a very mixed record of accomplishments in Bank-supported PSM reform. Two questions arise. First, does this accurately reflect operational experience? Second, might more instructive "lessons of experience" have been derived from focussing on the limited number of relative successes and extracting guidance from them?

5. The paper is down-to-earth in tone and unswerving in its focus on the three primary areas of PSM work discussed. Other than a "common conceptual thread" of down-scaling government and strengthening core functions and institutions, the paper has little by way of an overall framework setting out either:

-- A view of the desirable role of the state and a strategy for transition towards this state; or

-- the rationale for the Bank having concentrated on the three areas of public expenditure management, civil service reform and public enterprise reform.

Does this make the paper's review of Bank experience less coherent or convincing?

GOVERNANCE

6. The governance paper is intended to do two related things:

-- provide analysis and illustration to staff on areas where governance impinges most directly on Bank work, and suggest ways to address issues arising;

-- to delimit in an operationally relevant way areas of and approaches to governance so as to protect the Bank from pressures to exceed its legitimate operational and intellectual concerns. Does it succeed?

7. The main elements of the paper's approach are accountability, rule of law and openness of government information and decision. Are these the right emphases, and does the paper provide coherent reasons for selecting them?

8. It is arguable that most reasonable people would regard governments which are themselves frankly predatory or anti-development as central to the "governance problem". The paper acknowledges this only obliquely, with a reference to "egregious cases" of abuse, and concentrates on more limited corrective reforms of government actions. Is this the right balance, or should such difficult problems of "anti-development regimes" be more frankly discussed?

9. The paper's discussion of the impact of governance on the private sector environment concentrates on the rule of law. But predictability of government behavior is important for private sector confidence also in discretionary matters beyond legal recourse, for example economic policy and regulatory behavior. Should the paper not also discuss capriciousness in these areas as a symptom of bad governance?

10. The section on openness or transparency of information and decisions is thin. How can this best be strengthened?

11. In the current draft, the "discussion paper" is a sort of expanded executive summary, while the background paper has more extended discussion plus more country examples and boxes. Current intentions are to make the former the main focus of Board discussion. Is this the right course?

Distribution:

Messrs. Thalwitz (Chairman), G. El-Rifai, P. Isenman, W. Kaffenberger, A. Karaosmanoglu, R. Picciotto, V. Rajagopalan, I. Shihata, L. Summers, T. Thahane, W. Wapenhans, J. Wood

For Information:

Messrs./Mmes. Alisbah (PAAVP), Annez (WDR), Bock (OPNSV), Burmester (SECGE), Churchill (IENDR), Colaco (PRSVP), de Tray (DECVP), Golan (EDIDR), Grilli (EAS), Hamilton (PHRDR), Husain (LACVP), Ingram (RAD), Jaycox (AFRVP), Kashiwaya (CFSVP), Khanna (EXC), Lateef (EXTIE), Liebenthal (PRDRA), Linn (CECDR), Michalopoulos (PRDDR), Nellis (CECPS), Okonjo-Iweala (OPNSV), Petit (AGRDR), Pfeffermann (CEIED), Piddington (ENVDR), Pouliquen (INUDR), Rao (IECDR), Sandstrom (EXC), Shakow (EXTDR), Shalizi (PRDPM), Shirley (CECPS), Steer (WDR), Wyss (CODDR)

GLamb:lsa

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: May 22, 1991

TO: Distribution

FROM: Geoffrey Lamb, Chief, PRDPD

EXTENSION: 32544

SUBJECT: PRE Committee Schedule

1. Attached are the materials for review at the PRE Committee Meeting scheduled for May 29, at 2:30 p.m. in Rm. D-1204:

- The Reform of Public Sector Management: Lessons of Experience
- Governance for Development

2. The agendas for the discussion of these materials will be distributed by c.o.b. May 24 (Friday).

Distribution:

Messrs. Thalwitz (Chairman), G. El-Rifai, P. Isenman, W. Kaffenberger, A. Karaosmanoglu, R. Picciotto, V. Rajagopalan, I. Shihata, L. Summers, T. Thahane, W. Wapenhans, J. Wood

For Information:

Messrs./Mmes. Alisbah (PAAVP), Annez (WDR), Bock (OPNSV), Burmester (SECGE), Churchill (IENDR), Colaco (PRSVP), de Tray (DECVP), Golan (EDIDR), Grilli (EAS), Hamilton (PHRDR), Husain (LACVP), Ingram (RAD), Jaycox (AFRVP), Kashiwaya (CFSVP), Khanna (EXC), Lateef (EXTIE), Liebenthal (PRDRA), Linn (CECDR), Michalopoulos (PRDDR), Nellis (CECPS), Okonjo-Iweala (OPNSV), Petit (AGRDR), Pfeffermann (CEIED), Piddington (ENVDR), Pouliquen (INUDR), Rao (IECDR), Sandstrom (EXC), Shakow (EXTDR), Shalizi (PRDPM), Shirley (CECPS), Steer (WDR), Wyss (CODDR)

CBryant:ltv

GOVERNANCE FOR DEVELOPMENT

DISCUSSION PAPER

MAY 22, 1991

draft-Revised
May 22, 1991

GOVERNANCE FOR DEVELOPMENT

A Discussion Paper

I. Introduction

1. Governance issues are not new to the Bank. As a development institution, the Bank has grappled with these issues from its inception. However, the relatively good growth performance of developing countries between 1965 and 1980 helped to conceal the endemic problems of governance and provided Bank projects a climate of relative prosperity within which its lending could proceed. By the beginning of the 1980s, as growth decelerated sharply and the developing world reeled under the impact of a severe worsening in the terms of trade, the emergence of a climate of relative scarcity began to expose governance issues in many countries. At the same time, it was becoming increasingly clear that investment lending was not achieving its objectives in the absence of an appropriate policy environment.

2. Structural adjustment lending and related public sector management reforms were aimed at creating an enabling environment for growth. Their focus was on reducing fiscal deficits and reducing the area of government discretion in incentive policies. While this indirectly addressed governance issues, the Bank, partly out of concern for not overstepping its legal mandate, did not directly or consciously address governance issues except in isolated cases, and that too in a haphazard manner. Despite some success with structural adjustment lending and public sector management reforms, there is increasing recognition that the enabling environment is still proving elusive, and that improvement in the sustainability of Bank financed investments and structural adjustment reforms is tied to improvements in governance.

3. The Africa Region was the first to articulate this concern in its Long-Term Perspective Study on Sub-Saharan Africa. But recent events have demonstrated that the problems are not confined to Africa. In a number of the Bank's borrowers, the effectiveness of both adjustment and investment operations is impeded by a poor supply response, weak institutions, lack of proper financial accounting and auditing systems, damaging discretionary interventions, and a lack of transparency in decision making that feeds corruption and waste. As noted in the 1991 WDR, underlying these symptoms in many cases is the lack of accountability, an uncertain investment climate due to unpredictable government behavior, and the lack of an adequate legal framework.

4. Outside the Bank, there has been a vigorous debate on issues of governance. This was stimulated in part by the growing dissatisfaction of peoples with their governments and, since the late 1980s, has led to radical political changes in Eastern Europe, Latin America and parts of Asia and Africa, giving rise to a new

range of governance problems. In many countries in these regions, the role of the state is changing to reflect a greater preoccupation with the creation of an enabling environment for development, the private sector is being strengthened and assuming larger responsibilities, the size of governments is being reduced, and the structure of government is being decentralized as economic and political power is devolved to lower levels of government. In many cases, these rapid changes are associated with difficult economic reforms and macro-economic adjustment, requiring considerable skills in developing a political consensus around these reforms.

5. Bilateral donors, now freed from the strategic imperatives of the Cold War, have been pursuing a broader political agenda in fashioning their response to these major developments. They have been particularly sensitive to increasing public criticism of concessional aid flows to governments which lack democracy, have a poor human rights record, or are seen to be corrupt.

6. The Bank's mandate is the promotion of sustained development, and its concern for governance must be driven by that mandate and by the impact of issues of governance on its effectiveness as an institution. In his legal opinion of December 21, 1990, discussed in a Board seminar on April 12, 1991, Mr. Shihata set out "a legal framework for the Bank's dealing with this issue as a prelude to any future analysis of the manner in which the Bank may take it on operationally". He identified five aspects of governance that are beyond the Bank's mandate: the Bank cannot be influenced by the political character of a member; it cannot interfere in the partisan politics of the member; it must not act on behalf of donor countries in influencing the member's political orientation or behavior; it cannot be influenced in its decisions by political factors that do not have a preponderant economic effect; and its staff should not build their judgements on the possible reactions of any Bank member. Mr. Shihata's memorandum then considered, by way of illustration, a number of areas that do fall within the Bank's mandate such as civil service reform, legal reform, accountability for public funds and budget discipline.

7. This discussion paper, prepared by a Task Force with participation from the Operations, Policy, Research and External Affairs, Legal, Corporate Planning and Budget, and Finance complexes, is an initial analysis of the issues of governance that are within the Bank's mandate. A Background Paper, which provides a more detailed discussion of issues, is attached. The paper is not a comprehensive policy review of the Bank's work on governance. Such a review would be premature, given the limited nature of the Bank's direct operational experience outside the public sector management area. The paper instead is exploratory in nature, defining the major concepts, and reviewing recent Bank experience in this area. The paper also attempts to identify key operational issues that might emerge as the Bank begins to address a wider range of issues of governance. The paper is intended to stimulate discussion within the Bank, to seek the guidance of Executive Directors, and to sensitize staff both to the importance of issues of governance and the sensitivities of borrowers.

II. The Nature of the Problem

8. The governance problem can be seen at different levels. Major symptoms of poor governance are:

- a lack of capacity/ability to identify and decide on priorities, resulting in a misallocation of resources;
- the existence of numerous rules, regulations, licensing requirements which impede the functioning of markets and encourage rent-seeking behavior;
- an unwillingness to make a clear separation between what is public and what is private, and hence, the tendency to divert public resources for private gain;
- the inability or unwillingness to establish and apply a legal framework conducive to economic development;
- arbitrariness in the application of rules and laws; and
- a lack of concern for the "national interest", and the pursuit instead of ethnic, regional or elitist agendas.

9. When such failure in governance, either in terms of capacity or volition, contributes to poor economic performance, the authority of governments over their people tends to be corroded. This reduces compliance with decisions and regulations. Authoritarian regimes often then resort to coercion or populist measures to enforce authority and retain power. This, in turn, has a high economic cost including diversion of resources for internal security, and excessive corruption.

10. The most important underlying cause of poor governance is the low level of economic and human development. Other causes include a high degree of concentration of political power, and a colonial inheritance that in several cases has bequeathed weak accountability systems, large standing armies and national boundaries imposed as a result of agreements between the major colonial powers which has often led to ethnic strife and border disputes. Often such strife is fuelled by arms exports by other countries to rival factions/states.

11. These symptoms and causes of poor governance are not unique to any particular form of government: democracies and authoritarian regimes show the same symptoms. However, as the WDR 1991 points out that while there is no clear causal relationship between democracy and economic growth, there is no evidence to support the view that "authoritarian governments, on average, show greater promise for achieving rapid growth". Looking beyond growth, democracies in general are associated with better social indicators.

III. The Definition of Governance

12. Governance, for the purposes of this paper, is defined as the exercise of political authority and power. Governance has three different aspects: (i) form of political regime (parliamentary/presidential, military/civilian, authoritarian/democratic); (ii) processes by which power and authority are exercised; and (iii) capacity to design, formulate and implement policies. The first aspect clearly falls outside the Bank's mandate. Capacity issues, the third aspect, interacts with how power and authority are exercised, and will, to a lesser extent, be discussed. The accompanying paper The Review of Public Sector Management: Lessons of Experience (PSM paper) is the source for more detailed information about Bank work on capacity building and efficiency in the public sector. The major focus will, therefore, be on the second aspect -- the way in which power and authority are exercised to promote economic development.

13. Even in societies that are highly market-oriented, only governments can provide two sorts of public goods: rules to make markets work efficiently, and in some cases, corrective interventions where there are market failures. With respect to rules, without the institutions and supportive framework of the State to create and enforce the rules, establish law and order, ensure property rights, and control the money supply, production and investment will be deterred and the economy will operate well within its technical production frontier. This is because high "transaction costs" (i.e., the cost of arranging, monitoring and enforcing contracts) would inhibit such activities. Compensation for market failure is more problematic. Governments in the 1970s relied on this rationale to rush into unwise investments, when frequently their own policy interventions were responsible for market failures. Nevertheless, the State must play a key role in providing public goods such as education and health and essential infrastructure, particularly when such goods are directed at the poor, and when investment is not forthcoming from the private sector to provide these services. Such a provision of public goods can facilitate, and enhance the quality of, private investment.

14. However, to provide these public goods, the state needs revenues. In the economic sphere, the state has a long term contractual relationship with its citizens based on the exchange of public services for taxes. The state also needs "agents" who will collect taxes from the public and who will produce the rules and produce and deliver essential services (such as education and health, and a legal framework). This, in turn, requires systems of accountability -- accountability of the government to its citizens, of agents to the government and of agents to those to whom they deliver services. Finally, for the system to work, there must be adequate information. Without adequate and reliable information flows, the rules are not known, accountability is low, and uncertainties, excessive. Thus, the rule of law, accountability, and openness are all key elements of good governance. Moreover, the institutional framework needed to provide these public goods must be managed efficiently.

15. A survey of the literature on governance reveals that the emergence of productive institutional arrangements takes a great deal of time, but also that there is no guarantee that such arrangements will emerge. The state may pursue

strategies that hinder property rights. Its agents may behave in an opportunistic manner and indulge in "rent-seeking". Thus, good governance is a continuum, and not necessarily unidirectional: it does not automatically improve over time. Citizens must demand it. Governments must prove responsive to those demands. Neither of this can be taken for granted. Change occurs sometimes in response to external or internal threats. It also occurs through pressures from different interest groups. While donors and outsiders can contribute resources and ideas to improve governance, for change to be effective, it must be rooted firmly in the societies concerned, and cannot be imposed from outside.

IV. Dimensions of Governance

16. Four dimensions of governance are considered in this paper: capacity and efficiency issues in public sector management, accountability, rule of law, and openness. These are now discussed.

a. Improving Public Sector Management

17. The capacity of the public sector to manage the economy and deliver public services is a key component of governance. When this capacity is weak, governance for development is poor. The public sector in many developing countries has been characterized by uneven revenue collection, poor expenditure control and management, a bloated and underpaid civil service, a large parastatal sector that provides poor returns on the scarce public funds invested in it and weaknesses in the capacity of core economic agencies to design and implement policies that would address these problems. Not only does this state of affairs contribute to large fiscal deficits, requiring adjustment measures, but it also progressively erodes the capacity of the state to provide the basic public goods, such as economic and social services. Poor economic performance in turn leads to poor governance, reflecting the two-way relationship between governance and development.

18. The Bank's involvement in this area, till the 1980s, was almost exclusively on the institutional development of the agencies implementing Bank-financed projects. With the introduction of adjustment lending, the Bank began to focus on improvements in overall public sector management, and improvement of sector wide institutions and service delivery. This is currently the dominant area of focus of the Bank's work on governance. Within this dimension, three areas have received primary attention in the 1980s: public expenditure management, civil service reform, and parastatal reform. Within public expenditure management, the emphasis has been on assisting borrowers improve public investment programming and the budget process. Less advanced have been efforts to improve the execution and monitoring of public expenditure programs. Under civil service reform, in the short term, the emphasis has been on cost-containment measures; in the medium term, on strengthening personnel management and the effectiveness and efficiency of public agencies. In the management of public enterprises, the Bank has been assisting borrowers rationalize the size of the public enterprise sector, privatize public companies, improve the competitiveness of the policy environment, and clarify the relationship between

the central government and public enterprises with a view to increasing the returns on the government's investment in the sector. The core agencies for key sectors and for national economic management have been assisted to help manage better these reform programs. Supporting governments in their efforts at decentralization and tax reform are other areas of the Bank's work.

19. The accompanying PSM paper provides a review of selected issues in this area and concludes that initial results have been positive, often in trying circumstances. The effort has been long and arduous, reflecting obstacles of a socio-political nature. In public expenditure management, imperfect accountability has gone hand in hand with weak institutional capacity. In civil service reform, there is an important shift to improved personnel management. In all cases, the need for strong political commitment is noted. It is particularly difficult to ensure commitment to reforms over time. Tensions between economic benefits and political costs is typical of reforms in this area.

b. Accountability

20. Accountability describes the mechanisms by which decision-makers are held responsible for performance by those affected by their decisions. At the macro-level, accountability is a means for the efficient allocation and use of national resources. Systems of financial accountability are a basic requirement for the state. This includes properly functioning accounting systems, an external audit system, and a process to review the results of audits and act on the findings. Beyond concern with financial resources, governments need systems to ensure accountability for overall economic performance. This requires mechanisms for setting agreed objectives, targets and performance indicators for managers, sometimes through performance contracts for government departments and autonomous public entities.

21. The Bank's primary concern has been with financial accountability, mainly for project implementation agencies. Compliance with accounting and audit covenants has often been disappointing, reflecting weaknesses in country-wide accountability mechanisms. To address this problem, the Bank has been pursuing a three-pronged strategy: (i) improving borrower incentives to comply with accounting and audit covenants; (ii) encouraging a more systematic review of auditing and accounting issues during project preparation; and (iii) strengthening borrower capacity through country-wide reviews of accounting and auditing. Thus, for example, accounting and auditing functions are being strengthened in Ghana, Madagascar, Mauritania and Indonesia, as well as a number of Latin American countries. Accountability assessments are underway in some countries. Such reviews, however, to be effective, must also focus on the processes by which audited reports are reviewed and action taken to deal with the corruption and waste identified. In the area of overall performance monitoring, the Bank's Operations Evaluation Department (OED) has for long advised planning and performance ministries on monitoring and evaluation functions. But the Bank could be encouraging governments to do more in this area, particularly when accounting standards are adequate.

22. Decentralization is sometimes seen as the means of reducing overloaded macro-accounting systems by relying on local decision making, micro-level accountability and through participation of beneficiaries in the monitoring of service deliveries. However, decentralization must be managed with care if it is not to result in fiscal imbalances,, wastage and corruption due to lack of adequate oversight from national authorities, weak administrative capacity at local levels and the risk of capture of local institutions by local elites. Both in Latin America and Eastern Europe, the Bank has been active in assisting with the rapid decentralization proceeding in those regions, mainly through technical assistance for the strengthening of local governments and for ensuring fiscal and financial accountability. In Mauritania, an institutional framework for the creation of municipalities is being established.

23. Micro-level accountability can sometimes reinforce macro-level accountability through competition, or opportunities for "exit" (to borrow Albert Hirschman's famous terminology from his classic work: Exit, Voice and Loyalty), or by enhancing opportunities for participation or other forms of "voice." Exit mechanisms include deregulation, contracting out, and public-private competition. Voice mechanisms include dissemination of information on services, complaint procedures, public hearings, representation on Boards, participation by beneficiaries in the design of projects.

24. The Bank has encouraged exit through deregulation and contracting out of services in various projects. It also encourages the involvement of NGOs as a means of enhancing the voice of the poor, and appropriate popular participation in Bank-financed projects. NGOs were involved in 50 Bank-financed projects in each of the past two fiscal years, compared to 15 projects in FY88. Some 20 projects, with exceptionally participatory approaches, are being studied by an Operations-PRE learning group in an exercise designed to draw lessons from Bank experience with popular participation. The Philippines Communal Irrigation Project remains a particularly good example of successful beneficiary participation on a large scale producing consistently good results. What is needed now is a much more systematic effort to build in exit and voice opportunities into projects to ensure greater accountability at the micro level.

c. The Rule of Law

25. The rule of law has been defined by Mr. Shihata as a "system based on objective rules, which are actually applied, and on functioning institutions, which ensure the appropriate application of such rules". Such a system is needed to create a climate of stability and predictability, where business risks may be rationally assessed, transaction costs lowered, and governmental arbitrariness reduced to a minimum. Five key elements of the rule of law have been identified as of particular relevance to the Bank's work:

26. First, there must be a set of rules known in advance. There are three components to this element: coherence, communication which is also an aspect of openness, and non-retroactivity. Coherence requires that there be no contradictory statutes. Yet, particularly in cases of socialist economy reforms, new measures instituted are often in conflict with existing laws or

constitutional provisions. Furthermore, some governments have ceased to communicate laws. The Bank is helping in some cases with restarting publication of gazettes. More can be done by most governments to explain to citizens the content of new legislation.

27. Second, rules must actually be in force. Laws are frequently ineffective or are not applied. Sometimes this is because laws have been blindly transposed from developed countries (usually the former colonial power), and are not relevant to local situations. In other cases they are obsolete or are not being enforced in the absence of competent administrators of the legal system. The underlying reasons for non-compliance with the rules are manifold and the Bank is assisting borrowers in analyzing the causes and improving the efficiency and competence of the institutions which administer the laws.

28. Third, mechanisms are required to ensure application of the rules. While all state power must be exercised under the authority of the law, flexibility requires that the executive branch have discretionary power to deal with diverse situations difficult to predict in advance. The problem is that discretion tends to be abused in the absence of mechanisms to prevent it. Some countries have independent or specialized courts or ombudsmen; civil service reform will also address the underlying causes of abuse. Rationalization of obsolete rules and regulations, by updating and simplifying legal systems is also being attempted.

29. Fourth, conflicts must be resolved through binding decisions of an independent judicial body. Confidence in the enforceability of agreements and commitments is critical to the proper functioning of an economy. Unreasonable delays and high costs, typical in many countries, can hamper economic activity. Similarly a strong judiciary is an effective shield against arbitrary exercise of executive power. The Bank is beginning to be active in this area with several operations under preparation that will assist borrowers train judges in economic and business fields and handle commercial matters in specialized courts. Other dispute settlement measures such as commercial arbitration would also assist in reducing the burden on courts.

30. Fifth, there should exist known procedures for amending the rules when they no longer serve their purpose. When laws are changed arbitrarily and subjectively without recourse to established procedures, they lack acceptance and invite evasion. The Bank's involvement in issues related to the rule of law is relatively recent. While it is outside its mandate to determine what legislative process should be in place to amend laws, the Bank is assisting borrowers in developing their capacity to put in place appropriate procedural rules for enacting and repealing laws.

31. These five elements address the processes of the formulation and application of rules and constitute the procedural and institutional framework necessary for stability and predictability needed to elicit compliance with rules.

d. Openness

32. Openness refers to the availability of and access to information from public and private sources, transparency of decision-making processes and tolerance for public debate over policy choices. Openness has an instrumental character as it is in some sense a precondition for both accountability and the rule of law. Absence of openness provides opportunities for deception, unfair or inequitable treatment and corruption.

33. Availability of and access to information is essential for markets to function well, as also to ensure accountability of governments to the general public. The Bank, together with UN agencies, has been assisting to improve collection of economic data and its dissemination. More than statistical information is at stake here. Openness concerning government intentions is important to permit sound cost-benefit calculations by the private sector and to discourage destabilizing speculation.

34. Transparency of decision-making is a safeguard against corruption, wastage and the abuse of executive authority. The Bank assists by encouraging governments to remove unnecessary controls and reduce regulations, improve procurement procedures and make budgets more transparent, including the elimination of "black boxes" and greater transparency of military expenditures. East European Governments have been particularly active in seeking Bank assistance for improving procurement mechanisms. Corruption is a two-way street. Donors have an important moral responsibility to ensure that commercial considerations do not undermine good governance in the developing world. Encouraging governments to develop sound public investment programs and respecting the priorities established in such programs is an important contribution donors can make.

35. Availability of information and transparency may lower uncertainty and transaction costs, but will not, by itself, bring about greater accountability in the absence of organizations and mechanisms that analyze and disseminate information. The mass media, in particular, plays a key role here. The African Capacity Building Initiative is an example of the potential role of donors in strengthening the analytical and research capacities of institutions in developing countries.

V. The Role of the Bank

36. Governance is a concern for the Bank for several reasons. As noted above, it is inextricably linked with both the returns and the sustainability of investments that the Bank finances. Quality problems in the Bank's portfolio, or lack of observance of financial accounting and auditing covenants, inevitably have an adverse impact on the Bank's reputation for technical excellence and financial probity. The Bank must continue to impose high standards on itself and its borrowers. Bank support for countries with poor economic performance, particularly when such performance is linked to large scale corruption or gross human rights abuses, may affect its credibility as an institution.

37. However, given the complexity and diversity of governance issues, the long term nature of much of the work on governance, and the sensitivity of borrowers to these issues, the Bank must approach the subject with careful calculation, great caution and due humility. Such a cautious approach and the Bank's relatively limited direct experience outside the public sector management area, argues against a formal policy exercise or conferring on governance the status of a Special Initiative. This is particularly because governance for the Bank is an instrument, not an end in itself. The first priority for the Bank is to better understand the complex relationships among the different dimensions of governance as they impact on economic development through direct operational experience and analytical work.

38. The priorities for Bank operational work on governance must be determined separately for each country. The objective must be to ensure the existence of an enabling environment for a more equitable and sustained development path. Sound systems of accountability at macro and micro level, a legal framework that establishes a clear set of objective rules and institutions ensuring their proper application, and sufficient access to information and transparency of decision-making processes to reinforce accountability and the rule of law are essential but hitherto neglected elements of such an enabling environment. The Bank must help its borrowers address the underlying causes rather than the symptoms. The existence or lack thereof of this more broadly defined enabling environment needs to be taken into account in setting priorities and designing country programs.

39. It is important to recognize that merely establishing a legal or financial accountability infrastructure does not guarantee the rule of law or accountability. A broad consensus and government commitment to those objectives is essential. When this is missing, the Bank must factor this into its country strategy and dialogue. Thus, the Bank's role on governance issues comprises:

- Assisting governments in reforms that they have identified or assisting them to identify reforms when they have expressed a felt need. The Bank is already experiencing a growing demand for technical assistance in support of a legal and procurement framework in Eastern Europe and strengthening decentralization in Latin America;

- Persuading governments through dialogue and economic and sector work of the need for reforms. Institutional and public sector management assessments and public expenditure reviews in Africa, and accountability and legal sector reviews in Africa and Asia are examples of how this has begun to happen already;

- Reducing Bank involvement in egregious cases where poor economic performance is clearly related to significant corruption, civil war or pervasive human rights abuses. There are already currently a number of countries where lending has ceased or been reduced to core programs reflecting poor development performance due to a variety of factors including governance-related issues.

- Projecting a long-term vision of an enabling environment for better governance for development, including universal education, a vibrant private sector, including NGOs, and a well-informed public debate on development issues.

40. Bilateral donors, who are pursuing a broader agenda, reflecting a concern for democracy and human rights, are considering ways of linking the volume of lending to the quality of governance, and are debating the wisdom of creating performance benchmarks on governance. This would be inappropriate for the Bank since, for it, good governance is not an end in itself but a means to sound development. The quality of governance is already indirectly taken into account in that it influences judgements about the quality of the Bank dialogue, the strength of the policy framework and the quality of public management. There is no need for additional criteria: merely the effective use of existing criteria. However, unless the Bank is seen to be willing to reduce lending substantially where governance is so poor that development is drastically affected, the exercise is unlikely to be taken seriously. As noted above, this is well recognized already.

41. If governance issues are fully reflected in the Bank's country strategy, then these should be discussed with borrowers in the broader context of a Government's overall development performance rather than in isolation. In conducting this dialogue, the level at which policy issues are discussed must be a function of their sensitivity and will require the judgements of senior managers. Thus, for example, policy issues relating to military expenditures are best handled at an appropriately high level, i.e., the Country Director and above. In approaching this subject, the Bank should focus on the appropriate level of overall government expenditures, given resource availabilities, and the legitimate financial resource needs of economic and social sectors, thus pointing to the crowding-out effect of military expenditures.

42. The dialogue could be strengthened by persuasive Economic and Sector Work. Depending on country circumstances, this could cover the enabling environment for private sector development, legal sectoral reviews, institutional assessments at national and sectoral level, public expenditure reviews, and assessments of procurement and accountability systems.

43. The long-term nature of institutional development may make some aspects of governance work inappropriate for support through adjustment lending and imply greater reliance on long-term technical assistance and such innovations as the Africa Capacity Building Initiative. However, governance issues need to be taken into account in all operations wherever appropriate, focussing on opportunities for improving governance and obstacles that weaknesses in governance create for the attainment of objectives, particularly in relation to poverty alleviation. This includes both traditional interventions that reduce opportunities for rent seeking anfd reduce public monopolies as well as attention to opportunities for encouraging participatory approaches to development or assessment of exit and voice options to strengthen accountability at the level of specific public services.

VI. Implications for Bank Practice

44. There is awareness in the Bank of the need to be part of the solution to the problems of governance and not part of the problem. This implies greater efforts at understanding the political , social and ethnic structure of the country, greater emphasis on popular participation in project design, increasing attention to fostering an implementation culture in the Bank and greater transparency and openness in the Bank's own procedures.

45. Given the technical complexity of the preparatory work on adjustment operations and the speed with which borrowers require resource transfers, there is a constant danger that the Bank, by deploying large missions and leaving insufficient time for adequate dialogue, can weaken ownership of programs that are then seen to be externally imposed. In an ideal world, sufficient preparation time would permit a better understanding of the political economy of the country, and through a more intensive and extensive dialogue, greater ownership and understanding of the program by the borrower is assured. However, Bank staff frequently do not have that luxury. Governments frequently delay adjustment and come to the Bank when they are facing a serious crisis. There is, then, an inherent conflict between the need for quick resources frequently in support of sensitive policy reforms (like exchange rate policy) which do not lend themselves to an open consultative process, and the need to build ownership and understanding of the program. Moreover, greater ownership invariably comes after a program begins to show results. It, nevertheless, remains important to ensure that operations are designed, taking into account, the political economy of the country, and that ownership of the program, however narrow at the start, is genuine, and that it is rapidly broadened over time, as is the borrower's understanding of the program.

46. Work on governance will raise unit costs and change some skill requirements. Given the overall budget constraints, these fresh claims on resources will need to be handled like all other such claims through a determination of priorities with existing country programs. The skill mix problem can be partly addressed through use of consultants. The LAC region, for example, has innovatively hired a number of auditors and tax specialists as consultants and staff to assist its work on accounting systems, decentralization and tax reform. The Bank also should not attempt to take too much upon itself when other agencies and donors are willing and able to help. Thus, there are a number of UN and other agencies who have a comparative advantage in some governance areas which the Bank, through its aid coordination function, should seek to tap on behalf of its borrowers. There will nevertheless inevitably be some trade-offs, since this is one of a number of areas, such as the greater focus on policy, that increases the staff intensity of the Bank's work. As with policy work, the rationale for the Bank's involvement in governance must be that it will help improve the effectiveness of its programs and projects, and not as a new line of business. In the medium to longer term, however, high quality work on governance issues, and improved Bank practices reflecting the "implementation culture" may well help improve cost-effectiveness and the development effectiveness of Bank interventions.

VII. Next Steps

43. Following discussion of this paper at the Board, the following activities are envisaged:

(i) Dissemination to the staff of the key messages for the Bank in this paper and the Board's guidance:

- the critical importance of promoting an enabling environment for development -- broadly defined to include issues of accountability, rule of law and openness;

- the need to approach issues of governance with caution and humility, and sensitivity to the concerns of borrowers;

- the need for a better understanding of country governance issues by the Bank, and the way they affect economic performance, through economic and sector work and research;

- increased attention to governance issues in the preparation of projects and adjustment operations and publlic sector management work; and

- increased attention to governance issues as they affect implementation and development effectiveness.

(ii) A broad-based dialogue with borrowers, interested academics and others, has begun in the Africa Region, and depending upon this experience, could be emulated elsewhere;

(iii) A modest training and research program based on the ideas presented in paras. 168-175.

(iv) Given the above conclusions, a progress report to the Board on the Bank's experience with the operationalization of governance issues would be appropriate in about two years time.

GOVERNANCE FOR DEVELOPMENT

BACKGROUND PAPER

MAY 22, 1991

GOVERNANCE FOR DEVELOPMENT
A BACKGROUND PAPER

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Second Draft
May 22, 1991

I - WHY GOVERNANCE MATTERS

> "Policies are not chosen in a vacuum. All but the most repressive governments need to retain a measure of popular support for their actions. Often this support has been bought with an assortment of damaging interventions (such as high tariffs, currency overvaluation, and industrial licensing) as well as corruption and wasteful public spending....Military spending remains high in many countries....Insecure authoritarian governments have been at least as prone as democratic ones to go down this path. At the end of it, all too often, lies an economic and political crisis that sets development back years.
>
> Many countries have suffered a vicious circle of harmful interventions that entrench special interests and lead to rent-seeking and the capture of the state. All too often, the combination of pervasive distortions and predatory states results in development disasters."
>
> World Development Report 1991

1. The major objectives of the Bank's operational, policy and research agenda in the 1980s has been the creation of an enabling environment for development. In the 1970s, it became clear that investment lending could not achieve its objective in the absence of an appropriate policy environment. The balance of payments crises facing most developing countries in the aftermath of the sharp deterioration in the terms of trade in the early 1980s led to structural adjustment lending in support of stabilization and policy reforms.

2. The emphasis of adjustment lending operations has been on the creation of an appropriate macro-economic policy and incentive framework. The need to reduce the large fiscal deficits in many adjusting countries resulted in an emphasis on public expenditure rationalization, civil service retrenchment, and parastatal reforms. There was also a recognition that changed policies required effective, competent core organizations. This enhanced focus on public sector reforms coincided with an increasing awareness that the Bank's traditional concern with strengthening individual project implementation agencies/ministries was not achieving its objectives. This was because of macro-level problems such as weak civil service systems, poor personnel management and shortage of counter-part funds, which could only be addressed through economy-wide reforms.

3. The Bank's experience with adjustment lending and with public sector management reforms has been mixed. The Report on Adjustment Lending II (World Bank 1990d) notes that while Bank involvement in a country's adjustment program has, on average, been associated with better growth performance, more needed to be done to stimulate sustainable growth, which required substantial increases in efficient investment. This has been reinforced in the most recent Annual Report on Implementation and Supervision (ARIS FY90) (World Bank 1990a). The report notes that despite substantial adjustment efforts in borrower countries, the overall project performance has not improved significantly. This is attributed in part to the fact that a majority of countries still face large macro-economic imbalances. While external factors such as barriers to market access, high interest rates and adverse terms of trade have clearly played a role, the report also notes that, "Government failure or inability to implement fully and forcefully the needed structural adjustments continues to hamper the development of an enabling environment to sustain development operations".

4. The ARIS report points to the key role of governance in the quality of the Bank's portfolio. "In the better performing countries, governments show a strong commitment to reforms, have a well-defined set of priorities for development and make efforts for timely and result-oriented implementation...In contrast, countries with poor performing or deteriorating portfolios often suffer from a faltering macro-economic environment, frequent changes in government policies and priorities due to...political instability or social disturbances, weak public sector management and severe human resource constraints."

5. The accompanying PRE paper, The Reform of Public Sector Management: Lessons of Experience (hitherto referred to as the PSM paper), also notes that while what has been tried has yielded positive results "often in trying circumstances", the impact has been less than hoped for at the outset. Moreover, the timeframe within which results are achieved has proved to be much longer because of "obstacles of a socio-political nature that require patience and perseverance to overcome". Public sector management reforms, particularly in such sensitive areas as public expenditure policy and civil service reform are highly technical and intensely political. The extent of government commitment to reforms is a major factor in their success or failure.

6. The Africa Region was the first to articulate the link between overall development performance and what was called the "crisis of governance" in the Long-Term Perspective Study on Sub-Saharan Africa (LTPS) (World Bank 1989). The work of the Task Force on Governance has revealed that the problems highlighted in the LTPS were not confined to Africa. In a number of the Bank's borrowers,

the effectiveness of both adjustment and investment operations is being impeded by a poor supply response, weak institutions, lack of proper financial accounts, damaging discretionary interventions, and a lack of transparency in decision-making processes that feeds corruption and waste. Underlying these symptoms is the lack of accountability of policymakers and policy-implementers, an uncertain investment climate due to unpredictable and irrational government behavior and the lack of an adequate legal framework.

7. Not surprisingly, governance issues have begun to surface in the Bank's dialogue with borrowers in the context of country implementation reviews, lending and economic and sector work. There has been increasing attention to public sector management issues that deal with the capacity constraints to good governance. Policy reforms that reduce the area of government discretion have for sometime already been contributing to improvements in governance. However, the focus of attention has been rather narrow.

The External Environment

8. While the Bank has been weighing its approach to governance, a major debate is ensuing outside on issues of governance. This has been stimulated in part by the LTPS's frank discussion of the issue, as also that of the UN Economic Commission for Africa's "Alternative Framework Paper" (United Nations 1990). In part, this debate is in response to the rapid political changes in Eastern Europe, Latin America and Asia, and more recently in Africa, which represent the outcome of the growing dissatisfaction of people with their governments. Bilateral donors, taking a cue from these historic events, have been weighing their response to these developments. With the Cold War seemingly coming to an end, the strategic imperative that has driven bilateral aid allocation has waned in importance. Public criticism of official development assistance is also causing bilateral donors to be concerned about issues of the quality of governance and human rights in their aid policy.

The Bank's Mandate and Purposes of this Paper

9. The Bank has been grappling with concerns about governance at the same time that bilateral donors were embarking upon their own more political agenda. The Bank's concern, however, is with ensuring operational effectiveness and remaining within the mandate and comparative advantage of the Bank. Mr. Shihata, Vice President and General Counsel, took the initiative, before the debate over governance went any further, "to establish the legal framework for the Bank's dealing with this issue as a prelude to any future analysis of the manner in

which the Bank may take it on operationally". Mr. Shihata's legal opinion, dated December 21, 1990, and discussed at a Board seminar on April 12, 1991, sets out the five aspects of governance beyond the Bank's mandate:

(i) The Bank should not be influenced by the political character of the member. The form of government of the member is immaterial to the Bank. Thus, conditionality introducing "political transformation" would not be consistent with the Bank's Articles of Agreement.

(ii) The Bank should not interfere in the domestic or foreign partisan politics of any member. It should deal with the Government in charge, and act impartially with regard to the different political factors in the country.

(iii) The Bank, as coordinator of foreign assistance for a given country, should not act on behalf of donor countries in influencing the recipient country's orientation or behavior.

(iv) The Bank should not allow political factors or events (no matter how appealing they may seem) to influence its decisions, unless ...it is established that they have a direct and obvious economic effect relevant to its work. For these to be taken into account, such economic effects have to be preponderant. One exception is noted. The Bank must give "due regard to decisions of the Security Council under Articles 41 and 42 of the UN Charter".

(v) The staff should not build their assessment on the possible reactions of a particular Bank member or members to their analysis.

10. Mr. Shihata concludes from the above that "the Bank's purpose is not to substitute itself for the peoples and governments of its borrowing member countries in deciding how those countries are to be governed... Nor do the Bank's purposes allow it and its staff to be involved in the political reform of its borrowing countries, no matter how badly needed such a reform may be... The issue at hand is simply to identify aspects of governance which are relevant to the Bank's work and may, therefore, defensibly fall within its mandate, and aspects which are clearly political consideration which cannot be taken into account without breaching the Bank's articles". The General Counsel's memorandum then considers, by way of illustration, a number of areas that fall within the Bank's mandate: civil service reform, legal reform, accountability for public funds and budget discipline.

11. The discussion paper and this more detailed background paper are, therefore, a modest step towards the analysis of governance issues suggested by the General Counsel. The papers are exploratory in nature, defining the major concepts, discussing a few key dimensions of governance and reviewing Bank experience and best practice in these areas. They also attempt to identify key operational issues that might emerge as the Bank begins to integrate governance concerns into its country strategy and work program. They are intended to stimulate discussion within the Bank, to sensitize staff both to issues of governance and the sensitivities of borrowers, and to provide a means of seeking the guidance of Executive Directors as the Bank attempts to respond better to issues of governance. Part I of this background paper provides a brief overview of issues of governance and lists the dimensions of governance of concern to the Bank. Part II provides a more detailed discussion of three key dimensions of governance: accountability, openness and the rule of law, describing the Bank's experience with these dimensions and current best practice. Part III explores the implications of the preceding discussion for the Bank's operations in a preliminary and tentative way.

Issues of Governance

12. Issues of governance vary so widely between different regions of the world and within each region, and often within the same country, that they do not permit any easy generalizations. Nor is it practical to attempt a taxonomy classifying states say, by different governance problems. The complexity arises from the unique imprint of history on each country and the multi-dimensional nature of governance as a concept. Thus, within the authoritarian states, there is a wide spectrum ranging from countries with a high degree of concentration of power in the hands of one individual based on family hegemony, religious or military power or personal charisma, to countries with roots in traditionally hierarchical societies, such as the East Asian NICs which, while displaying lack of political openness, have demonstrated high levels of economic efficiency and achieved considerable success.

13. Within the democracies, there are at one extreme the well-established stable democracies with half a century or more of adult franchise and all the other institutions that go with democracy to countries that have only recently emerged from a long period of authoritarian rule, and others in between who have periodically gone back and forth between military rule and democracy.

14. Each country displays its own unique problems of governance. But poor governance is readily recognizable whatever the form of government. The key

symptoms of poor governance are, inter alia:

- a lack of capacity/ability to identify and decide on priorities, resulting in a misallocation of resources;

- the existence of numerous rules, regulations, licensing requirements, which impede the functioning of markets and encourage rent-seeking behavior;

- an unwillingness to make a clear separation between what is public and what is private, and hence the tendency to divert public resources for private gain;

- the inability or unwillingness to establish and apply a legal framework conducive to economic development;

- arbitrariness in the application of rules and laws; and,

- a lack of concern for the "national" interest, and the pursuit, instead of ethnic, regional or personal agendas.

15. When such failure, either in terms of capacity or volition, contributes to poor economic performance, governments tend to lose their authority over the people they rule. This erosion of authority reduces compliance with the rules of society. Authoritarian regimes often then resort to coercion to enforce compliance or to populist policies, which may have high economic costs, including higher than necessary expenditures on police and military forces used for civilian control (see paras. 116-120 below).

16. By the same token, good economic performance can enhance the authority of governments and increase the degree of confidence citizens place in it, whether or not this comes from good policies or fortuitous external circumstances. High commodity prices, for instance, may provide a cover under which poor governance survives. Thus, it could be argued that although poor governance is not a new problem, the good growth rates enjoyed by developing countries in the 1965-80 period cushioned the impact of poor governance on citizens.[1]

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[1]/ Low income economies other than China and India in the 1965-80 period enjoyed an average growth rate of 5.5 per cent, as against 2.0 per cent in the 1980-88 period.

17. There is, thus, a two-way relationship between governance and economic development. Exogenous shocks can contribute to poor governance by eroding the confidence of citizens in their government, and causing insecure governments to behave irrationally, but more directly by eroding the resource base. However, it sometimes takes a substantial deterioration in the economic situation before governments are willing to undertake reforms.

18. Underneath the natural calamities such as drought, as witnessed in recent years in the horn of Africa, are severe governance problems arising out of civil war and the failure to resolve ethnic and other disputes peacefully.

19. The relationship between governance and poverty needs further study. But to the extent governments, in the words of the 1991 WDR, "yield to the interests of narrow constituencies," they are prone to neglecting the poor who are disorganized, and unable to voice their views. This not only shows up in public expenditure priorities which are directed to the special interest groups but also in the lack of concern with distribution of income and wealth.

20. The most important underlying cause for poor governance is the low level of economic, human and institutional development. Poverty and illiteracy permit and encourage poor governance. The 1991 WDR shows the broad positive association among attributes of development, including civil and political liberties. It cites empirical literature on the relationship between economic performance and political systems: "by developing human resources and more particularly by investing in education, countries have been found to strengthen the basis for open political systems" (World Bank 1991b: 7.11).

21. Other causes of poor governance are a high degree of concentration of political power and the colonial inheritance. The impact of the latter has been particularly marked. On the positive side, many former colonies inherited Western systems of governance: systems of financial accountability, an independent civil service, and a legal framework. However, since they were imported from outside and were not a product of a genuine dialogue between rulers and the ruled, they have not always taken root.

22. Colonial rule implied accountability to the colonial power, rather than to citizens, sometimes destroying indigenous systems of accountability. In the West, accountability was demanded by citizens as a result of a struggle with the state over the collection of tax revenues and their proper use. It could be argued that in some of the poorer countries, aid flows constitute such a large

part of government resources that they perpetuate a colonial system of accountability to outsiders rather than to citizens.

23. Colonial rule has also frequently bequeathed large standing armies, thus diverting resources away from development and making fragile civilian governments prone to military coups and related political instability. According to data reported in the WDR, since 1948 there has been one coup attempt per developing country every five years (World Bank 1991b: 7.2). Governance has also been complicated by colonially imposed frontiers that have resulted in border disputes and ethnic strife. Often such strife has been fuelled by arms exports to rival factions/states.

24. These problems of governance are not unique to any particular form of government. Democracies often display some of the same symptoms of poor governance. Some authoritarian regimes have been relatively free of some of these symptoms and have delivered considerable economic success despite a lack of political openness. The East Asian NICs stand out in this regard.

25. The nagging question, given this paradox, is whether there is any relationship between democracy and development. Which comes first, democracy or development? This has been debated extensively. There are three schools of thought. First, that economic development sets in motion factors which evoke responses which lead inevitably to democracy.[2] Second, and a contrasting view, is that economic development requires a strong state which needs to exercise authority without the constraints imposed by democracy, such as pressures from special interest groups. A third view is that aggregating and then generalizing about countries will not lead to explanations - the problem is better analyzed through multi-variable analysis, in a more disaggregated manner. There have been several empirical studies of the relationships. To date the evidence is

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[2]/ A recent empirical study of 147 countries, their political structures and processes and the democratization process marshall data to argue that there is a process of natural evolution which takes place within and among countries as international trade and economic development increase. It is not that development "trickles down" but rather that structures go through their counterpart of Darwinian evolution. Structures lacking democratic features become obsolete and are either changed or atrophy. See Tatu Vanahnen, The Process of Democratization, (Crane Russak, 1990). This line of argument echoes that of an article reprinted in the Harvard Business Review (Sept.-Oct. 1990, pages 167-176), in which Philip Slater and Warren Bennis argue that because it is the only system that can successfully cope with the changing demands of contemporary civilization, in business as well as in government "Democracy is Inevitable." (The article was originally published in the HBR 1964).

inconclusive[3]. The 1991 WDR argues that while the relationship between forms of government and development is unclear, there is no evidence to support the view that "authoritarian governments, on average, show greater promise for achieving rapid growth". Looking beyond growth, there appears to be a positive association between political freedoms and civil liberties and progress in health and education (World Bank 1991: 16).

26. The complexity of governance issues described above is greatly enhanced by the rapid changes governments in the developing world are bringing about in the role of the state, the size of government and the structure of government. Thus, in much of Latin America, Eastern Europe, and parts of Asia and Africa, the relative roles of the state and the private sector are being redefined, with a de-emphasis by the state on production and marketing and a greater emphasis on creating an enabling environment and providing essential services such as infrastructure and social services. At the same time, governments are reducing the size of over-bloated bureaucracies, privatizing parastatals and, in the new or recently restored democracies, moving towards a substantial devolution of economic and political power. Since many of these reforms are being accompanied by major macro-economic and incentive reforms designed to strengthen the private sector, management of this whole process requires considerable skills in developing a political consensus around these reforms and structural changes.

Definition of Governance and Key Dimensions

27. Governance is a word that has recently regained currency. It means different things to different people.[4] For some, the concept is all embracing. Others prefer to define it more narrowly. Webster's unabridged dictionary defines governance as the "exercise of authority, control, management, power of government". We propose to use this definition.

28. Governance has three distinct aspects: (i) form of political regime, (parliamentary/presidential, military/civilian, authoritarian/democratic); (ii) processes by which power and authority are exercised; and (iii) capacity

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[3]/ See for example, Sorensen (1990) and Sirowy and Inkeles (1990).

[4]/ Thus, the 1965 edition of Fowler's Dictionary of Modern English Usage says of the word: "Governance has now the dignity of archaism, its work being done except in rhetorical and solemn contexts, by government and control". A certain number of words are described in Fowler's dictionary as archaisms, and such reference, when nothing more is said, is intended to "give warning that the word is dangerous, except in the hands of an experienced writer who can trust his sense of congruity"!

to design, formulate, and implement policies. The first aspect clearly falls outside the Bank's mandate. Capacity issues -- the third aspect -- interacts with how power and authority are exercised and will, to a lesser extent, be discussed. The PSM paper is the source for more thorough and detailed information about Bank work on capacity building and efficiency in the public sector. **The major focus will therefore be on the second aspect -- the way in which power and authority are exercised to promote economic development.**

29. Governance for development is largely about the processes, organizations and institutions that structure the relationships between governments and markets. Even in societies that are highly market-oriented, only governments can provide two sorts of public goods: rules and compensation for market failure. Without the institutions and supportive framework of the state to create and enforce rules, establish law and order, ensure property rights and control the money supply, production and investment will be deterred and the economy will not operate well within its technical production frontier. This is because high "transaction costs" (i.e., the costs of arranging, monitoring and enforcing contracts) would inhibit such activities.

30. The role of the state in compensating for market failure is more problematic. Governments in the 1970s relied on this rationale to rush into unwise investments in a vast range of activities. This has been responsible for much of the overextension of the state in the economic sphere. Frequently, however, it was their own interventions in the economy that created a disenabling environment for the private sector and which led to the so called market failures. There is nevertheless an important role of the state to provide key public goods, such as education and health, and essential infrastructure, particularly when such goods are directed at the poor, and when investment is not forthcoming from the private sector to provide these services. Such a provision of public goods can facilitate and enhance the quality of private investment.

31. To provide these goods, the state needs revenues. Citizens are willing, in principle, to pay taxes in order to receive these public goods, even if there are major disputes about the level of taxation. This then is the social contract in the economic sphere: a long-term contractual relationship between the state and its subjects based on the exchange of public services for taxes.
These services include both the establishment of rules that lower transaction costs and the provision of key services.

32. The state also needs "agents" who will collect the revenues from the public, who will produce the rules and the public services (the rule of law, education, health services, etc). This gives rise to the so called "Principal-Agent" problem[5] and requires systems of accountability: accountability of the government to its citizens; accountability of the agents of the government to the government, and accountability of agents to the people to whom they deliver services. Finally, for the system to work, there must be adequate and reliable information. Without this, rules are not known, accountability is low, and uncertainties excessive. Thus the rules, or predictability, accountability and openness are all key elements of good governance. Moreover, the institutional framework needed to provide these public goods must exist and must be managed efficiently.

33. It is beyond the scope of this paper to provide an analysis of the historical origins of good governance. But a survey of the literature (Brautigam 1991) reveals some key lessons from history: first, productive institutional arrangements take a great deal of time to bring about. Second, there is no guarantee that such arrangements will emerge. The state may be predatory or otherwise pursue strategies that hinder property rights. Its agents may behave in an opportunistic manner and indulge in rent-seeking. Thus, good governance does not automatically evolve over time; nor can one assume that progress is uni-directional. Citizens must demand good government. Governments must prove responsive to those demands. Neither can be taken for granted. Change occurs sometimes in response to external or internal threats. It also occurs through pressures from different interest groups. Donors and outsiders can contribute resources and ideas for good government, but for change to be effective, it must be firmly rooted in the societies concerned.

34. There are at least four dimensions of governance that are of direct relevance to economic development: (i) capacity in the public sector to design,

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[5]/ There is a growing body of literature on the Principal-Agent problem. Agency theory, as it is called, is "concerned with resolving two problems that occur in agency relationships. The first is the **agency problem** that arises when (a) the desires or goals of the principal and agent conflict, and (b) it is difficult or expensive for the principal to verify what the agent is actually doing. The problem here is that the principle cannot verify that the agent has behaved appropriately. The second is the problem of **risk sharing** that arises when the principal and the agent may prefer different actions because of the different risk preferences....The focus of the theory is on determining the most efficient contract governing the principal-agent relationship given assumption about people, (e.g., self-interest, bounded rationality, risk aversion) organizations (e.g. goal conflict among members), and information (e.g. information is a commodity that can be purchased.)" (Eisenhardt, 1989).

formulate and implement efficient policies; (ii) accountability; (iii) predictability and the rule of law; and, (iv) openness. What is meant by these concepts and the Bank's experience to date in these areas is briefly described below.

Capacity

35. "Capacity" relates to the ability of the public sector to design, formulate 77and implement efficient policies and hence, is an integral part of the governance dimension. The Bank has been heavily engaged in assisting its borrowers to improve management in the public sector. When such capacity is weak, there are potentially severe adverse consequences for the performance of the economy which cannot be overcome simply by better "political governance". While a more detailed assessment of the Bank's experience with public sector management issues is provided in the accompanying PSM paper, a brief summary is presented here.

36. At the macro level, the focus of the Bank's work in PSM, in the short to medium term, has been on the efficiency of resource use, with the objective of assisting borrowers to reduce their fiscal deficits. In the medium to long term, the Bank has been concerned largely with helping strengthen core economic agencies in their capacity to design, formulate and implement policies and programs. Three areas have received special attention:

(i) Civil Service Reform has featured in 76 operations, of which 52 were adjustment operations. Two-thirds of these programs have been to Sub-Saharan Africa. The main objective has been, in the short to medium term, to assist in reducing public sector wage bills, shed surplus staff and to rationalize the salary structure. For the long term, the focus has been on improving morale and productivity of the civil service and strengthening personnel management systems. Progress in this area has been uneven, with programs judged to be insufficiently "ambitious and forceful" to bring about the degree of change needed. In the future, more attention would need to be paid to longer-term civil service management issues to bring about the required improvement in administrative capacity.

(ii) Public Expenditure Management: Initially, the focus was on public investment programs. More recently, a wide range of public expenditure issues have been addressed such as fiscal policy, tax reforms, public debt, local government finance, operations and

maintenance expenditures and subsidies, and strengthening the budget process. The initial results have been encouraging, with significant improvements in budgeting and financial management in, for example, Uganda, Ghana, Nepal, Jamaica and Ecuador. Future directions include improved capacity for policy analysis and medium-term expenditure planning, better aid management and improved information systems.

(iii) Public Enterprise Reform: The emphasis has been on rationalizing the size and scope of the enterprise sector, improving the market and competitive environment in which enterprises operate, creating and strengthening effective institutions through which governments exercise their ownership function and assisting in the rehabilitation or restructuring of viable enterprises. The overall impact of reforms has been positive, with public enterprises playing a smaller role, and showing an improvement in financial performance. For example, Mexico, Philippines, Jamaica, Togo and Guinea have sold large portions of their public enterprise holdings.

37. At the sectoral level, the Bank has been concerned with strengthening key sector institutions for both policy analysis and project preparation and implementation. It has also been concerned with sector-level public expenditure and parastatal reform issues.

38. The Bank's work in this area remains of vital importance. The main lessons learned so far as described in the PSM paper are as follows. The initial results have been positive, often in trying circumstances. The effort has been frequently long and arduous, reflecting obstacles of a socio-political nature. In public expenditure management, widespread weaknesses of accountability systems have been reported. In the civil service reform, there is an important shift to improved personnel management. In all cases, the need for strong political will is noted. It is particularly difficult to ensure commitment to reforms over time. Tensions between economic benefits and political costs is central to reforms in this area. The PSM paper recommends greater selectivity in the choice of institutions to reform and a more explicit focus on countries where the chances of success are high, because of the level of government commitment.

Accountability

39. By accountability is meant the ways in which decision-makers at various levels, in a country are held to account for their performance by those governed. The range of mechanisms and systems of accountability vary widely, depending upon

the country's historical traditions, institutional capacities and the public's access to and use of information. Thus, openness is closely related to accountability and enhances it. In a well-developed system, accountability has several related components: (1) the existence of constitutional or legislated protection of the public interest through a code which regulates both public and private behavior; (2) the enforcement of such laws through specific institutions which receive adequate budgetary allocations and are independent of the political of the political system; (3) a set of social expectations reflected in an implied social contract between rulers and ruled which provides the social underpinnings of enforcement and compliance (Brautigam 1991).

Predictability and the Rule of Law

40. Predictability and the rule of law require a system based on objective rules which are actually applied and on functioning institutions which ensure the proper application of rules. Predictability implies "standard operating procedures, institutionalized rules, non-personalized decision-making, with modest levels of discretion and regularized procedures for establishing and implementing policies". In systems with high predictability, rules and regulations are clearly promulgated and applied indiscriminately, lines of authority are clear, and capriciousness is at a minimum. The civil service is depoliticized. When political leadership changes, the civil service provides continuity. The rule of law is a key element. When justice is administered impartially, when "due process" is followed and arbitrariness is limited, then the rule of law can be said to prevail. As noted in para. 29, without basic legal safeguards for the security of the person, for enforceable contracts and for property rights, the transaction costs to be incurred by investors are too high to justify investment.

Openness

41. By openness is meant processes that facilitate economic openness and transparency - the availability of information from public and private sources, tolerance for competitiveness over policy choices and public access to financial and economic data. Transparent systems have well-established procedures for public decision-making. Budget information is published, including military expenditures, "black boxes" are minimized, subsidies are stipulated, government procurement procedures are open and publicized, the hiring and firing of personnel is done under systems that are clearly set out.

42. Concern for open economies has its counterpart in open governance -- and for similar reasons. Just as closed economies harbor distortions, provide opportunities for unfair or inequitable treatment, or opportunities for rent-seeking or corruption, so does government in which policy choices and budgetary/administrative decisions are made in secret or without public debate. Public debate can provide a check on mistaken assumptions, clarify choices or flag unintended consequences of different economic policies.

43. Openness is critical to the proper functioning of systems of accountability and the rule of law. Without the free availability of reliable information, both within and outside government, economic and financial performance cannot be properly assessed and judged and corrective actions taken. Without dissemination of laws, court verdicts, etc., the legal framework necessary for a functioning economy is impeded. Yet, openness is also a complex issue. Since, as mentioned earlier in regard to the principal-agent problem, differential access to information is endemic to governments and large organizations. Sometimes, there are valid and important reasons for confidentiality. Openness as a goal, however, leads to clear rules about access, and timing of access, to information.

44. This paper now turns to a more detailed discussion of three dimensions of governance: accountability, the rule of law, and openness, drawing on the Bank's operational experience to date. As noted above, issues of public sector management are discussed in the accompanying PSM paper.

DRAFT

May 22, 1991

II - KEY DIMENSIONS OF GOVERNANCE

> "[Accountability] is found where rulers readily delegate authority, where subordinates confidently exercise their discretion, where the abuse of power is given its proper name, and is properly punished under a rule of law which stands above political faction."
>
> - John Lonsdale-[1]

A. ACCOUNTABILITY

The Nature and Scope of Accountability

45. Accountability at its simplest means holding decision-makers responsible for their decisions. Political leaders are ultimately responsible to their populations for government actions and this means that there has to be accountability within government as well as up the chain of administrative command. How this happens varies widely in different countries, depending upon history, political institutions, administrative capacities and the public's access to, and use of, information. At a broad level, economic objectives of public accountability include ensuring congruence between public policy and actual implementation, and the efficient allocation and use of public resources. This not only requires systems of financial accountability, but also the capacity and willingness to monitor the overall economic performance of the government. At the micro level, the primary concern is similar efficiency in investment and in the production and delivery of goods and services in the public sector.

46. Accountability is important throughout the economic system, not just within government. Governments also have an important role to play in ensuring accountability in the private sector, through company and securities legislation,

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[1] Lonsdale, 1986.

competitive policy, and regulatory oversight. As the state sheds many productive investments in developing countries, this function becomes particularly important.

47. Public accountability involves three inter-related groups: (i) the general public and particularly recipients of public services, who are interested in service providers being accountable to them; (ii) political leaders and supervisors of service providers, who would like the service providers to be accountable to them for a mixture of public policy and private/parochial interests; and (iii) the service providers themselves, with objectives and interests often different from the first two.

48. The phenomenon of "capture" of public services and resources by relatively narrow special interests is an ever-present problem in all countries. It is made worse by monopoly, and also by limited capacity of the public to demand and monitor good performance, especially since it is often hard to measure the benefits of public services. These factors make improvements in public accountability an especially complex and difficult undertaking.

49. The historical evolution of accountability reveals three features. First, micro-level accountability has become more important as the role of the state has expanded and made it impossible to apply broad political accountability to all the myriad actions of modern government. Second, the focus in public accountability tends to be on inputs, especially public expenditure, rather than on outputs or impacts, which are often diverse and complex to measure. Third, except for legal accountability for government action in some countries , accountability has mostly been by internal administrative controls by political leaders, government agencies and bureaucrats acting as proxies for the public. But hierarchical control is often ineffective, especially when collusion between supervisory and subordinate personnel is likely. Micro-level accountability, remains critical, especially in ensuring government responsiveness to the views and needs of the "publics" for which services are intended.

Macro-Level Accountability

50. There are two key aspects of macro-level accountability that are particularly relevant: financial accountability, and accountability for overall economic performance.

Financial accountability involves:

(i) A properly functioning government accounting system for effective expenditure control and cash management;

(ii) An external audit system which reinforces expenditure control by exposure and sanctions against misspending and corruption;

(iii) A political process that reviews and acts on the results of audits and ensures that follow up action is taken to remedy problems identified.

51. Without a well-functioning system of financial accountability, government-efficiency is poor, and the probability of corruption increases greatly. Corruption is clearly an issue of concern not only because of potential misuse of external resources (including the Bank's) but also because it generally reduces the efficiency of resource use (Box 2A).

52. The Bank has historically focussed on financial accountability, especially in the context of investment projects. The record is poor. Compliance with Bank accounting and auditing covenants has been uneven. Five months after the end of FY1990, only 40 percent of project audit reports due during that fiscal year had been received in the Africa Region, 74 percent in Asia and and average of 58 percent Bankwide. There is a growing recognition that the problems encountered in these areas are not project specific but are symptomatic of weaknesses in country wide financial accountability. The need

BOX 2A

Reflections on Corruption

Corruption is the misuse of power for personal gain. Many people, anywhere, can be tempted to misuse power for personal gain, if permitted to do so at no cost or risk to themselves. Thus, corruption occurs in all countries in many different forms. It tends to emerge and increase in any country when inequalities are acute, resources scarce, rules unclear, disclosure and punishment unlikely, and upward mobility is restricted. Efforts to reduce its incidence need first to identify the kind of corruption (graft, bribery, theft, conflict of interest, nepotism, bias, or favoritism), its frequency (pervasive, occasional, or intermittent), and its perpetrators (contractors, public officials, political elite, businessmen, foreign suppliers).

The causes of corruption relate to political and economic conditions within the society and their linkages to problems in the world economy (Theobald 1990: 10-11; 161-169).[8] As such, causes are as complex as types of corruption are varied. While distinguishing between symptoms and causes is important, sometimes symptomatic relief provides opportunities for needed social and economic change leading to more lasting "cures". For example, bribery of public officials allocating essential licenses can be mitigated by clear rules, disclosure, and effective enforcement. Further, the amount of licensing can be reduced with clear rules. The longer-term measure of civil service reform adds more long lasting relief. Only over time, and with major policy reform, can improved economic performance increase economic opportunities and thereby provide the environment and context for diminished corruption. Yet, every generation has to make its own struggle against its resurgency.

Competition, clear rules, and disclosure are important first steps. Many countries have sophisticated and strict laws addressing corruption. Yet the existence of legislation alone is insufficient. The problem may lie with a lack of dependable enforcement. Simultaneously with enacting legislation, the strength and independence of the judiciary has to be secured[9] (Rigo and Gruss 1991: 24).

Many political leaders in countries with serious poverty have amassed extraordinary fortunes. Foreign exchange reserves were transferred to foreign bank accounts. Such abuse, needless to say, adversely effects economic

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[8]/ This is the thesis of one of the more thoughtful books on this complex issue by Robin Theobald, Corruption, Development and Underdevelopment, (Duke University Press, 1990). See pages 10-11; 161-169.

[9]/ See Chapter II-B.

development. It unleashes cynicism which corrodes public trust -- and signals to others to do likewise. Private wealth accumulated through abuse of power amidst public squalor undermines legitimacy. Yet graft on this large scale is not possible without collusion between major private corporations and public agencies. Often the "commissions" are paid by foreigners --foreign contractors, companies, or consultants. Sometimes such activity is associated with foreign aid. Foreign companies allege that bribery is but one of the costs of doing business in a country. Financing necessarily flows through different agencies; a percentage "take" off the top is considered wide recipients to a fee by some, a kickback by others.

What, if anything, can donors do in these circumstances? In part, the recommendation for countries is also true for donors --reduce the number of unnecessary regulations, and rely more on market forces, ensure that laws are observed. Insist upon meeting procurement and contracting standards, up on meeting audit requirements, study audit reports, pay attention to the manner in which disbursements are handled. Even with these safeguards, the problems are daunting. Aid coordination provides another venue for flagging the importance of supervision, audits, and attention to disbursement processes. Audits may be required, and not always performed, or where performed, they may not be read. Project supervision is difficult to maintain in the best of circumstances; when donor agencies are pressed to do more with fewer people, supervision suffers.

However, donors need to recognize their role and responsibility in this problem. The use of donor funds to finance large infrastructure projects has helped intensify competition for such projects among suppliers and associated malpractices. The DAC Working Party on Financial Aspects of Development Assistance has been wrestling with the issue of the trade-distorting effects of subsidies tied aid credits with a view to developing fair trade practices and introducing the benefits of ICB on large projects.

Should the international community move towards clear and simple guidelines on appropriate conduct for procurement and contracting? Should companies, contractors, or consulting groups identified as having participated in graft, bribery, or larceny be blacklisted among donors? Is now the time for international cooperation to limit opportunities for corruption -- a contribution towards the international rule of law?

for improved financial accountability at the national level is of particular relevance in countries where the Bank is undertaking adjustment lending and is, in effect, providing substantial resources directly to government budgets.

53. To address this issue, the Bank is pursuing a three-pronged strategy. First, it is trying to improve borrower performance through stricter enforcement and the introduction of penalties for non-compliance. The penalties include not extending closing dates, conditioning further processing of loans to compliance with requirements on past loans and suspending disbursements.

54. Second, it is trying to encourage more systematic review of auditing and accounting capacities and needs during project preparation, and encouraging greater contracting out for project accounting and audit services.

55. Third, it is helping to strengthen borrower capacity through country-wide reviews of auditing and accounting systems, and following up with assistance. In Ghana and Madagascar, Economic Management Support Projects aim to remedy deficiencies in public financial management in those countries. The projects would clear the backlog of government accounts and introduce new accounting methods and software to improve the accuracy and timeliness of financial data. Similarly, the Development Management Project in Mauritania helped to establish the Office of Auditor-General. Audit systems in the banking sector are being reformed in Poland and Algeria, while Poland has also requested technical advice on audits and evaluations of government programs and accounts. In January 1990, the Africa Region set itself a target of 12 projects or project components aimed at strengthening financial management capabilities of borrowers through FY92. The Asia Region established a Task Force on Auditing which also suggested the need for a more comprehensive approach to the problem. In Indonesia, the Bank is supporting a comprehensive Accountancy Development Program (Box 2B). These country-level reviews need to focus on coverage, timeliness and quality of financial control of projects and public expenditures, but also take account of legislative or other review of government policies and programs and of public access to information.

BOX 2B

Indonesia-Accountancy Development Project

Indonesia's government accounting practice had changed little since the 1864 Dutch Financial Administration Act. Finding that they could not cope with the increasing complexity of government financial transactions, the government requested Bank support for an accountancy project. Budget reports and financial statements did not provide a comprehensive view of financial situation and were often delayed. It took three years before government expenditures for a given period were reported to the Parliament.

In the private sector, the accounting system had fallen behind other skills required in industry and commerce. The shortage of trained accountants and managers who could produce and use accounting information was severe. The professional body of accountants -- the Indonesian Institute of Accountancy -- was relatively young and lacked detailed accounting and auditing standards to guide the profession, a code of ethics and disciplinary processes to regulate it.

The Bank-financed accountancy development project will address all these areas by:

- improving accounting practices in the public sector by supporting the introduction of modernized government accounting;
- improving accounting practices in the private sector by supporting the development of technical standards and a code of ethics for the accountancy profession;
- supporting the government's program to raise the quality of accounting faculty and to prepare for future expansion of accountancy education and training; and,
- improving the legislation on accounting, auditing and disclosure requirements.

The modernization of government accounting is being carried out with the use of local and foreign specialists who are assisting in the design of a uniform chart of accounts and a clear and specific classification of expenditures. Similar changes in accounting practices will be adopted by public enterprises and by lower levels of the government.

With regard to private sector accounting, the World Bank will support the Indonesian Institute of Accountants to continue the Certified Accountant's professional education. Accounting principles and auditing standards will be formulated for more consistent financial reporting by commercial and industrial businesses and a code of ethics will be developed.

In accounting education, the Bank will finance programs for personnel development, procurement of teaching equipment and materials, research, fellowships to train accounting teachers, and loan programs for institutions and students. The improved quality of accounting programs in universities and institutions will permit expansion of accountancy enrollments and increase the supply of accounting professionals.

The project will be implemented over five and half years. Its total cost is US$162.5 million, of which the Bank loan will finance US$112.0 million.

56. Accountability for Economic Performance: In some industrial countries (and a few developing countries), a current wave of public sector management reforms seeks to raise the efficiency with which public resources are used by giving public managers greater freedom to run their operations but substantially increasing their accountability through objectives, specific targets and performance monitoring. There has also been an attempt to link such efficiency concerns to broader notions of performance in implementing government policy objectives. This accountability is sometimes reflected in contracts, programs or memoranda of understanding (a device which a number of developing countries have also adopted in the context of parastatal reforms), which are negotiated by heads of government departments and chief executives of public enterprises. This is accompanied by a movement away from a single year to a medium-term budgetary framework that provides managers with a stable resource stream. Alongside this, accounting systems and internal auditing are being strengthened, with increased emphasis on cash management and in some cases accrual accounting. The audit function is now being widened to include not only financial probity but also "Value For Money" audits.

57. The applicability of these innovations to developing countries will vary. Some of the Bank's borrowers are probably ready for reforms along the lines described above. However, in most countries, the basic accounting and auditing systems are not in place. Greater autonomy to managers must be linked to improvements in financial information systems. Similarly, only when financial audit systems are functioning well can VFM auditing be considered.

58. The Bank could however, do more to strengthen the overall monitoring and evaluation function, currently largely donor driven and project specific. Yet in many countries, departments are required by legislation to prepare annual reports on their activities. Some countries have performance monitoring ministries. OED has tried to encourage these activities, and the Bank could give considerably more attention to strengthening the monitoring and evaluation function in governments. This will need to be a gradual process, given the competing claims on resources, but it is not a function that should be neglected.

Decentralization: The Macro-Micro Linkage

59. Decentralization is an increasingly common phenomenon in Latin America, Asia and Eastern Europe. In theory, it can lead to significant improvements in efficiency and effectiveness by reducing overloading of central government functions and improving access to decision-making and participation at lower levels of government, for example by improved service design, user financing targeting and delivery. (See Box 2C)

60. However, if not carefully managed, decentralization can lead to a deterioration in the use and control of resources, especially in the short-term. National goals can be seriously distorted by local governments and scarce resources diverted to misuse. Moreover, radical decentralization can seriously weaken the capacity of the central government to manage the economy through fiscal and monetary means. In the late 1980s, Argentina's provincial governments were responsible for the largest and fastest-growing portion of the public sector deficit. Apart from the potential damage done to macroeconomic stability and expenditure efficiency, resources are arguably more open to capture by elite groups at the local level than at national levels.

61. Perhaps the most serious problem is weak administrative capacity at local levels, leading to waste and corruption. The poorest local authorities, whose constituents stand to gain the most from improved delivery and targeting of social services, are precisely those least able to manage increased responsibilities.

62. The Bank's present approach to decentralization and local government development relies heavily on financial tools to ensure efficiency, including cost recovery for municipal services. An upcoming study on decentralization in LAC countries points out the need for a more comprehensive strategy, suggesting that greater attention be given to mechanisms such as hearings or surveys, which allow local preferences to be ascertained. In Mauritania, a project helped to establish the institutional framework for the creation of municipalities. In

BOX 2C

DECENTRALIZATION IN POLAND AND ROMANIA

Perhaps the most important phenomena widely present in Poland and Romania at the beginning of this decade are: (a) political liberalization; and (b) recognition that macroeconomic adjustment and reform of the state are prerequisites to sustainable economic growth. Closely linked to both of these phenomena is a significant movement to decentralize the public sector.

Strengthening local government is widely viewed as essential to ensuring greater responsiveness and accountability in many infrastructure and service areas that have been dominated from the center in both delivery and financing aspects. Development of political and institutional means to hold local government authorities accountable to their constituents is important because much of the justification for public sector decentralization is based on the premise that many areas of infrastructure and services are provided more efficiently at the local level since beneficiaries can better express their demand for these services, control costs and hold local authorities accountable for their actions.

Decentralization of the public sector in Poland and Romania requires fundamental reforms in the expenditure and financing responsibilities of local governments. Fiscal chaos could ensue if local revenue capacity is not enhanced and intergovernmental fiscal transfers are not controlled. A collapse of local infrastructure and services is likely if local expenditure assignment is not matched with revenue authority and local institutional capacity. Local government reforms must include, therefore, fiscal reforms at the national and local levels and local government institutional strengthening. These reforms also will be crucial to stimulating increased private sector productivity, not only through improved delivery of public infrastructure and services, and a prudent regulatory framework, but also because local governments will be key to implementing an effective policy of property rights through legal cadastre that provide security for the transfer of property.

Local governments will be key implementing institutions for the Bank's pipeline of proposed projects in both countries, primarily in the areas of infrastructure, the social sectors, environment, rural development and poverty alleviation. However, before these decentralizing countries may absorb effectively lending operations, local governments must be strengthened to discharge effectively their new and growing responsibilities. Key areas for institutional strengthening include: local taxation policy and administration (and consistency with national taxation policies); management of local enterprises (e.g. privatization and/or regulation in areas such as water supply and sanitation, transport, solid waste and housing); budgeting, accounting and audits; maintenance programming and implementation; investment planning and evaluation; and procurement practices.

Because decentralization in these countries comes after decades of tight, central control, the pace and scope of the decentralization process are issues of concern for the countries and for the Bank, and all recognize that there is no broadly recognized "road map" for public sector decentralization. (For

example, there is also the Hu ngary CEM which focuses on public sector reform and decentralization.)

Therefore, the Bank's strategy for assistance to the decentralization process is broad and country-specific, but the short-term strategy is evolving in four key areas: (a) policy dialogue and possible inclusion of local government strengthening measures as part of SAL conditionality; (b) country and regional sector work on local government reform (e.g. regional work in FY91 and local government reform in Poland for FY92); (c) targeting technical assistance on local government reform (e.g. local government component of Infrastructure Technical Assistance Loan to Romania); and (d) highly selective project support through lending operations in areas critical to overall adjustment and reform (e.g. proposed housing project loan to Poland).

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this instance, local elections followed, providing the public with one accountability mechanism. Other initiatives could focus on strengthening the oversight function of national government. Venezuela has successfully used an executive council (COPRE) to marshal ideas, try out policies and legislation, and develop guidelines and administrative models. Future Bank efforts such as the Africa Municipal Development Program could build on these experiences.

Micro-level Accountability

63. Micro-level accountability can reinforce macro-level accountability when: (i) there is competition, or scope for the public to "exit" when dissatisfied with a service.[2] This can have a salutary effect on the agency concerned, through a reduction in its revenues and a related threat to the careers or pay of its staff; (ii) there is participation, so that the public can influence the quality or volume of a service through some form of articulation of preferences or demand. If such "voice" makes the public agency more responsive, accountability is enhanced. In the National Irrigation Administration in the Philippines, the exercise of voice resulted in a greatly improved irrigation system (Box 2D). Often however, competitive provision is more efficient except where national monopolies or market failure are predominant -- and it is undesirable to regard participation mechanisms as a substitute for (rather than an adjunct to) the availability of alternative providers. In any case, there are inherent problems (free riding, elite dominance, resource diversion)[3] in collective action: the costs and benefits of "voice" options need to be evaluated case by case.

64. Legal and policy-induced barriers to exit and voice are more easily dealt with; natural barriers, such as spatial barriers (e.g., an isolated village can afford only one school) are more difficult to remove. Services that the poor

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[2] The concept of "exit" and "voice" are borrowed from Albert Hirschman, Exit, Voice or Loyalty, (Yale University Press, 1970).

[3] See Olson (1982).

BOX 2D

The Philippine Communal Irrigation Program

In May 1982, the World Bank approved a US$72 million loan to the Philippines for a communal irrigation program that would involve the participation of farmer beneficiaries in all phases of the project planning, design, and construction of the system. The project would involve construction or rehabilitation of 144 communal irrigation projects covering about 33,500 hectares in 35 provinces of 11 regions. After completion of a system, the farmers would assume full control of its operation and maintenance.

The project was remarkable in two ways: first, it was one of the most participatory projects ever to involve the Bank. Second, the initiative for the participatory approach came from a government agency, the National Irrigation Administration (NIA), which had been developing and testing the participatory approach for five years. NIA had launched its participation originally for its first participatory project, and expanded gradually to allow cumulative learning.

Before the participatory approach was introduces, nearly all of NIA's professional field staff in charge of communal projects were trained exclusively in technical subjects such as construction, design, and survey. The participatory approach, however, required the addition of staff oriented toward people and trained in building the problem-solving capacities of local people. Consequently, NIA hired community organizers who could work with the farmers to develop irrigation associations.

NIA hired six community organizers for its first participatory project in 1976. By early 1983, the number had expanded to 401. Of that number, 295 worked on communal projects and 106 on national projects. The gradual approach to expanding the program allowed the community organizers to accumulate learning. Organizers who worked on initial projects became the trainers and supervisors for later arrivals.

Evaluations in 1989 concluded that:

> "It is clear that participation produced consistently positive results. The canals and structures were viewed by the farmers as more functional and the system was more productive, with greater increases in rice yields and in irrigated area in the dry season. The irrigation associations were more likely to use water distribution methods that assured greater equity of water access to the members and were more likely to use sound financial management practices. They contributed more to construction costs at the time of construction and subsequently paid a greater percentage of their loans due. The costs of achieving the wide range of benefits demonstrated for the participatory projects was only 3% of the total cost of construction."

This program, widely studied around the world as a model of the possibilities of increasing effectiveness and sustainability, is still under way. A new Bank loan in 1988 for the operation and maintenance of the national system (which is distinct from the communal system) provided funds for community organizers and farmer training. Work has begun on a follow-up loan for the communal program.

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(weak voice) require and for which alternative sources of supply are difficult to find (low exit) will be the most difficult to deal with.

65. Exit mechanisms: There are several possible exit mechanisms, notably deregulation and contracting out of services to multiple private providers. The key element is contestability: when incumbents are made to bid for contracts along with outside competitors, they will be more careful about their performance and their terms. Similarly, when regulations favor new entrants, the knowledge of potential entry can mitigate monopolistic behavior on the part of incumbents. New technologies can be used to broaden choice and access (e.g. mobile courts, mobile schools and health or the use of VCRs or television for education).

66. Voice mechanisms: Dissemination of information about services can aid the public in demanding greater accountability from service providers. Periodic evaluation of services can exert pressure. For example, a poll of beneficiaries' views on the service or the gathering of data from both beneficiaries and service providers can sometimes be an effective alternative to elaborate participation arrangements. Complaints procedures and institutional mechanisms such as ombudsman are ways of providing voice when there is no need or incentive for collective action. These mechanisms are in place in countries, and their effectiveness varies widely: in particular, elites tend to make the most use of these services. Consequently, they are most useful to the poor when the service is "non-excludable," like drinking water.

67. Participation of public representatives in decision-making or regulatory bodies is one way of enhancing "voice." Users representatives, for example, can be appointed to the board of directors of these organizations or hold equity shares of utilities. Where direct participation of users in decision-making is difficult or inappropriate, a consultation process can be instituted through public hearing, advisory panels, etc. When all else fails, legal action by consumer action groups is a possibility, though not common in developing countries.

Governments and NGOs

68. A number of developing countries have witnessed a mushrooming of private voluntary organizations (e.g., India, the Philippines, Bangladesh, Kenya, Zimbabwe, Senegal, Colombia and Chile to name a few), while some other countries clearly have not (e.g., C.A.R. or Malaysia) and depend much more heavily on governmental organizations and initiatives. Various factors contribute to the emergence of a strong voluntary sector, among them culture, level of development, and the stimulus provided by the influx of external NGOs after a natural disaster.

69. A powerful factor clearly is government hostility or encouragement. Enabling government policies include most basically the freedom of speech and association. Regulatory policies can also help or hinder NGOs. Many governments are suspicious of NGOs precisely because they are a channel to the poor. There is thus a tendency to coopt NGOs and make them mere extensions of the state or to create a dependency syndrome. Direct donor funding of NGOs can be an important means of supporting NGO activities. But it carries with it a number of attendant risks including shifting NGO accountability from their natural constituents to donors, and making them vulnerable to subtle pressures from governments who must approve direct funding of NGOs.[4] The existing literature (mostly sponsored by bilateral donors) shows that NGOs tend to be effective at reaching low-income groups, especially in remote areas, and at working in a relatively participatory way. They tend to be weak in planning and administration. NGOs' most important contribution is not service delivery but a pilot role for social initiatives developing new approaches which are sometimes replicated on a larger scale. The role of NGOs needs to be more fully evaluated. The relationship between the State and non-government organizations also bears further research and reflection.

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[4] For an interesting discussion of these pitfalls, see Alan Fowler's "NGOs, Official Aid, Democracy and the State in East and Southern Africa," Overseas Development Review, March 1991.

The Bank's Role in Promoting Exit and Voice

70. The Bank is active in promoting deregulation and improving the working of markets in structural adjustment loans, in parastatal reforms and in much of its sector lending. The Bank has in recent years also worked to expand participation and the involvement of NGOs in Bank-financed projects. In FY89 and FY90, NGOs were significantly involved in 50 of the projects the Board approved. In some sectors, most notably agriculture and population, NGOs are contributing significantly to effective project implementation. NGO criticism, although sometime unduly harsh, has nevertheless contributed to the redesign or improved implementation of a number of Bank-financed projects.

71. Voice can also be enhanced through **popular participation** in the design and implementation of Bank-financed projects. Bank experience suggests that participation can be important to project success and sustainability. It is especially useful for activities focussed on particular communities and dependent on their active cooperation, but it is also relevant to large scale infrastructure projects. Participatory approaches in Bank projects have been tested successfully in sectors (notably, irrigation, forestry, livestock and agricultural credit, urban development and rural water supply, health and nutrition, environment and social investment funds). The Bank has recently embarked on an effort to learn better how to foster popular participation in Bank supported activities (BOX 2E).

72. Systematic attention to "exit" and "voice" options should be considered at the design stage of relevant Bank projects, to complement the strengthening of internal control systems. The use of such mechanisms, however, will cause accountability to improve only when this leads to a change in the behavior of the service provider--its efficiency, access, and quality of service, not just its compliance with internal rules. This must be reinforced with incentives that reward responsiveness to users and the wider public.

73. Accountability at the micro-level will, in turn, be sustained only when the government and society at large are concerned and wish to improve it.

BOX 2E

Popular Participation and the Bank

"We affirm ... that the economic crisis cannot be resolved ... without the full and effective contribution, creativity and popular enthusiasm of the vast majority of the people."

-- ARUSHA, 1990

Popular participation is the process by which people, especially disadvantaged people, influence decisions which affect them. The term "popular" refers not only to the absolute poor, but also to a broader range of people who are disadvantaged in terms of wealth, education, ethnicity, or gender. "Participation" means influence on development decisions, not simply involvement in the implementation or benefits of a development activity, although those types of involvement are important and are often encouraged by opportunities for influence.

The World Bank has learned from its experience that popular participation is important for the success of projects economically, environmentally, and socially. The most important lesson has been that popular participation is a question of efficiency, as well as being desirable in its own right. In one study, the Bank evaluated 25 projects five to ten years after completion. Strong beneficiary organizations (an instrument of facilitating participation) proved to be a key factor in determining project sustainability (World Bank, 1985). Another study of 68 Bank-financed projects found that the economic rate of return was twice as high for projects which had been sensitive to local social and cultural realities (Kottak, 1985).

The Bank's experience with participatory projects is limited, but growing. Participatory approaches have most often been adopted in projects designed to help particular communities--agriculture, especially irrigation, forestry, and livestock; urban development and rural water supply; population, health, and nutrition. Social investment funds are a promising way for governments to support community-initiated micro-projects. A recent review reveals that in virtually every participatory project the Bank has financed, participation has contributed to project effectiveness (World Bank, 1990b). Individuals, households, groups, and communities are more likely to have a stake in, contribute to, and maintain projects which respond to their needs, knowledge, and initiative.

But popular participation is also valuable for bigger projects. The Bank's experience with environmental issues and adjustment loans indicates that public consultation and information sharing can improve the design and build public support for large-scale investments and policy decisions. This approach is working, for instance, in Mexico's Hydroelectric project, India's Upper Krishna Dam project, and Ghana Private Investment and Sustained Development Promotion Credit.

Operations and PRE are pursuing a modest program of action and learning, supported by SIDA trust-fund resources, designed to strengthen the Bank's support for popular participation where this would contribute to the development effectiveness of Bank-related operations. Learning is being stressed because there are relatively few large-scale participatory development projects in the developing world. It is important to learn in what situations participation is worth the effort, and, in those cases, how the Bank and borrowing governments can effectively promote participation more widely. To date, Bank-supported participatory projects have been the exception rather than the rule, sometimes stemming from the personal commitment of individual task managers.

In most situations, the constraints on popular participation are external to the Bank (the intrinsic difficulties of engaging low-income people in project decisions, for example, and reluctance on the part of some governments). But improvements in income and education, together with increased interest among borrowing member governments, are relaxing external constraints in some situations. While grappling with the problems of making government implementing agencies more people-centered, the learning process is focussing especially on ways the Bank's own operational practices could be more supportive of participatory approaches.

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BOX 2F

Improving Accountability and the Environment

The deteriorating quality of air, water and land resources in many developing countries is linked to problems of accountability and capacity. Government decision-makers in charge of natural resource management often contribute to environmental deterioration through poor management decisions. Poor decisions are a function both of inadequate incentives, and of an inability to project the actual effects of well-meant decisions or to evaluate alternative uses of scarce government funds.

Environmental resource management is further complicated by the multi-sectoral nature of many decisions. Water resources, for example, are affected by solid waste systems, storm water drainage, the demands of commercial, household and recreational users, and the requirements of ecological habitats.

Research currently underway in the Bank addresses this problem. The "Service Level Indicators for Capital" (SLIC) research sponsored by the International Economics Department is seeking service level indicators for public facilities (sewerage, water, etc.) and for natural resources, based on measures of quantity, quality and reliability for both users and decision makers. Included in this research effort is a framework for applying Service Level Indicators through Benefit/Cost analysis. This extends the usefulness of these measures into investment decisions. SLIC creates a bottom-up measure of resource performance, provides an information base which allows users and managers to view how decisions are made and the effects they have, and establishes a transparent accounting framework for government service and natural resource decisions. based on the level of services they provide to users. SLIC indicators are currently being formulated in a number of different Urban Development projects in Indonesia.

For example, service indicators for water resources can be related to the specific uses described above for water resources. Indicator sets for each purpose would be specified by aggregating relevant measures. Service levels for industrial or agricultural water supply users would be based on physical measures; for household water users or recreational users, service levels might be based on total health risk; for ecological habitat, service levels could be the number of viable ecosystems exposed to risk in the river stretch or habitat area.

By identifying and monitoring the specific environmental quality measures identified as important by decision-makers and users, SLIC will improve the effectiveness of infrastructure and natural resource management decisions, and help establish operations and maintenance priorities for public infrastructure. In addition, by measuring these indicators over time, SLIC should be able to establish trends in environmental resource quality, improving natural resource accounting and defining more precisely the relationship between natural resources and economic development. And as SLIC enables line managers to make better decisions, publicly available service level indicators can also enable users to hold service providers accountable for the level and quality of the services they receive, both from government facilities, and from other providers.

Comparative information on how different countries perform in respect of key public services can be a powerful tool to generate national and international interest in this area. Selected performance indicators based on good professional judgement can be assembled on these services from as many countries as possible for wide dissemination (including the WDR) (Box 2F). It will provide the data for governments, scholars, media and the public at large to see where they stand in respect to the level and quality of their services. The Bank is well positioned to initiate this exercise.

B. THE RULE OF LAW

74. The literature on the rule of law is voluminous and the concept lends itself to endless discussions at jurisprudential level with limited practical relevance. The emphasis here is on a pragmatic view of the rule of law in the context of Bank economic development and Bank operations.

75. Mr. Shihata has defined the rule of law as "a system based on objective rules which are actually applied and on functioning institutions which ensure the appropriate application of such rules" (Shihata 1991: 42-43).[15] There is empirical evidence that investment is adversely affected by uncertainty. Investment will not take place and will not succeed without a system which provides a minimum of stability and predictability.

76. Stability and predictability create a climate where business risk may be rationally assessed and the cost of transactions lowered. In turn, the rule of law is a necessary condition for stability and predictability. It is primarily this connection of the rule of law with the level of investment and the more efficient use of resources that explains its importance as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself. It is only to the extent that it establishes some of the pre-conditions for economic development that it is legitimate to bring it within the purview of the Bank. As we will see below, the aspects of the rule of law are varied and so are the views about them. Not all have the same bearing on the purposes of the Bank.

77. From the great variety of definitions, two major aspects of the rule of law emerge. The first is sometimes called the instrumental notion of the rule of law. It concentrates on the formal elements necessary for a system of law to exist without judging the content of the laws or their purpose.

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[15]/ hereinafter "Issues of 'Governance'".

78. The second aspect refers to the content of the law and is linked to concepts such as justice (e.g. the element of due process), fairness (the principles of equality) and liberty (civil and political rights). In the view of many, the formal aspect has to be complemented by substantive principles of the rule of law to create a "fair" legal system. In terms of the Bank's work, a "fair" legal system would have to be conducive to balanced development, e.g. a system which facilitates growth and responds to the needs of the poor. These would seem to represent issues the Bank is normally concerned with in its project and policy lending. They are outside the scope of this analysis which focusses on the basic "processes of the formulation and application of rules," (Shihata 1991: 45) and analyzes each of the five elements listed in "Issues of 'Governance.'" In so doing, we incorporate the Bank experience so far, and draw conclusions for Bank operations and the relationship of the rule of law with the other elements of governance considered in this paper. The five elements are: (i) a set of rules known in advance; (ii) rules to be actually in force; (iii) mechanisms to ensure application of the rules; (iv) resolution of conflicts through binding decisions of an independent judicial body; and, (v) procedures for amending rules when they no longer serve their purpose.

A Set of Rules Known in Advance

79. This comprises three elements: the existence of rules as a set (denoting coherence), their communication (with accuracy, clarity and effectiveness) and the application of rules only known in advance (non-retroactivity of laws). Communication and coherence are two elements with which the Bank has been concerned. As regards communication, many developing countries inherited formal rules for the communication of laws similar to those of the metropolis. Frequently, the obligation of governments to disseminate new laws was and still is limited to their publication in gazettes. The law is available but the citizens have the burden of acquainting themselves with the law.

80. Publication of the official gazettes in many countries has ceased. The Bank has assisted, or is in the process of assisting, several countries to restart at least publication of the gazette (Box 2G). It is also assisting in making

BOX 2G

Communication of the Law

MAURITANIA: Development Management Project (Credit 1865 MAU)

The publication of the Mauritanian Official Gazette was done under a contract between the Government of Mauritania and a French printing company located in Bordeaux. This arrangement was however not effective and the Gazette was rarely published. Then the Government of Mauritania, with the assistance of IDA and the French Government, decided to print and publish the Official Gazette domestically. To do so, a contract was awarded to a private printer and the functioning of the Department of the Legislation (Services of the Presidency) were improved within the framework of the above-mentioned IDA Credit. The French Government provided technical assistance in the preparation of the Official Gazette using the French Official Gazette as a model.

The Official Gazette which had not been published for over two years, has now been published in French and Arabic on a monthly basis for the last two and a half years.

GUINEA: Second Economic Management Support Project (Credit 1963 GUI)

The Guinean Official Gazette was experiencing delays of up to two years in the printing of its issues. In order to correct this situation, the Secrétariat Général du Gouvernement (SGG) obtained, as part of this project, US$80,000 from USAID to finance printing of the Official Gazette for two years, and signed a contract with a private printing company to ensure its regular publication. In addition, the contract provided that the backlog caused by the two-year delay in the publication of the Gazette be gradually eliminated.

As of January 1989, the Official Gazette has been published fortnightly. Texts of a general nature and government decrees are published within a month of their signature. The backlog of previously unpublished legislation is being cleared.

The SGG is responsible for the distribution of the Official Gazette within the Government and the subscriptions and sales to public. It is expected that, as revenues from legal notices increase, the Official Gazette will be able to fund itself.

LAO PDR

In 1975 the National Congress of the People's Representative in the Lao People's Republic abolished the former constitution and all existing laws and regulations. In 1989 the government endorsed the establishment of a new economic mechanism, separating the state's administrative and regulatory function from production activities and increasing the role of the private sector. Under a component of a UNDP funded project supporting the New Economic Mechanism, the Bank will assist the government to prepare and implement key economic and

financial legislation, to train lawyers in business law and to establish a center of economic law. As part of such activities the project will make a proposal to the government to establish an official gazette to publish and promulgate new laws and regulations.

the law more accessible and better known within the government itself.[16] However, in many developing countries, large segments of the population are illiterate, the media are ineffective and languages are diverse. Under these circumstances, there are obvious limitations as to how much the law can be known and understood by the average citizen and it is necessary that law be as clear and explicit as it is technically feasible.

81. To the extent that economic policies must be reflected in rules which are to be complied with, governments need to make these rules known through all possible means of communication. Rules are understood here in a broad sense and include legislation, courts' decisions, guidelines, etc. When land is being expropriated, for instance, simple explanatory pamphlets outlining the rights of those affected and explaining how they can exercise those rights should be made available to the population affected. Knowledge by people of their own rights contributes to limiting the arbitrary behavior of government officials and assist in creating the climate of predictability associated with the rule of law.

82. As regards the coherence of the rules, the Bank also may have a useful part to play. When conditioning disbursements in specific operations on the enactment or modification of certain laws, it is essential for the success of the operation that the country implements its own rules. A decree, for instance, should not derogate from legislation. There should be no contradictory statutes. There are, for instance, countries whose constitution forbids private ownership of the means of production. In the context of private sector development operations, the Bank needs to ensure that the operation is based on a sound legal premise (Box 2H). In this respect, it would be advisable that, whenever possible, local legal expertise be brought into the action together with any expertise from abroad as may be needed.

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[16]/ This is the case of the legal information system included in the Social Sector Management Technical Assistance Project in Argentina (Loan 2984 AR).

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BOX 2H

Legal Inconsistencies in Eastern Europe and Africa

The centralized systems of state planned economies of Eastern European countries face a number of legal problems in their efforts toward economic reform and the development of market economies. Lately, these countries have been introducing reform elements for private sector development. However, contradictions and inconsistencies are often encountered. For example, several countries have started privatization efforts. In this process some have already amended their constitution to make provision for private property rights. Others have not yet changed their constitution to this effect, but, nevertheless, proceed with the privatization effort. In the context of Bank operations an effort should be made to address these issues which can hamper reform. Following are some examples.

In Romania, there has been considerable legislative activity. With regard to private sector development, the law on Restructuring State Economic Units as Autonomous Units and Commercial Companies was passed in September 1990; a draft law on Privatization (currently under consideration) will govern this issue. Other laws under preparation will cover bankruptcy, commercial and company law, foreign investment and SME development (to supersede Law No. 54 defining and permitting small enterprises, which was passed in early 1990). These laws are reducing the role of the government in productive activities while retaining its monitoring functions, introducing private ownership and encouraging foreign investment through joint ventures. The legal framework is, however, operating under the severe constraint of the clearly defined property rights. The Parliament has been given two years from the time of its inception to develop the relevant provisions.

By contrast, in Czechoslovakia, amendments were introduced to the Constitution effective May 1, 1990, recognizing all forms of ownership rights, and providing that they (whether state, cooperative or private) enjoy the same level of protection and that no form of property ownership has a privileged status. A law on Small Privatization was introduced effective December 1, 1990, while a law on Privatization is currently under consideration. (See Box 3F for details on Developing a Legal Framework in Czechoslovakia).

Another example which illustrates the effects of inconsistencies and contradictions in a legal system is the following: the socialist economic system has been protected by the rules of constitutional law, labor law, administrative law, as well as by the rules of criminal law. In the Soviet Union, "undesirable" economic behavior has been controlled through criminal or administrative sanctions for behavior which violates accepted socialist norms and undermines the economic system. There are several articles in the criminal and administrative codes of most republics which criminalize behavior that in a market system is rational and economically desirable. It seems that many of these articles will be eliminated in the next major revision of the codes. In the meantime, however, the existing criminal codes continue to stand and to

hamper the economic reform effort. Prosecution under most of these articles continues, with thousands of convictions per year. Even if it is not feasible to amend the codes immediately, steps need to be taken to limit the effect of these provisions on those who wish to engage in new forms of legitimate business.

Although the Eastern European countries are the most striking example, similar examples can be found elsewhere. For instance, Guinea-Bissau is presently amending its Constitution, approved May 16, 1984, as part of a general political transition from a socialist state to a more "capitalist" state. An impediment to developing the private sector is Article 12 of the Constitution, which provides for state ownership of all land (leases are granted to private individuals), minerals, banks, insurance companies, etc. Article 13 also provides for state control of foreign trade and exchange transactions. Guinea-Bissau has begun the process of amending their Constitution to be more conducive to private sector development. One of the objectives of the legal technical assistance provided to Guinea under the Second Economic Management Support Project is to coordinate the various donor financed pieces of legislation so that they dovetail as a whole. In the first Structural Adjustment Credit to Uganda now under preparation, the proposed conditionality includes the repeal of the Industrial Licensing Act of 1969 because it conflicts with more recent and liberal investment laws.

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Rules to be Actually in Force

83. It is not enough for a law to be on the books: it has to be applied, it has to be in force in reality and not only in the formal sense, and most important, it has to be complied with. When a law is left in abeyance or is not respected, the answer does not necessarily need to be a new law. An analysis of why the old law does not work will avoid placing yet another law on the books.

84. The reasons why laws are ineffective vary greatly. In many developing countries, the fact that many laws are not applied is often related to their inadequacy to the local situation. They had been transplanted from other countries and not adjusted to the local situation. Alternatively, they were not updated to current developments in the countries concerned. For a law to be effective, one has to consider many elements leading to its observance. Such diverse factors as custom, geography, technology, and history play a role in inducing obedience to laws. Because of these factors, the same law and its sanctions in different times and places within different physical and institutional environments will not induce the same behavior. Furthermore, societies evolve and laws may become obsolete. There is a certain inertia in legal systems and they simply may not have been updated to take into account social, business or technological changes.

85. Another obvious reason why laws fail to be applied is the absence of competent administrators of the legal system. The law is not only a set of rules but it encompasses procedures and institutions for implementing these rules. To the extent these are lacking, laws most likely will remain on paper.

86. The Bank must be sensitive to the variables which affect the success of the transfer of legal institutions and the application of the laws. It must also be aware of the limitations of sanctions to induce behavioral change. Punishment best enforces already institutionalized law, nudging the occasional deviant into conformity. In many instances, it is more appropriate to use incentives and roundabout measures to achieve results, normally, at lower costs than punishment and to the relief of over-burdened courts.

87. As regards legal institutions, the Bank may assist in improving the efficiency or competence of judicial systems to reduce the costs of economic transactions. In advising governments to adopt new laws, the Bank should be fully aware of the limitations of the government concerned in implementing them. As regards enforcement of the laws, some aspects of it have a clear bearing on economic development and have been the subject of Bank operations; for instance, improvement of tax collection, and changes in security laws to permit financial institutions to foreclose on debt and mortgages (Box 2I).

Mechanisms to Ensure Application of the Rules

88. Mechanisms must exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures. The concept of the rule of law requires furthermore that all government officials act within the ambit of the law. State power ought to be exercised under the authority of law. The proper application of the rules by government officials is the essential element of establishing legality and - in conjunction with the idea of justice - legitimacy. To act within the law means that the executive branch of the government bases its actions on the statutory power from which the government officials derive their authority and that the exercise of such authority is within the boundaries set by the law. Of course, the legislation authorizing government actions cannot prescribe for all circumstances precise and clearly-defined standards. Thus, while the proper application of the rules should ensure predictability, it should leave some room for flexibility. There is a difficult choice between laws which require the officials to act in a particular way and those which delegate discretionary power to the bureaucracy. Traditionally, the rule of law called for narrow grants of discretion. But the complexity and variety of issues have led to increasing delegation of authority to the executive branch based on broad standards, discretion secures flexibility and responsiveness to different situations which could not have been predicted by the legislatures. Discretion represents a counterweight to legal formalism.

89. Discretionary power is not absolute power. Discretion in law is always limited. The most basic guidelines for the exercise of discretion require that

Box 2I

Enforcement

In Guinea under the Private Sector Promotion Credit, the deficient functioning of the judicial system and the legal void on bank sureties has been identified as major constraints for banking activity in the country. Banks are unable "to enforce their rights as creditors through foreclosures or other court-approved actions, due in particular to debtor-judge collusion and rampant corruption".[17] This operation is a modest start to address these problems and it will be followed by training of the judiciary and legal professions in banking and commercial matters and by improvements in material working conditions.

In Sri Lanka, the Association has been working in two operations in the financial sector to reform the laws allowing financial institutions to foreclose on collateral pledged under loans. Sri Lankan law had prevented direct execution by institutions, who were forced in each case to go to court to get a judgment before they could move against the property. This protection for debtors stemmed from historical concerns about unscrupulous money lenders but did not match the needs of a modern economy. On the advice of the Association the law was changed to permit direct execution. The result is a law which establishes a better balance between the rights and obligations of debtors and creditors.

In the Philippines as part of the Financial Sector Adjustment Loan, the Bank not only advised that the lengthy holding period for repossession by debtors of pledged property be shortened to a more reasonable period, but revising the 1905 bankruptcy law to make it less punitive on debtors and more rehabilitative, in the interests of both creditors and debtors.

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[17]/ Report, p. 5207 GUI, para. 55.

any exercise of powers be based on reasons, that these reasons be applied consistently, fairly, and impartially, and that they be intelligibly related to a framework of purposes, policies, principles and rules.

90. As with all exercise of power, there is a need to ensure the respect for these limitations to secure the correct exercise of discretion. Thus, there is a need for mechanisms to ensure the proper application of laws, and rules that regulate how to depart from them. Several different forms of checking administrative action and avoiding the abuse of discretionary power have been adopted in various legal systems ranging from review by independent civil and criminal courts to specialized administrative courts and ombudsmen.

91. In addressing the issue of functioning and effective institutions, the Bank has assisted borrowers to improve their civil service and to establish well-defined administrative structures. Support of civil service reform has concentrated on better training for civil servants, pay structures and the need to ensure that the financial remuneration of civil servants is adequate. The Bank is advising governments on how to improve their administrative decision-making processes and to establish administrative structures which clearly assign authority and responsibility.

92. At times, the proper application of the rules is hampered by an overabundance of - in some instances - contradictory or obsolete rules and regulations which overwhelm the bureaucracy. The Bank is assisting countries to review, update and simplify their legal systems.[18] Such reforms of legal systems will improve the administrative capacity of the government to regulate the economy and to reach administrative decisions based on a clear set of new and relevant laws (Box 2J).

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[18]/ A practical example is Ghana. The legal and regulatory framework governing private sector activities is being reviewed by the government in order to eliminate obsolete laws and revise other laws to reflect the policy change from a command economy to a free market system. This follows the changes of the regulatory framework for the financial sector which has already led to encouraging results.

BOX 2J

Reform of the Regulatory Framework

GHANA: Financial Sector Adjustment Credit (Credit 1991 GH)

Banking activities in Ghana have been governed by laws and regulations enacted in the 1960s and early 1970s with a number of amendments and decrees issued on an ad hoc basis since the enactment of the original legislation. Several serious omissions in this body of legislation, together with weak bank supervision, led to the concentration of risk in the portfolios of banks, inadequate capital and reserves, inflated profits and unrecognized loan losses.

In connection with the IDA-financed Financial Sector Adjustment Credit, the Government of Ghana established a committee of legal experts to review the existing legislation, draft the changes necessary to improve the regulatory framework and introduce prudent standards to ensure the viability of the banking system. Risk exposure limits as a percentage of capital have been set on a bank's exposure to a single customer or related group. A minimum capital-adequacy ratio has been established, taking into account the quality of the bank's assets as well as its off-balance-sheet risks. Banking supervisors will have the ability to mandate even a higher capital-adequacy ratio, when, in their opinion, conditions warrant. Banks which do not meet the minimum guidelines are not allowed to pay dividends. New regulations specifying the format and content of audit reports and the minimum scope of audit reviews have been introduced together with uniform accounting and auditing standards and prudent reporting requirements. The accounting standards include guidelines for loan portfolio review and classification, the treatment of interest on non-performing loans, and provisioning for potential loan losses. Monetary penalties for violations of laws and regulations are strengthened and will be periodically revised to serve as a deterrent to illegal and imprudent acts.

POLAND: Structural Adjustment Loan (Loan 3247 POL)

In Poland, the Government's Economic Transformation Program (ETP), pursues structural reform towards the establishment of a market economy. The SAL will support reform initiatives mainly in the areas of: (i) enterprise restructuring, privatization, private sector development, with emphasis on appropriate legislation to define the "rules of the game" (including privatization, demonopolization and competition), the establishment of an adequate institutional framework for enterprise restructuring; (ii) financial sector reform, with emphasis on improved banking regulation and supervision, introduction of adequate accounting and auditing standards, etc. and (iii) social safety.

SRI LANKA: Economic Restructuring Credit (Credit 2128 CE)

The Economic Restructuring Credit (ERC) supports the Government's efforts

aimed at stabilizing the economy and implementing structural reforms. In addition to addressing the country's serious internal and external imbalances, the size of the public sector, its claim on resources and the efficiency with which it uses its resources, the ERC also focuses on the development of the private sector through improvements in the existing regulatory framework and incentive system and through transfer to the private sector of activities and assets now being managed by the public sector.

Conflict Resolution

93. Conflicts in the application of the rules can be resolved through binding decisions of an independent judicial or arbitral body: The existence of an independent judicial or arbitral body which can render binding decisions with respect to conflicts in the application of the rules is an essential element of the rule of law concept. The law loses its conflict-resolving and confidence-inspiring function if there is no independent and credible judicial system which assures that private contractual arrangements are respected and that the law is applied uniformly by the executive. With regard to the first aspect, it is obvious that confidence in the enforceability of agreements and commitments is instrumental to the proper functioning of an economy and the conduct of private economic activities. If there are unreasonable delays and high costs in enforcing laws and agreements between private parties, the efficient conduct of economic activities is hampered. With regard to the second aspect - i.e. the check on government actions -it is also evident that a strong judiciary can provide an effective shield against the concentration of arbitrarily-exercised executive power.

94. The state of the judiciary in a number of developing countries is precarious. Even in those countries where there is a nominally-independent judiciary, the courts are usually overworked and dispute resolution takes a long time. Often, the courts lack proper facilities and there is an urgent need for improving the training of the persons involved in the administration of justice. Despite all this, arbitration proceedings outside the court system are not well-developed.

95. This is an area in which the Bank has made a modest start (Box 2K). There are several operations under preparation that will assist member governments in the training of judges in economic and business law and may go as far as recommending certain division of labor in the court system so that commercial matters would be handled by specialized courts.

96. In assisting to make the court system more efficient and competent the Bank may wish to look beyond the basics of training and of providing adequate

Box 2K

Improving the Judiciary

BANGLADESH; Financial Sector Adjustment Credit (Credit 2152 BD)

The court system in Bangladesh took an average of 10-15 years to dispose of suits brought by financial institutions against defaulting borrowers. The result was that transaction costs were extremely high and collection rates were very low. With the assistance of the Association and the International Monetary Fund, Bangladesh enacted a Financial Loan Courts Act in 1990 which established special commercial courts in the major economic centers of Bangladesh, whereby financial institutions could bring actions against defaulting borrowers and the loans could be adjudicated. Progress, which to date, has been highly favorable, is being monitored under the Financial Sector Adjustment Credit and involves the establishment of courts, appointment of judges and disposal of cases.

physical facilities. For instance, many developed countries also have in the past encountered the problem of a judiciary too unwieldy, expensive and slow to handle disputes. The answer has not necessarily been to improve on the courts but to expand extra-judicial means of settlement by permitting commercial arbitration.[19] Another alternative is to search what caused the growth of disputes by updating or clarifying archaic or uncertain legal situations. The business world has also responded by rationalizing business practices through the development of standard forms and patterns of doing business. The courts themselves may help by mass handling of certain commercial matters, e.g. garnishment and collection of debt. These are areas within the mandate of the Bank in as much as functioning rules and institutions, including an effective dispute-settlement mechanism, are essential for economic development.

Amendment Procedures

97. **There are known procedures for amending the rules when they no longer serve their purpose:** As noted above, the rule of law is instrumental in creating a climate of predictability and stability - as the antithesis to governmental arbitrariness. Rules that are constantly changing cannot fulfil this function. Neither can rules that are arbitrarily repealed, amended or waived. The perception of arbitrariness and subjectivity is created by ad hoc decisions whereby the creation, amendment or invalidation of laws is undertaken without known and established procedures. Laws created this way will be perceived by those affected as not being enacted through "the right process. "Furthermore, it will lead to a general disobeyance of the law beyond the particular rules, and affect the credibility of the whole legal system.

98. The requirement of procedures in place for amending or repealing laws is limited to the existence of such procedures. It is the prerogative of the country concerned - and outside the mandate of the Bank as stated earlier - to

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19/ For example, the Indonesia Report concluded that strengthening the arbitration system and arbitral bodies could improve contract enforcement and avoid some of the constraints in the judicial system.

decide how the legislative process is organized. What matters is that the public be aware of the process through which laws can be amended, repealed or waived.

99. The Bank's involvement in this area is not yet well defined. In the context of attempts by borrowers to introduce legal reforms, the Bank has stressed the importance of having appropriate procedural rules in place for enacting and/or repealing laws. In order to improve the technical capabilities of the countries concerned in drafting procedural rules and regulations, the assistance financed by the Bank has supported governments' legal offices, i.e., Attorney General, Ministry of Justice, etc., and consisted of training and technical assistance (Laos, Guinea and, under preparation, Angola and Mongolia).

100. The foregoing analysis of the procedural and institutional elements of the rule of law has focussed on their contribution to establishing a "good order" understood as "a system in place, based on abstract rules which are actually applied and on functioning institutions which ensure the proper application of such rules" (Shihata 1991: 43). The existence of such a system is needed for economic development; in particular, the economic reform policies introduced by many of the Bank's members and supported through Bank operations cannot be implemented effectively if these reform measures are not translated into workable rules and applied by functioning institutions in a proper and appropriate manner. Thus, the elements of the rule of law discussed above address these processes of the formulation and application of rules and constitute the procedural framework and institutional system which - if adhered to by the governments concerned - lead to stability and predictability and elicit compliance with the rules.

101. The rule of law and the various other elements of governance are closely interrelated. There is no doubt that by simplifying existing rules and limiting discretion in certain decisions the Bank has assisted in reducing the opportunities for corruption. The publicity that the Bank has insisted on in the administration of certain processes such as procurement has increased transparency in decision-making. Also, the development of communication systems for making the laws known helps in making governmental bureaucracies more accountable.

C. OPENNESS

102. Efficiency depends on economic agents having access to all relevant information: the poorer the information, the greater the uncertainty and risk, and therefore the cost, of committing capital or labor. In all countries government is a major part of the information picture. The government is the source of most information about economic conditions in general: even more importantly, reliable information about the behavior and intentions of government itself is critical to individual economic decisions. The cost and reliability of information from and about government is especially important in most developing countries, where non-government sources of economic information are typically poorly developed, and where government's economic influence is pervasive.

103. One important aspect of good governance as an information problem, therefore, is making sure that governments provide citizens with decent economic information--production, prices, and market conditions. The collection and dissemination of economic data has been a focus of Bank assistance and advice for a long time including support for statistical offices and the like. However, despite its importance, adequate economic information has been a casualty of economic crisis and government stringency, especially much of Africa. Central Banks which once produced excellent reports on the economy (as in Ghana) have ceased to do so, and government statistical series in many countries have become less timely, less reliable and less complete. Given the expanded and more sophisticated data requirements implied by the Bank's poverty agenda, this is an area which deserves much greater emphasis. China's post-reform Statistical Yearbooks are an example of how substantial breakthroughs can be made in the quality and availability of economic information.

104. It is even more vital, in many circumstances, that information about government policies and actions is widely available, that major processes of economic decision-making (for example the budget) are reasonably transparent, and that there is some opportunity for public comment, influence or debate in the process of economic policy-making. While this aspect of "openness" is

clearly sensitive to different forms of government and different political conceptions about the relationship of government to the governed -- questions beyond the Bank's purview -- there are two important economic reasons for greater openness in public policy and decision-making.

105. First, where government decision-making is unexamined and uncontestable the danger of corruption and diversion of public resources (including external assistance) increases: openness is not a sufficient condition to control corruption, but it is in most circumstances a necessary one.

106. Second, closed decision-making increases the risk of government error -- and of negative reactions. Government's impact on the private sector environment, through an array of influences from monetary and exchange rate policy through taxation and expenditure policies to public procurement, is pervasive and profound. In too many instances, it is negative because decisions are taken in ill-informed isolation from private-sector reactions. In the same vein, governments have often been taken aback by violent popular reactions to the distributional consequences of closely held decisions -- for example, over pricing and subsidy issues -- where a more open process of public education and debate might have improved both policy design and outcome.

107. On such general issues of style of government decision-making, the Bank has been primarily concerned to work with governments to ensure broad awareness and acceptance of economic reform programs (e.g. in the context of structural adjustment operations), and to focus government attention particularly on the impact of its actions on private sector confidence and the business environment. Madagascar's government, on its own initiative, and without Bank involvement, has issued guidelines for openness which represent remarkable progress for a government that bended towards secrecy not long ago. (See Box 2L)

108. The Bank is also active in several more specific areas where openness of government is an important issue: in the whole area of public expenditure decision-making; in assisting governments to improve public procurement; and, increasingly, in the assessment of environmental impact. The Bank is becoming

BOX 2L

OPENNESS IN GOVERNMENT: THE "TEN COMMANDMENTS" IN MADAGASCAR

The following are excerpts from an Official Communication published in the December 18, 1990 issue of the Official Gazette of Madagascar.

FROM: The President of the Democratic Republic of Madagascar
TO: The Prime Minister and Head of Government and the Presidents of Institutions

...

The terms of annexed communication from the Prime Minister...will serve as a rule of conduct and as general guidelines...The Government and other institutions of the Republic are requested to ensure that this is given the widest possible circulation and is applied in both the central and the local public services...

Communications

My own observations and complaints reaching my office lead me to submit the following proposals with a view to establishing a proper code of conduct within the Administration as regards its relations with the public. The principal aim is to improve attitude and behavior in the Administration and to preserve trust between the Administration and the public.

1. The Administration must not be permitted arbitrarily to block correspondence addressed to it.

...

The principle must be that the authority that is addressed must forward the request to the authority with power of decision. The former is free to issue a favorable or unfavorable opinion, but must nonetheless pass the request on. If it believes that the dossier is incomplete, or deficient in some other way, it should inform the applicant and ask him to put matters right; this is particularly important as regards our incentives for investors...

...

2. The Administration should assist the public.

...

3. The Administration should facilitate inquiries by the public.

...

Requests from the public sometimes relate to laws or regulations that contain all the relevant information being sought. The Administration should therefore make leaflets, etc., available to the public...In brief, each agency should make available to the public all the necessary information regarding the activity...Within each agency, a public information unit should be established...

...

4. The Administration must establish and observe set periods for handling requests.

Few laws or regulations stipulate that the Administration must respond within a certain period. As a result, the public is at the mercy of officials and is never certain as to when it will get a reply...Some departments have made efforts to improve this situation by stipulating maximum periods...This practice should be extended to all agencies...

5. The Administration must have the courage to question certain principles.

(a) The principle that silence is equivalent to a refusal...it is time to stipulate that silence...after a certain period has elapsed, is equivalent to acceptance...

(b) The legal principle of implicit rejection

It is high time the Administration understood that time is money.

6. The Administration must opt systematically for the automaticity of decisions.

The administration's discretionary power must be reduced to a strict minimum by the publication of clear and precise rules of the game, which it must respect. Regulations and laws that have an impact on the public must move towards this objective, which is also stated as a principle...regarding the conceptual framework for the preparation of laws.

7. The Administration must do away with anonymity.

The myth of the anonymous civil servant is no longer appropriate in a modern administration. The names and positions of agents interacting with the public should appear on nameplates on their doors or be posted on signs in their offices so that people know who they are dealing with. The use of badges could be courteous innovation...

8. No official should have permanent tenure of a position requiring contact with the public. Periodic rotation, even if only within the organization, is strongly urged...The Head of State issued a directive on September 12, 1990 to the effect that enforcement agents should not remain in the same position for more than three years...This measure...should be extended to other officials in contact with the public...

9. The Administration must know how to punish and reward.

There are some good officials and they must be encouraged and rewarded...Poor officials, on the other hand, should be punished and their promotion should be prohibited.

The best way to assess an official that works with the public is to listen to what the public thinks about him. An official, fully documented register could be provided for members of the public to record their complaints or their satisfaction...

10. The Administration must evaluate itself and be open to external audits.

Self-evaluation is carried out by an internal audit unit which each agency must establish to monitor its operations, verify how, and how fast, dossiers are handled and study users' complaints.

...

more involved in broadening and strengthening capacities for informed policy analysis and debate, for example through support for private sector institutions and professional associations, through its work with NGOs, and through the fledgling African Capacity-Building Initiative.

109. The collection and dissemination of data has been a focus of Bank activities for a long time. However, despite the importance of adequate economic information for the proper functioning of markets this is still a relatively neglected area in much of Africa. Central Banks which once produced excellent reports on the economy (as in Ghana) have ceased to do so. Given the renewed emphasis on the improvement of data in the context of the Bank's poverty agenda, this is an area which deserves much greater emphasis. China's post reform Statistical Yearbooks for example represent a substantial breakthrough in the availability of economic information on that country's economy.

110. Transparency in decision-making refers to an open process of government that reduces opportunities for corruption and the capture of benefits by individuals or elites. The Bank's involvement in transparency is through its work on public expenditure (transparency of budgets, elimination of "caisse noires"), through its assistance to governments in establishing transparent procurement procedures and conducting environmental assessments.

111. Procurement is a critical aspect of project implementation. Procurement difficulties are symptomatic of governance problems, either of a capacity nature or reflecting the pressures and temptations governments are subject to when dealing with large contract awards. Since 1983, the Bank has been systematically undertaking country Procurement Assessment Reviews (CPAR) which review public procurement laws, procedures, and institutions in borrowing countries to identify any fundamental conflict with Bank procurement guidelines, and to decide on acceptability of local procedures for contracts which are appropriate for ICB. The procedures are assessed from the perspective of competition, transparency, disclosure of selection criteria, award to lowest qualified bidder, fair contract conditions, mechanisms for dispute settlement, and an assessment of institutional capability and efficiency in implementing

Bank operations. With the advent of adjustment lending, the CPAR has expanded to parastatal and private sector procurement practices and their compatibility with practices in market economies in developed countries. To date, CPARs have been completed for 60 countries with the remainder in the process of being completed; they are updated every four years.

112. Where institutions are weak or procedures inefficient, the loan includes technical assistance components, or support to hire procurement agents. Thus, for example, technical assistance has been provided to improve the institutional framework and introduce more efficient procedures in Uganda and Madagascar. In other cases, new procurement codes have been issued. In the Philippines, action was taken under a Debt Management Loan to streamline overall procurement rules and procedures so as to permit greater delegation of authority to implementing agencies and to establish standards to shorten contract award procedures. Work initiated under this project has been pursued under subsequent projects (the Fifth Highway project) and guidelines acceptable to the Bank are now available for local procurement of goods and consultants. This has facilitated an easing of regulations relating to contractors thereby increasing their willingness once again to accept government contracts.

113. Several North African and Middle Eastern countries do not require public bid opening, and permit bargaining even after bids have been opened. The Bank is attempting, in such cases, to review the rationale for existing local procurement regulations rather than simply requiring conformance to Bank guidelines. It is attempting through local seminars and discussions, to focus attention, for example, on the importance of procurement processes to the development of local contracting capacity and pointing to the value for a development perspective, of adopting revised national systems to conform to international norms. In almost all reforming Central and Eastern European countries, institutions were not familiar with local or international competitive bidding. However, these countries are now requesting and showing receptiveness to Bank technical assistance on procurement legislation and procedures. (Box 2M). In 1990, the Africa region convened a conference on public procurement procedures at which African public officials presented papers

along with procurement experts from developed countries on the merits of different approaches to improving the efficiency of public procurement.

114. Public disclosure of environmental assessments is one instrument that the Bank is using increasingly to contribute to greater accountability and openness. This is particularly critical in ensuring that people involved in involuntary displacement by development projects (such as the Narmada and Upper Krishna river) are kept fully informed of the results of such assessments. Thus, under the Ecuador Municipal Development and Urban Infrastructure project (FY91) an attempt is made to ensure public review of environmental impact studies of infrastructure projects.

Analysis and Dissemination Capacity

115. The capacity of non-governmental organizations and institutions (professional associations, trade unions, business organizations, grass roots groups, research centres, universities and mass media) to analyze and disseminate information on specific and general aspects of government economic performance is also an essential component of "accountability." It is not enough to have access to information. Unless the capacity to understand, process and use it effectively is disseminated widely throughout society, information assymetries will lead to the concentration of power -- with the attendant risk of "capture,
"and lack of accountability. Of particular importance is the information processing and analytical capabilities of mass media institutions, since they have a most important role in disseminating ideas and in mobilizing public opinion. Legislatures also need to strengthen their policy analysis capabilities for they are frequently at a disadvantage in their dealings with the executive branch.

116. The Africa Capacity Building Initiative represents a potential instrument for strengthening this capacity of non-government institutions. The Bank's External Affairs Department has done much to improve access to economic information for developing country journalists. UNESCO is taking the lead in implementing a recent unanimous General Assembly Resolution which calls for an

unfettered development of a free and pluralistic press. The Bank could work with UNESCO and the UN Information System to develop facilities to train economic and financial journalists in developing countries.

Openness and the Special Case of Military Expenditures

117. A recent area where the Bank is beginning to focus attention in public expenditure reviews is the high levels of military expenditure, particularly in relation to expenditures on health and education. That military expenditure is not just a public expenditure issue is best summed up by the recent report of the South Commission (South Commission 1990):

> "By 1980, developing countries' military expenditure on average amounted to 25 per cent of the world total. Their arms imports averaged $22 billion per year during the 1980s. It is true that arms purchases in the South tend to be highly concentrated in a few countries, notably in the Middle East, and hence average figures of expenditures are not very meaningful. But only a few developing countries can rightly claim that their military expenditure is proportionate either to any external threat or to the resources at their disposal. The direct human cost of well over one hundred cases of international and civil conflict in the South since the end of the Second World War has been a horrific addition to the daily ravages of poverty and deprivation. By 1980, more than 10 million people had been killed in wars fought in the Third World; many millions more had been maimed or injured."

118. The Report rightly goes on to note that not all conflicts could have been averted by action within the South. "Nor can one ignore the very real threat posed by armed insurgencies, terrorism, separatism, and fundamentalism, among other manifestations of violent conflict. Direct military threats have left no option to some developing countries but to increase military expenditure for self-defense." Calling for an international framework that would guarantee the security of all nations against external threats, the report poignantly notes the high costs of militarization:

> "Militarization has perverse implications for development. The diversion of resources to pay for instruments of war and repression retards progress in many countries. Just as

BOX 2M

CHANGING PROCUREMENT POLICIES AND PRACTICES IN EASTERN EUROPE

The countries of Eastern and Central Europe[1] are rapidly accelerating their transition from centrally planned to market-oriented economies, a process involving profound changes, also in the field of public procurement. They are increasing their externally supported investment project operations, in cooperation with bilateral agencies and international financing institutions. During the past forty years, the countries have performed public procurement through direct allocation of resources, or negotiated contracts. They do not have a recent background in using open, competitive bidding procedures, and vary in their abilities to applying international procurement practices.

The countries lack the requisite public procurement laws and related legal systems, regulations and experienced procurement officers. New and comprehensive legal systems for public procurement are required at all levels of government: national and local, and would ideally apply to all sectors. At the same time, training of procurement personnel would need to be performed on an urgent and massive basis, to implement the new procurement practices. The delays in project implementation caused by inefficient procurement practices may result in opportunity, interest, and inflationary costs of considerable magnitude (10-20% of total project costs).

The World Bank has, at the invitation of several of the countries, advised their senior officials on the requirements for implementing the needed legal and policy changes, and to train involved personnel. Contacts have also been made with multi- and bi-lateral agencies which have a direct interest in the issues, with the objective of their participating financially and technically with the Bank in country and regional projects which would address the problems through technical assistance. Financing of such projects could also come from Bank loans, should the countries so request.

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[1]/ Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia.

> deleterious is the growth of a military culture which is contemptuous of democracy, popular participation, human rights, or the principle of government accountability. It breeds corruption, the abuse of power and the consequent alienation of the people from the political system. These disturbing symptoms can be seen in many countries of the South today."

119. The level of military spending is the prerogative of individual governments. All countries have legitimate security needs and it is not for the Bank to say that these should not be met. The Bank's role in this area must focus on two issues. The first is the consequences for the economy of any given level of public expenditure, in relation to resources, availability and the effectiveness with which this expenditure is being utilized for purposes of economic and social development since these factors could have a bearing on the credit risk the Bank is being asked to assume. The second relates to the fungibility of resources, particularly in cases of structural adjustment lending or local cost financing, where the Bank indirectly frees up foreign exchange resources that can then be used for military expenditures.

120. Military budgets typically lack transparency. They are usually one line budget transfers. Sometimes, not even openly identified. They therefore escape scrutiny, avoid accountability and expenditure control and auditing, and usually involve substantial off-budget transactions. As a result, there is often significant waste associated with such spending, particularly when it comes to purchase of hardware. The waste comes from inappropriate and costly weaponry (weapons that are grossly over-specified or are incomplete parts of an overall system or too sophisticated to maintain). This is possible because of ruthless salesmanship reinforced by generous trade credits and outright bribery on a lavish scale, the gullibility (and greed) of the customers, and the reluctance of civilian financial managers to question military procurement.

121. The Bank should not get into details on military expenditures. Most countries would regard this as an infringement of their sovereignty and rightly so. The Bank should be concerned firstly, that, the country itself has systems of financial accountability in place to ensure that military expenditures are

transparent and subject to serious scrutiny within the government; secondly, that the overall size of public expenditure is not excessive in relation to resource availability; and thirdly, that allocations for economic and social purposes are adequate. Thus, the crowding out effect of a given level of military expenditure needs to be the focus of dialogue rather than the level itself.

III - THE ROLE OF THE WORLD BANK

"You cannot make a tree grow faster by pulling it from outside; it has to grow from its roots."
Claude Ake (World Bank 1990d)

122. Development thought, as pointed out in WDR 1991, has undergone a seachange over the past forty years. The faith in the 1960s in the ability of governments to direct development was displaced by the compelling need in the 1980s to get government out of roles more appropriately assumed by the private sector. Meanwhile, the concept of development also broadened, encompassing education, health, and environmental protection.

123. This broadening of the concept of development changes that which is expected of government. While it was clear that the earlier challenge was to trim its role, the second aspect -- improving the quality of government -- received less attention.

124. The Bank, as is clear in part II of this paper, is already supporting a number of activities that have a direct impact on key dimensions of governance, such as accountability and the rule of law. To date, however, the Bank has not focussed intensively on issues of governance, in part because of a legitimate concern that such a focus might pull it into areas too close to the boundary prescribed by its legal mandate. Yet now, with a serious crisis of governance in many borrowing countries, certain issues of governance are more linked to the Bank's development mandate. The Bank will remain clearly within the limitations of its charter; it will also seek to be responsive to governments requesting assistance in order that they might improve their capacity for efficiency and effectiveness, their rule of law, their openness, and their accountability. Within this context, three central messages emerge:

125. **First, issues of governance are both highly complex and extraordinarily diverse.** The complexity arises from the multi-dimensional nature of the subject, as well as the unique imprint that the history and culture of each country leaves on its governance. The diversity is both among different regions of the Bank and among individual countries within each region, and for the larger or ethnically diverse countries, even within each country. The political economy of Kerala state in South India is very different from that of Bihar in

eastern India, despite similar political structures and institutions and similar economic regimes. Thus, governance is not a subject that lends itself to any one single standard or simple prescriptions. The complexity and diversity call for a highly differentiated and contextually specific response that is based on a thorough understanding of a country's political economy, its social history and its institutions.

126. Second, **from available research, there appears to be no clear empirical link between types of political regimes and the substantive dimensions of governance that are of concern to the Bank.** While there is some evidence that democracies do better with respect to social services, there is no firm correlation between types of political regime and economic growth performance across countries. Successful and flourishing democracies, while open societies, may have weak financial accountability and high levels of corruption. Their legal systems may be so clogged that they are failing to provide the minimum level of services that are essential for development. Despite formal democracy and the rule of law, the access of the poor to government or legal services may, in practice, be limited. Authoritarian regimes which lack political openness may, nevertheless, because of the quality of leadership or cultural traditions (as in the East Asian NICs), have high standards of accountability and high degrees of predictability. And, in some instances, they have reduced poverty and delivered quality social services to a wide section of their populations. In any event, both its mandate and development experience indicate that the Bank must continue to work with a wide range of governments to promote development and improve governance as an important means to that end.

127. Third, **improving governance is a complex and long-term endeavor.** It may take generations to build effective bureaucracies or legal systems (Brautigam 1991). It has taken centuries of painful struggle for citizens to wrest accountability from their rulers in the developed world. While the advent of the Information Age may have compressed these time horizons, progress in this area tends, nevertheless, to be in North's words, "overwhelmingly incremental." At the same time, political change in the direction of greater pluralism and broader political participation has advanced rapidly in recent years in many member countries--especially in Eastern Europe and Latin America, and increasingly in Africa as well. Such changes in general may encourage better governance, but for this to succeed it must be firmly rooted in the culture and society of that country and cannot be imposed from outside. The Bank can assist the process of change; it can even help build commitment through its policy dialogue and through its economic and sector work. But it cannot substitute for

the commitment to better government that must come from within the country concerned.

128. There are at least four major reasons why the Bank cannot afford to ignore issues of governance:

129. **First, governance is inextricably linked with both the returns and the sustainability of the investments and structural adjustment reforms that the Bank helps finance.** OED studies show that while four-fifths of Bank projects seem successful at completion, only half of those that seem successful are sustained over time. Projects fail or are replaced by other instruments for many reasons, but among the main lessons we have learned in the 1970s and 1980s are that good projects and sound adjustment programs can be undermined by poor governance. Inadequate maintenance efforts, through distorted spending priorities or the corruption of departments responsible, erodes the value of past investments. Efforts to promote private sector led growth are undermined in the absence of the rule of law, lack of physical security, and low confidence in government behavior. Policy mistakes and resulting severe macro-economic imbalances can eat into the returns on productive investments. Lack of macro-level accountability can lead to wastage or misappropriation of adjustment loans. Lack of popular participation in project design and implementation can significantly reduce project benefits. And inadequate information compromises competitiveness and prevents the development of effective markets. In sum, the Bank's own operational experience demonstrates the critical importance of good government.

130. A second reason is that **the Bank must jealously guard its reputation for technical excellence and financial probity; these are central to its capacity to raise resources.** If a significant portion of its portfolio is seen to be having problems of sustainability or difficulties with financial accounting and auditing, then it could be risking that reputation, and all that such a loss would entail. If the Bank is seen to lend to countries where poor economic performance is clearly linked to large scale corruption or widespread human rights abuses, it may also risk its capacity to raise resources for other countries. It must continue to impose high standards on itself and its borrowers when it comes to fundamental issues. This implies assisting the borrower to address not just symptoms but underlying causes.

131. Third, **international events are changing the external environment within which the Bank works.** Several donors are moving towards political conditionality in their bilateral development assistance programs. While the

Bank's mandate remains clear and unequivocal, it is possible that Bank-financed programs in several countries will be affected in various ways (as they already are in some countries). There may be difficulties in raising cofinancing or assembling a financing package to support adjustment lending.

132. **Finally, at a minimum, in its own practices the Bank needs to ensure that it is part of the solution to difficulties of governance, and not part of the problem.** In many countries, the Bank is now a major external source of finance, policy advice, and technical support to governments. There are circumstances in which it can weaken institutional capacity in its borrowers or undermine ownership of programs by not paying sufficient attention to the context within which it is operating in that country. Similarly, an overloaded reform agenda that ignores fragile implementation capacity can do more harm than good.

133. The Bank must approach the issue of governance with careful calculation, great caution and due humility. It must at all times be extremely conscious of the sensitivities of borrowers, the long-term nature of institutional development and the local cultural context within which the Bank operates. Inevitably, this must involve a country-specific approach and making judgements. But without a measured and restrained approach, there are severe risks with long-term costs to the Bank's reputation for technical competence and independent judgement. The issue on the table is how the Bank should marry the careful approach that is called for with the obvious need to address issues of governance.

134. The complexity of the governance-development relationship and the diversity of country characteristics caution against a formal Bank policy on governance. Although the Bank has growing experience with the dimensions of governance described in Part II, in this area, experience does not by itself constitute expertise. Moreover given the complexity and diversity of issues, a great deal more work and experience is required before we understand why some approaches will work in some countries and not in others, and in certain situations and not in others. As the Bank learns more deliberately about governance in its day-to-day operational work, and enhances its training of staff, it will gradually improve its capacity to assist constructively and will be able to define positions on the critical issues.

135. Governance must not become a Special Initiative as it is qualitatively different from areas of concern that are Special Initiatives, in that, from the Bank's perspective, it is an instrument for development rather than an end in

itself. Rather, concerns about governance need to be integrated into the Bank's work program, and the Bank needs to improve its own understanding and knowledge of the governance-development links and the socio-ethnic context in which they are operative. The staff are already highly receptive to the underlying issues; that receptiveness will only be eroded by imposition of operational guidelines, codes of conduct, etc.

Priorities for the Bank's Work

136. As indicated above, the Bank's primary focus in the area of governance was in public sector management which has meant civil service reform, public expenditure review, public enterprise reform, sectoral institutional and policy reforms. That agenda has been largely driven by the need of structural and sectoral adjustment. More recently, decentralization issues and tax reforms have gained in importance, particularly in Latin America. As is clear from Parts I and II, of late there has been increasing attention to issues of accountability, openness and the rule of law. However, for the most part, the focus in these areas has been on addressing the symptoms rather than the underlying causes of poor governance.

137. The question the Bank continuously faces as the development agenda broadens, reflecting the complexity of the real world, is how to prioritize its work. Given the diversity of country situations, the answers are never straightforward. Priorities have to be set within the context of each country situation. In each country, priorities must be centered around the creation of an enabling environment for accelerated development and poverty reduction. For the private sector, this means that governments must foster a climate of predictability and stability, in part through a system of objective laws that are applied fairly and efficiently. The enabling environment is needed not just for the "organized private sector" to flourish; it is needed for more equitable and sustainable development. That in turn requires greater public understanding of policy choices. This understanding can be attained through greater participation in the development process; it is also enhanced by increased effectiveness in the delivery of public services.

138. At the micro or project level, Bank interventions need to ensure a greater emphasis on "outward" accountability in addition to "upward" accountability, i.e., accountability to the people who are directly affected: the beneficiaries as well as those adversely affected (due to environmental or other reasons). Providing choices or alternatives to beneficiaries must also be a high priority. Competition is the most effective means of improving the

quality and level of services. But where choices cannot be generated, enhancing participation is the next best option. These options need to be systematically explored. It is when governments understand the constraints on exit and voice and design projects to minimize those constraints that they will be closer to ensuring long-term sustainability of investments in public services.

139. Upward accountability is as essential as outward accountability. The low level of development of financial accounting and auditing systems in many borrowers is a significant impediment to the creation of an enabling environment. These systems are essential to ensure that resources are allocated and spent efficiently, corruption minimized, and corrective action taken where there is abuse. Ensuring that such systems are in place is important for the Bank to be able to do business with a country. There are many instances where systems have been allowed to run down to breaking point, or where they are not serving their functions effectively.

140. Reforms to strengthen accounting and auditing in the public sectors should be considered with the objectives of (a) improving financial decision-making, (b) better resource allocation, and (c) monitoring for better control over expenditure. Reforms in accounting need to focus on: information which is comprehensive and timely, classification of expenditures in a manner which is consistent with the budget and programs, appropriate analyses for decision-making, the comparison of budget and actual results, better coordination among ministries, improving the organization and responsibility for accounting in finance ministry and legal requirements for financial reporting. Reforms in auditing are required to enable appropriate independence of the audit organizations specified in the legal structures, improved training, greater focus on auditing the economy, efficiency and effective use of resources, and improvements in the educational systems and professional training.

141. Bank-financed projects have included finance and accounting assistance at the project level. In many countries there is a need to address these issues at the national level. The Bank has undertaken a few country wide projects - Madagascar, Indonesia, and Bolivia. Such country-wide projects are, however, resource intensive.

142. Accounting and auditing systems are equally critical for the private sector. This is not only to meet the needs of private sector managers but also to ensure good corporate governance including accountability to shareholders, as well as accountability to the communities within which corporations are residing. Again, there has not been much attention paid to corporate

accountability and the role of public oversight despite the substantial reorientation of the Bank's work towards private sector development.

143. A further prerequisite to an enabling environment is, as indicated above, the "rule of law", as defined in Part II. Without a sound and well-functioning legal system, business risks cannot be rationally assessed and transaction costs could be a significant deterrence to private investment. Good government, in part through the rule of law, lowers risk and transaction costs by reducing uncertainties relating to investment, contracts, and property rights.

144. Thus, the existence, or lack thereof, of this more broadly defined enabling environment must be taken into account in setting priorities and designing country programs. Three components are needed: systems of financial accountability that minimize waste and corruption and ensure good corporate governance, a participatory approach to development at the project level which ensures outward accountability and a "customer/beneficiary" orientation, and a functioning legal system that ensures the rule of law. In countries where these basic elements are in place, public sector reform along the lines currently being undertaken would be appropriate. In the absence of these basics, there is a risk that other reforms are being built on weak foundations. Sophisticated reforms in public expenditure policy may yield poor results if accounting systems are so weak that such reforms cannot be monitored or implemented. Similarly, reforms of laws in the statute books may come to naught if they are not enforced or if the legal system is so clogged up with a backlog of cases that the timely resolution of disputes in courts is ruled out. Or privatization efforts may not succeed if the absence of the rule of law has pushed transaction costs to a level where it deters investors. In practice, it may be possible to simultaneously pursue a renewed focus on these fundamentals and ongoing preoccupations with efficiency issues in the public sector. That is a judgement that borrowers and the Bank's regional managers will have to make as they look at the size of the reform agenda in relation to implementation capacity.

145. A strong emphasis by the Bank on prudent financial management and attention to auditing and accounting, or the rule of law, may bring to the surface deeper problems of governance. For example, sophisticated systems of financial accounting and auditing could be established, but the government may not absorb or use the results to good effect. A legal framework could be created but the lack of an independent judiciary could undermine its value. Where a weak environment for private sector development is due not to weaknesses

in capacity but to lack of government commitment, then there is a governance problem requiring attention in the Bank's country strategy and dialogue.

146. The implications of the foregoing analysis for the Bank's work program are reviewed below:

Country Strategy and Dialogue

147. In developing country assistance strategies, issues of governance are already implicitly factored into the analysis. A more explicit emphasis along the lines discussed above on the key ways in which governance affects the enabling environment would however, greatly strengthen the strategy and help prioritize the Bank's activities. The Bank's role on governance can be seen at four levels:

♦ Assisting governments in reforms that they have identified, or assisting them to identify reforms when they express a "felt need": as Eastern Europe makes the transition from command to market economies the Bank is currently facing a growing demand for assistance in creating the legal infrastructure, and in setting up systems of financial accountability and transparency. There are similar demands for assistance with decentralization reforms in Latin America. Governments that are simultaneously pursuing economic and political liberalization have a strong need for institutional reforms which is reflected in this demand led growth in Bank support for such reforms;

♦ Persuading governments of the need for reform: the Bank is currently using a range of instruments including policy dialogue and economic sector work to persuade governments of such a need; how some of these approaches may be strengthened or modified is discussed below, taking into account the legitimate sensitivities of governments;

♦ Reducing Bank involvement in egregious cases where poor economic performance is clearly linked to significant corruption or pervasive human rights abuses: there are currently a number of Bank country programs where lending has ceased or been reduced to core programs reflecting poor economic progress over a sustained period accompanied in some cases by civil war or other factors that represent gross misgovernment. The issue here is ensuring that such decisions are taken free of external political pressure, but based on the Bank's own objective assessment related to its primary concern with furthering economic development; and

♦ Projecting through its comparative and country-specific analytical work, a long-term vision for an enabling environment for economic development that embraces notions of good governance. This would increase accountability, transparency and the rule of law, and some of the major elements that promote better government such as universal education, a vibrant private sector including NGOs, and well-informed public debate which all contribute to strengthening overall accountability. The forthcoming Madagascar CEM (Beyond Stabilization to Sustained Growth) is an interesting example of this type of work.

148. In determining country strategy, the Bank's approach to issues of governance will be defined by some of the above considerations described depending on specific country situations. Many bilateral donors pursuing a broader agenda, are considering going further and linking the volume of lending to the quality of governance. There is considerable pressure to develop appropriate performance indicators or benchmarks, and some donors have urged the DAC Secretariat to take a lead in this area. While some are in favor of ranking countries by commonly agreed benchmarks established within the framework of the DAC, others, recognizing that comparisons between countries would be highly subjective and invidious, are proposing that such benchmarks be established for each country taking into account its special situation, and progress towards good government should be judged by achievements against those benchmarks.

149. This preoccupation with governance performance indicators may not be appropriate for the Bank given that the Bank concern is with governance as instrumental for economic development rather than as a good in its own right. IDA allocations are determined primarily by an assessment of performance and policies for growth and poverty alleviation. The quality of governance is inevitably factored into judgements about country commitment, and therefore, about the quality of Bank dialogue, the strength of the policy framework and the quality of public management. In the case of IBRD, creditworthiness considerations are preponderant, but once again these are in part driven by the quality of economic performance and judgements about the sustainability of policies. The Bank, therefore, needs to continue to judge effort and effectiveness in the sphere of development.

150. In assessing development performance, the Bank is now paying increasing attention to issues of poverty and sustainability. The Bank's assistance strategy to reduce poverty calls for linking volumes of lending to country effort to reduce poverty. This in turn involves judgements about the quality of economic management, the adequacy of social services and particularly in middle

income countries, the reliability of social nets. The poverty handbook will address issues of how governance issues need to be factored into the work on poverty. From the analysis in this paper, three areas appear relevant. First, in establishing systems of micro-accountability, the Bank can focus attention on trying to ensure that the poor are provided a voice in the design and implementation of projects financed by the Bank. This would imply, as argued above, increasing attention to issues of popular participation and an enhanced role for NGOs. Second, in its work on legal systems, the Bank needs to pay attention to how the existing legal structure affects the participation of the poor and women in society. Third, the planned work on improving data on poverty and income distribution provides an opportunity for increasing awareness of issues of poverty in borrowing countries.

151. Sustainability of projects after project completion is a good test of the quality of development management; the Bank's experience suggests that popular participation enhances sustainability by allowing beneficiaries to participate in design and implementation and giving them a stake in the success of the investment. Sustainability of adjustment programs also depends on the degree of ownership and understanding of the program in the government and the general public. Judging how serious governments are and whether policies are sustainable requires a sound understanding of the borrowers' political economy. Even with such an understanding, it is never an easy call, as is clear from the Box on Uganda (Box 3A) where good policies quickly proved ineffective given larger failures of governance.

152. Ultimately, unless the Bank is willing to reduce lending substantially where governance is so poor that development is drastically affected, this exercise is unlikely to be taken seriously. There is no need for additional criteria for allocation of IDA resources; merely the effective enforcement of existing criteria, resisting inevitable pressures to "move money" or "deliver projects". There is much greater consciousness of this need in recent years, particularly as IDA resources have become scarce. Beyond IDA, as heightened awareness of the need to improve the quality of the overall portfolio has spread, a serious effort has been made to develop an implementation culture that attempts to shift staff incentives away from simply delivering new operations.

153. If governance issues are to be taken into account in the Bank's country strategy, they should be discussed with borrowers in a broader context -- one including a review of the Government's overall development performance. This broader context could include, for example, issues of macro economic adjustment, lessons from country implementation reviews, and issues of sustainability.

BOX 3A

UGANDA: A LESSON IN GOVERNANCE

In 1981, Milton Obote returned to power as president of Uganda, the first deposed African president to do so. He did so through a rigged election, which itself followed three years of bloodshed and upheaval after the fall of Idi Amin in May 1979. Immediately the Obote government set about a program of reconstructing Uganda's shattered economy, while at the same time consolidating its own power.

During the Amin period, external assistance to Uganda had almost disappeared. The World Bank had ceased lending in 1974 [check]. After the fall of Amin, tentative steps had been taken to try to reactivate aid programs, but these had been thwarted by the chaotic conditions that prevailed, the failure of successive weak governments to grapple with economic problems, and specifically to pursue realistic fiscal and exchange rate policies. With Obote's return to power, it again became possible for external assistance to resume, with the Bank and the Fund taking the lead in reactivating their assistance programs.

These programs were based on some clear understandings and concrete actions by the Obote government, which moved quickly and decisively to reverse existing policies and, much to the surprise of outside observers, overturn most of the policies which Obote himself had introduced during his earlier spell in power, before 1971. The exchange rate was devalued; Africa's first unified foreign exchange auction was introduced in June 1984; agricultural producer prices were raised; the margins of the Coffee Marketing Board were reduced (though they still remained excessive); imports were liberalized; some halting first steps were taken to privatize parastatals and to restore properties nationalized by Amin. Some attention was even paid to institutional issues. The government's economic agenda was, on the face of it, both radical and comprehensive. Outside observers started to talk of a restoration of the sparkle to the "jewel of Africa".

The World Bank and IMF played an important, if not a central role, in this transformation. The government actively sought, and took their advice. Bank and Fund staff participated in many high-level policy discussions, and there were few issues or points of disagreement on economic policy between the two institutions and the government. Bilateral donors played an important role also, but, partly for political reasons, and partly because of the difficulty of resuming aid quickly after Uganda had been off the aid map for so long, assigned much less than the two major multilaterals.

The Bank's assistance strategy at this time was based on the program briefly drawn up by Fund/Bank staff. Emphasis was placed on selective technical assistance to strengthen key government agencies and on a series of three reconstruction credits, aimed at restoring essential infrastructure and supplying spare parts and raw materials to increase capacity utilization in agriculture and industry. IMF stand-by agreements ensured an acceptable macroeconomic framework. The reconstruction credits were not formally considered adjustment lending; nevertheless some important policy understandings were reached, some of which were incorporated as conditionality.

Up to 1984, these policies and programs were indeed quite successful. Exports grew rapidly albeit partly as a result of the return of coffee exports to official channels. Output growth recovered to 6 percent p.a. Despite massive devaluations, inflation was reduced to 30 percent and fiscal deficits contracted.

After 1984, however, the political situation began to deteriorate, as opponents of the Obote regime intensified their activities. To maintain its grip on power, the regime had throughout depended essentially on the army and various special security forces, which operated with a brutality that led many observers to compare them unfavorably with even the Amin regime. Not only was the regime unpopular, the means it used to remain in power increasingly worked against the objectives and instruments of the economic program. Military roadblocks disrupted internal trade; fear and intimidation of civil servants and businesses undid economic incentives and undermined discipline. To most observers, the regime's economic programs had, by 1984, become unsustainable. In July 1985, President Obote was ousted, and in January 1986 the National Resistance Movement assumed control.

Several governance issues should be posed, as we consider how Bank policies could, with hindsight, have reacted to this situation: First, should the Bank have concluded earlier that, notwithstanding Uganda's economic policies, the regime lacked sufficient popular support to sustain these policies? Second, how should it have done this? What evidence would have been required to reach such a conclusion? Third, supposing it did reach such a conclusion, what should it have done about it's program in Uganda? Should it have ceased lending? Should it have changed the nature of its support (away from reconstruction credits)?

First. By ignoring political realities, the Bank may have wasted scarce resources. Thus the Bank's mandate to ensure the efficient use of IDA resources require it to make such judgements. In fact, the Bank raised some political issues from time to time but only under the rubric of "security".

Second. The Bank has no expertise in political analysis. Indeed, there are few political scientists who would claim an ability to predict events and draw linear relationships between political actions and economic sustainability. Yet few observers of Uganda at the time doubted that the country was set on the path of further upheaval.

Third. The Bank could have reduced its support to a "core program" of high priority social and economic expenditures, seeking to only maintain essential infrastructure and prevent further deterioration. Yet this would have been less than was justified by the government's economic measures, which were -- at least up to 1984 -- having positive effects on output and incomes. In this sense, despite the difficulties, Bank assistance was not wasted. A retreat to project lending would have flown in the face of an important and innovative part of the Bank's assistance strategy, namely its willingness to provide flexible, fast-disbursing support to respond to the real economic priorities. The conditions for effective project lending were also not present, given institutional weakness, fiscal constraints, and the long lead time needed for project preparation. Thus, with the benefit of hindsight, the only realistic alternative, starting probably in mid-1983, would have been to reduce lending.

154. It is desirable that the Bank continue to insist on certain minimum standards of management responsibility, financial reporting and procurement relating to programs and projects it supports. In doing this, the Bank should be concerned with the factors that cause weaknesses in this area and not just on addressing project-specific problem. Thus, the focus needs to be on the fundamentals: country-wide systems of accountability that enhance development effectiveness, responsible financial management systems that provide a legal framework conducive to development. Where these are not present, the Bank could offer to assist.

155. There is one particular issue relating to country strategy and dialogue that is a concern with Bank's borrowers -- the level at which issues of governance are discussed with them. The concern arises from the prospect of relatively junior Bank staff raising issues of great sensitivity with senior government officials. Staff clearly need to exercise judgement and restraint since the level at which dialogue takes place should be a function of the nature of the governance issue at stake. There will be highly sensitive issues of governance which the Bank may wish to raise in situations where these are severely impacting on economic performance. Determining who will raise these issues and how they are to be raised requires the judgement of senior management. However, issues of a technical nature, for example, related to mechanisms for assuring managerial accountability in projects would be appropriate for discussion by the task manager concerned.

Economic and Sector Work

156. Issues of governance are already being covered in ESW (as shown in the previous sections). Public Expenditure Reviews and Public Sector Management and Institutional Development Reviews have touched on governance issues in a number of countries including Malawi, Tanzania and Zambia. As long as these are dealing with institutional or technical issues such as accounting and audit systems and do not get into more sensitive areas, such analysis is useful in promoting good government. Where sensitive issues are concerned, the Bank can find other ways of conveying the message to governments. There are several areas where the existing best practice in ESW could be usefully replicated or innovative ESW be attempted:

(i) Assessments of the enabling environment for private sector development (e.g. Uganda Private Sector Assessment). This enabling environment might include attention to the private-not-for-profit sector represented by NGOs, and approaches for

increasing public information about, and participation in, economic decision-making.

(ii) Where the legal framework for development is inadequate, the Bank may wish to undertake legal sectoral reviews to assist countries develop a strategy for establishing a legal system that is supportive of development (see Indonesia legal review and financial sector reviews in the Philippines, Guinea and Senegal).

(iii) When the Bank is working within sectors in borrowing countries, it should consider undertaking institutional assessments in order to better appreciate how sectoral decisions are made, and what might be done to strengthen institutional capacities within that sector to enhance performance.

(iv) Strengthen the role of public expenditure review work in order to achieve greater transparency in budget allocations. This analysis should include all government expenditures including those that are sometimes given to special status, such as military expenditures. Such analysis should focus on the productivity likely to be generated from different kinds of investments, their opportunity costs as well as other economic consequences. (See Uganda Public Expenditure Review, 1990). Military expenditures can be white elephants and need to be treated like any other white elephant in Bank public expenditure work. (How these should be treated is discussed above, in para. 121).

Lending Instruments

157. A key issue in work on governance of the kind described in Part II is the type of lending instrument that would be appropriate. There can be no hard and fast rules of course, but the Bank's experience with institutional development suggests that building or strengthening institutions has its own cycle, which is significantly longer than the traditional Bank investment project cycle. It calls for a comprehensive understanding of a country's institutional problems and the political, economic and social context within which those institutions function. Thus, in many cases, structural adjustment operations may be inappropriate, although they may play a role in affirming commitment to such reforms. The approach to technical assistance may itself

have to change. While this paper cannot address the financing issues in changing approaches to technical assistance, it is the case that both the time and resources devoted to preparation and the product mix and project cycle warrant attention.

158. Direct Bank assistance for efforts such as civil service reform, strengthening key economic agencies, strengthening accountability, transparency and the rule of law through technical assistance and institution building components in regular projects are the more direct way of supporting good governance. Indirect ways include such initiatives as the Africa Capacity Building Initiative which through its emphasis on creating centers of excellence increases the level of understanding within the educated elites of key issues of development. Similarly, broadly conceived approaches to human resource development also contribute to improvements in effectiveness, productivity and good governance.

159. But most important of all, concern for good governance needs to be more systematically integrated into all operations, focussing on obstacles that weaknesses in governance create for the attainment of the objectives under each operation. This approach includes attention to opportunities for encouraging participatory approaches to development, an outward customer oriented approach in project design, creating opportunities for choices among suppliers of public services. The strengthened poverty approach of the Bank along with its concern for women in development and the environmental focus are also encouraging good governance. The Bank and IFC can also assist to strengthen private sector associations, chambers of commerce, professional associations, bureaus of standards etc., thus, strengthening the quality of the private sector response. These efforts draw the attention of governments to issues they might be tempted to ignore and help create and give voice to new constituencies.

Aid Coordination

160. Mr. Shihata's paper has focussed on the issue of aid coordination and noted that the Bank should not act as the agent of donor countries at these meetings, although as Chair of the meeting, it would normally inform the country of the current thinking of donors. Issues of governance are arising more frequently at these meetings, and the Bank's preparatory work needs to focus on those issues of relevance to development such as described in this paper. In the preparatory work for the meetings, it would be important not to focus exclusively on the problems of the recipient, but also pay attention to the role of donors when their practices contribute to poor governance. This is

particularly the case when intense commercial competition for aid financed projects leads to unfortunate investment decisions. As noted above, the DAC is attempting to develop ground rules for these situations, including increasing reliance on ICB (see Box 2A). It is also looking to the Bank for judgements on the appropriateness of certain large projects as a means of reducing the number of aid-financed white elephants. An important role for the Bank is to "blow the whistle" on such operations.

161. Given the constraints the Bank faces in terms of staff resources, there is a strong case for using its leadership position in aid coordination to encourage other donors to assist in some aspects of the accountability, and openness of the rule of law.

Implications for Bank Practices

162. There are a number of implications of the above analysis for Bank practice. First, with regard to adjustment operations, given the technical complexity of the preparatory work and the speed with which borrowers require resource transfers, there is a constant danger that the Bank, by deploying large missions and leaving insufficient time for adequate dialogue, can weaken ownership of programs that are then seen to be externally imposed. In an ideal world, sufficient preparation time would permit a better understanding of the political economy of the country, and through a more intensive and extensive dialogue, greater ownership and understanding of the program by the borrower is assured. However, Bank staff frequently do not have that luxury. Governments frequently delay adjustment and come to the Bank when they are facing a serious crisis. There is, then, an inherent conflict between the need for quick resources frequently in support of sensitive policy reforms (like exchange rate policy) which do not lend themselves to an open consultative process, and the need to build ownership and understanding of the program. Moreover, greater ownership invariably comes after a program begins to show results. It, nevertheless, remains important to ensure that operations are designed, taking into account, the political economy of the country, and that ownership of the program, however narrow at the start, is genuine, and that it is rapidly broadened over time, as is the borrower's understanding of the program.

163. Second, since popular participation in projects has been demonstrated to improve project effectiveness, the Bank, as noted is attempting to spread best practice in this area. Spreading best practice will require staff skills in organizing participatory processes, mediating conflicting points of view while achieving results in a timely manner. In some cases, it means identifying

intermediaries through which the Bank can work. It may also mean working with local NGOs; in other instances, this may mean searching for special skills in local sociologists, development managers, or anthropologists who can be brought into projects for particular aspects of project work. In some cases, timetables will need to be adjusted in order that this labor intensive work--often at the beginning of the project cycle--has adequate time to be done.

a. It must be recognized that given current Bank budget constraints, it will be important to spread best practice in participation within existing staffing patterns and with few additional resources. Where possible, however, co-financing might be sought to support spreading best practice.

b. The Bank has an obvious comparative advantage in large scale investment projects and adjustment operations. Most of the success cases in participatory development have been relatively small scale projects. (One of the exceptions is the National Irrigation Administration in the Philippines. See Box 2D). Spreading best practice to large scale programs in order to improve their effectiveness and sustainability will require research to identify methodologies appropriate for the scale of these operations. The Bank's learning process on participation will address some of these issues. (Box 2E).

164. Third, staff concerned about sustainability and effectiveness are turning increased attention to fostering an "implementation culture". Best practice includes simple project design, discourages creation of autonomous project implementation units, encourages use of existing structures to implement projects, implies increasing supervision, suggests up-front action and conditionality rather than delayed dated covenants, recommend recruitment of key staff by appraisal and study fiscal effects of projects. This list itself shows an awareness of how the Bank can contribute to better or worse governance.

165. Fourth, it is arguable whether the Bank is as open and accountable as it would like its member governments to be. The Bank is accountable to its shareholders, its bondholders, and to its borrowers. But it may not be sufficiently open and transparent to the beneficiaries of its projects and to the public at large because of concerns about government confidentiality. Ways to encourage openness would be to encourage more formal consultations by borrowers with those affected by Bank operations. The Bank could make most

Board documents public after a certain interval and require that most CEMs and other sector work are routinely published or at least publicly available.

166. Work on governance will raise unit costs and change some skill requirements. Given the overall budget constraints, these fresh claims on resources will need to be handled like all other such claims through a determination of priorities with existing country programs. The skill mix problem can be partly addressed through use of consultants. The LAC region, for example, has innovatively hired a number of auditors and tax specialists as consultants and staff to assist its work on accounting systems, decentralization and tax reform. The Bank also should not attempt to take too much upon itself when other agencies and donors are willing and able to help. Thus, there are a number of UN agencies and bilateral donors who have a comparative advantage in some governance areas which the Bank, through its aid coordination function, should seek to tap on behalf of its borrowers. There will nevertheless inevitably be some trade-offs, since this is one of a number of areas, such as the greater focus on policy, that increases the staff intensity of the Bank's work. In the medium- to longer-term, however, high quality work on governance issues, and improved Bank practices reflecting the "implementation culture" may well help reduce overall costs and improve development effectiveness of Bank interventions.

Training and Research Implications

167. This discussion on the scope and limits of the Bank's concern with governance has direct implications for training and research. While the complexity of the issues at stake precludes formulation of a specific research agenda now, there were training and research issues which emerged in the course of preparing this paper which should be noted. Some aspects of this work will be pursued as a result of the research agenda generated by the WDR 1991, as well as the ongoing research and work program of CECPS.

168. The following general criteria emerged to serve are guidelines for training and resource on governance.

- Learn systematically from the experience of the Bank and other donors, and spread that best practice throughout the Bank.
- Maximize use of existing "cutting edge" scholarship in Bank practice.

- Explore possibilities for cooperation with other institutions and academic communities -- in borrowing as well as donor countries.

- Identify the specific comparative advantage of the Bank, in light of its leadership role, but also in light of staff, and resource limitations.

169. Training. This paper has stressed the need for a cautious approach to the dialogue on governance issues, staff judgement and restraint, and the tailoring of the level of dialogue and interlocutors to the nature of the governance issue at stake. It is evident, therefore, that the Bank staff involved in this dialogue must become familiar with the nature and complexities of the issues. Appropriate training is needed, and could be structured around three broad subjects.

170. The first subject should be the interaction between governance and the social and ethnic institutions of the country. Use should be made of the best of the current analytical literature available on these topics. The second subject should be the interaction between the dimensions of governance discussed here (accountability, openness, the rule of law) and economic development and other technical issues of direct relevance to that interaction--such as public sector management. For this, resource material would consist of a variety of scholarly articles and Bank documents--such as the WDR, the Public Sector Management paper, and the present document. The third subject should be the conduct of the dialogue on governance, at both the macro and the project level. The resource material could be a series of case studies of Bank or other donor projects and interventions whose design fosters accountability and openness or other aspects of development-promoting governance.

171. The Bank has experienced project officers within its staff whose knowledge of how to work with, through, and around problems encountered in the field should be marshalled for training programs. State of the art development management, institutional economics, and social theory combined with the Bank's storehouse of project experience should be integrated into future training programs.

172. Research. Because of the substantial existing literature on various aspects of governance and development, the first need is for synthesis of this material prior to new original analytical contributions. There remain, however, big unknowns to be explored. Precisely because of the vastness of the topic, and because far-reaching changes in governance are taking place in every region,

any proposal for new analytical research needs to be derived from a careful specification of problems encountered on endeavoring to design and implement more effective projects and programs. It will not otherwise justify the cost. In addition, before engaging in Bank funded new research, the knowledge gaps of greater immediate relevance for the effectiveness of development aid must be identified, and then the interest and resources of other donors and agencies need to be mobilized. Bank leadership on the research agenda, in short, does not necessarily mean Bank financing.

173. For the Bank, the research challenge is discovering more about that which is central in the design and implementation of robust and sustainable development policies. Any future research agenda must obviously be derived from obstacles and problems identified by staff as keys to achieving those more robust results. One area which clearly meets this criteria is the complexity of social systems in ethnically diverse countries and the relationships between diversity and stability. There are widely different approaches to the governance of ethnically diverse societies with different economic policies and outcomes. Research on what has worked well, and what can be replicated, would assist staff who work with these issues in projects and programs. The conclusions, moreover, feeds back into the training programs suggested above.

174. Three other research topics on which it is apparent more research is needed are: (1) the connection between macro and micro level accountability. Grassroots initiatives and people's participation in development activities have implications for accountability. This research would explore how these initiatives affect the responsiveness of public agencies; (2) As a related topic, and given the deepening of Bank experience in working with NGOs, work is also needed on the role of NGOs in developing aspects of civil society; and (3) finally, research is needed on decentralization and its economic, institutional and financial implications. As noted, decentralization is being demand driven in many countries; sometimes these changes are occurring before their financial and economic implications are widely understood.

Concluding Note And Next Steps

175. The 1980s were the decade of adjustment. For governance, the focus was on getting governments out of those functions more effectively and efficiently performed by the private sector. While this remains a high priority for the 1990s, increasing attention must be paid to improving the capacities and effectiveness of governments for that which they must do i.e., creating an

enabling environment for development, human resource development, and protecting the environment.

176. Following discussion of this paper at the Board, the following activities are envisaged:

(i) Dissemination to the staff of the key messages in this paper and the Board's reaction to it;

- the critical importance of promoting an enabling environment for development -- broadly defined to include issues of accountability, rule of law and openness;
- the need to approach issues of governance with caution and humility, and sensitivity to the concerns of borrowers;
- the need for a better understanding of country governance issues by the Bank, and the way they affect economic performance, through economic and sector work and research;
- increased attention to governance issues in the preparation of projects and adjustment operations; and
- increased attention to governance issues as they affect implementation and development effectiveness.

(ii) A broad based dialogue with borrowers, interested academics and others, has begun in the Africa Region, and depending upon this experience, could be emulated elsewhere;

(iii) A modest training and research program based on the ideas presented in paras. 168-175.

(iv) Given the above conclusions, a progress report to the Board on the Bank's experience with the operationalization of governance issues would be appropriate in about two years time.

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ANNEX A

TASK FORCE ON GOVERNANCE

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Beckmann, David M.	EXTIE
Bryant, Coralie	PRDPD
Campbell, Tim	LATIE
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Einhorn, Jessica P.	FODDR
Gruss, Hans Jurgen	LEGAF
Harris, Randolph L. P.	CODOP
Heyneman, Stephen Paul	EMTPH
Isenman, Paul	PRDDR
Jones-Carroll, Charlotte	PBDCP
Khanna, Anupam	EXC
Kohli, Harinder S.	EMTDR
Lacey, Robert Mark	EDICD
Lamb, Geoffrey B.	PRDPD
Landell-Mills, Pierre M.	AFTDR
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Nankani, Govind T.	LA1IN
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Pachter, Lisa	EXTIE
Paul, Samuel	CECPS
Pellegrini, Anthony J.	EMTIN
Rigo, Andres	LEGAF
Ritchie, Daniel	ASTDR
Sagasti, Francisco	EXTDR
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* Task Manager

786/92

First Draft
May 8, 1991

GOVERNANCE FOR DEVELOPMENT

A Discussion Paper

I - WHY GOVERNANCE MATTERS

> "History shows that well-functioning markets are indispensable for development. They promote competition and provide the incentives that spur entrepreneurship and innovation. History shows just as clearly that markets cannot work properly without the legal and regulatory framework that only government can provide. And at many other tasks, markets sometimes prove inadequate or fail altogether. That is why governments must invest in infrastructure, for example, and provide essential services to the poor. It is not a question of state or market: each has a large and irreplaceable role."
>
> World Development Report 1991

Introduction

1. The Bank has long been concerned with the issue of how best to harness governments and markets to promote economic development. In the 1970s, it became clear that investment lending could not achieve its objective in the absence of an appropriate policy environment. As a result, the major objective of the Bank's operational agenda throughout the 1980s has been to assist its borrowers in the creation of an "enabling environment" for development. In the early 1980s, the emphasis was on the need for an appropriate macro-economic policy framework together with improved incentives. To facilitate adjustment, the Bank began in the mid-1980s to place considerable emphasis on improving public sector management. As its understanding of the process has grown, the Bank's definition

of development has broadened, as also its understanding of what constitutes an enabling environment. Thus, with the renewed emphasis on poverty, and the enhanced focus on women, the environment and private sector development, there is increasing recognition of the important role of governments must play in addressing this rapidly broadening agenda.

2. At the same time, it is becoming increasingly clear that many governments in the developing world are having difficulty rising to this challenge. The relatively poor economic performance of the developing world during the 1980s (with some notable exceptions, mainly in Asia) is attributable to a number of factors, including the constraints to growth from industrial country policies (trade barriers, high interest rates), weak terms of trade, and the debt overhang. However, the poor policies and implementation capacity have clearly contributed significantly both to the overall performance and to the failure to adjust to the external shocks. In some cases, severe mismanagement has been at the heart of poor performance. These problems of governance have been a source of increasing concern to the Bank in its operations, and have become a subject of intense debate outside.

The Bank's concern with governance

3. For the Bank, governance issues have surfaced at three levels. First, the Bank's increasing involvement with macro-economic policy reforms brought forth greater concerns about the quality of economic management. It called attention to the incentive framework in borrowing countries and exposed Bank staff to the inherent difficulties in ensuring that adjustment programs are genuinely "owned" by governments, that there is adequate commitment to and understanding of the program, particularly beyond hard-pressed ministries of finance, and that the programs themselves are politically sustainable. As noted in the two PRE Reviews of Adjustment Lending, the mixed record with adjustment lending demonstrates the importance of these preconditions to successful adjustment.

4. Second, the Bank's efforts to help strengthen the capacity of governments to undertake adjustment has led to a broadening of its involvement in public

sector management reform from institution building related to specific investment operations to cross-sectoral issues such as the strengthening of core agencies responsible for economic policy, the civil service, public expenditure management and parastatal reforms. PRE's recent review of Bank assistance for public sector management notes that these efforts have "proven difficult and costly to conceive, sell to concerned governments, implement and sustain."

5. Third, there is increasing recognition of the close relationship between the quality of the Bank's investment lending portfolio and issues of governance. In part, this reflects "Government failure to implement forcefully the needed structural adjustments" the absence of which continues to "hamper the development of an enabling environment to sustain development operations."[1] The FY90 ARIS report draws a close relationship between government performance and portfolio ratings:

> In the better performing countries, governments show a strong commitment to reforms, have a well-defined set of priorities for development and make efforts for timely and result-oriented project implementation...In contrast, countries with poor performing or deteriorating portfolios often suffer from a faltering macro-economic environment, frequent changes in government policies and priorities due to...political instability or social disturbances, weak public sector management, and severe human resource constraints.

6. Not surprisingly, governance factors have begun to surface in the Bank's dialogue with borrowers, in the context of country implementation reviews and adjustment lending, and in its economic, sector, and project work.

The External Environment

7. At the same time, a great debate is raging on issues of governance. In part, this debate is in response to the rapid political changes in Eastern

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[1]/ FY90 ARIS Report. (CITE FULL REFERENCE).

Europe, in Latin America, and more recently in Africa, which represent the outcome of the growing dissatisfaction of people with their governments. Bilateral donors, taking a cue from these historic events, have been debating their response to these developments. With the Cold War seemingly coming to an end, the strategic imperative that has driven aid allocation has waned in importance. NGO criticism of official development assistance is also causing bilateral donors to be concerned about issues of the quality of governance and human rights in their aid policy.

The Bank's Mandate and Purposes of this Paper

8. The Bank had been grappling with concerns about governance at the same time that bilateral donors were embarking upon their own more political agenda. The Bank's concern, however, is with ensuring operational effectiveness and remaining within the mandate and comparative advantage of the Bank. Mr. Shihata, Vice President and General Counsel, took the initiative, before the debate over governance went any further, "to establish the legal framework for the Bank's dealing with this issue as a prelude to any future analysis of the manner in which the Bank may take it on operationally." Mr. Shihata's legal opinion, dated December 21, 1990, and discussed at a Board seminar on April 12, 1991, sets out the five aspects of governance beyond the Bank's mandate:

(i) The Bank should not be influenced by the political character of the member. The form of government of the member is immaterial to the Bank. Thus conditionality introducing "political transformation" would not be consistent with the Bank's Articles of Agreement.

(ii) The Bank should not interfere in the domestic or foreign partisan politics of any member. It should deal with the Government in charge, and act impartially with regards to the different political factors in the country.

(iii) The Bank, as coordinator of foreign assistance for a given country, should not act on behalf of donor countries in influencing the recipient country's orientation or behavior.

(iv) The Bank should not allow political factors or events (no matter how appealing they may seem) to influence its decisions, unless ...it is established that they have a direct and obvious economic effect relevant to its work. For these to be taken into account such economic effects have to be preponderant.

(v) The staff should not build their assessment on the possible reactions of any Bank member to their analysis.

9. Mr. Shihata's memorandum then considered, by way of illustration, a number of areas that do fall within the Bank's mandate: civil service reform, legal reform, accountability for public funds and budget discipline.

10. This paper is, therefore, a modest first step towards the future analysis of governance issues suggested by Mr. Shihata. This paper does not attempt a comprehensive policy review of the Bank's work on governance. Such a review would be premature, given the limited nature of the Bank's direct operational experience outside the public sector management area. The paper instead is exploratory in nature, defining the major concepts, outlining possible areas where the Bank's agenda on governance could be broadened with some benefit to its borrowers, and discussing operational issues that might emerge if the Bank were to broaden its agenda. As such, it will provide a discussion of a few key dimensions of governance as they relate to the Bank's mandate for development and its concern for helping create an enabling environment, and describe the Bank's experience with some of these dimensions and current best practice (Parts II and III of this paper). To provide a context for that discussion, this section of the paper provides a brief overview of issues of governance and the dimensions of concern to the Bank. Implications of this analysis of key dimensions of governance for the Bank's operations are explored in a preliminary and tentative way in Part IV. The objectives of this paper, therefore, are:

i) To briefly review the Bank's experience to date with issues of governance as they affect economic development;

ii) In light of that review, to identify and analyze key dimensions of governance which seem to emerge as central to country economic development performance and Bank operations;

iii) To sensitize staff both to governance issues and the sensitivities of borrowers; and,

iv) To set out an agenda for further work.

Definition of Governance and Key Dimensions

11. Governance has three distinct aspects: (1) form of political regime, (parliamentary, presidential, military, authoritarian); (2) processes by which power and authority are exercised; and (3) capacities to design, formulate, and implement policies. The first aspect clearly falls outside the Bank's mandate and hence will not be discussed here. **The major focus here will be on the second aspect -- the way in which power and authority are exercised so as to have a direct impact upon economic development.** Capacity issues -- the third aspect -- interacts with how power and authority are exercised and will, to a lesser extent, be discussed. As there is, however, simultaneously with this paper, a PRE review of the Bank's experience with public sector management, that paper is the source for more thorough and detailed information about Bank work on capacity building in the public sector.

12. Governance is largely about the processes, organizations and institutions that structure the relationships between governments and markets. Governance is not a "black box" -- only to be taken as a given, but rather it is a bundle of processes, organizations and institutions affecting how economies function and through which the Bank has been working, and must continue to work. The differential performance of economies over time is a story about how institutions evolved -- their historical and cultural roots. The perspective of this paper

is that institutions are central to economic performance and that governance describes some of the key processes affecting the evolution and effectiveness of society's institutions.

13. The first dimension to which we will turn is efficient resource management -- a concern that has been central to Bank work from its beginning. Efficiency can be defined as getting maximum results for minimum inputs. It means producing results in ways that do not waste resources.

14. The second dimension is accountability by which is meant the ways in which decision makers in a country are held to account by those governed for their performance. It also means answering up the chain of command to organizational leaders. Many aspects of current Bank work on macro management address essential components of the accountability problem. Public expenditure management, for example, as discussed in detail in the accompanying paper on public sector reform, provides critically needed technical assistance to borrowers with managing their budgets.

15. The third dimension is openness by which is meant processes that facilitate economic openness -- availability of information from public and private sources, tolerance for competitiveness over policy choices, and public access to financial and economic data. One aspect of the concept of openness is that of transparency -- the manner in which budgetary and procurement processes are managed.

16. The fourth dimension -- predictability and the rule of law -- means, for the purposes of this discussion, a system of objective rules which are actually applied and an independent judiciary capable of enforcing the law without regard to person. Bank experience indicates that the presence -- or absence -- of legal rights protecting life, liberty, and property directly affects investment, risk, and uncertainty.

17. The overall quality of government is also heavily influenced by the quality of leadership -- the ability to marshall resources and motivate followers in order to guide an endeavor from inception through implementation, learning from

errors along the way. Leadership goes to the crux of the issues embedded in commitment and hence sustainability of Bank programs and projects.

18. In brief, all four dimensions and the quality of leadership are within that aspect of governance called "the exercise of power and authority." Each of them are also at work within each sector and factor involved in production. It is their interactions which determine choices by allocating resources, whether those resources are foreign exchange, licenses, fertilizer, or access to schooling. Those with the power to make those decisions may do so under more or less of a legal framework, they may be more or less efficient, more or less accountable, their decisions may be more or less transparent. The effectiveness of Bank projects and programs are determined in this process.

Relationships Between Public Sector Management and Governance

19. As the public sector management paper points out (para 8) public sector reform is integral to the larger issue of governance yet " as important as the PSM issues are, they are not the whole of the governance subject." As that paper notes governance includes "a focus on the public's role in the determination of policy and actions, or the methods by which public officials are held accountable (or not) to the population." Yet while governance is a broader subject, the range and depth to which improvements in public sector performance and efficiency add to the prospects for good governance cannot be underestimated. With that in mind, it is worth recalling briefly the Bank's work in public sector management.

20. First, Bank work on public expenditure management -- instituting better systems of budgetary management, expenditure control, and investment programming -- has resulted in significant improvements in budgeting and financial management in, for example, Uganda, Ghana, Nepal, Jamaica, and Ecuador. The needs and demands for this kind of assistance have steadily grown. The work requires technical expertise and great sensitivity to the forces at work in specific country situations.

21. Second, public sector reform work concentrating on civil service reform has featured in 76 projects, including 52 adjustment operations and 24 technical assistance loans. While most of this work is in Sub-Saharan Africa, several Latin American countries are also reducing and reorienting their civil service.

22. Third, Bank work on restructuring public enterprises has been far reaching. The overall impact of these reforms is positive: public enterprises play a less significant economic role than they did in the past. For example, Mexico, Philippines, Jamaica, Togo, and Guinea have sold large portions of their public enterprise holdings. Further, the introduction of performance evaluation systems, cost-cutting measures and improved managerial structures and incentives in the framework of overall policy reform have raised productivity. In addition to the more detailed discussion in the accompanying public sector management paper, there is a separate paper under preparation on divestiture.

Regional Experience With Dimensions of Governance

23. This section of the paper will discuss the Bank's regional experience with each of the dimensions defined above. The point here is both what the governance problem has been for the Bank, and the very different regional experiences to date with governance.

24. At root, governance is an issue because people perceive it to be a problem. People feel the effects of poor governance --when it does not deliver economic performance -- when they live with the consequences of poverty, inefficiency, corruption, a degraded environment, and public insolvency. The problem is the ineffectiveness of many governments in reaching these goals and resuming growth; for the Bank, governance is additionally an issue when borrowers either do not share these goals or are not committed to them within Bank projects and programs within their countries. Bank staff within each of the regions, on the other hand, have identified those opportunities to generate commitment and to improve the performance of governance within widely different specific country circumstances.

25. The diversity of country experience is a major feature of the governance story. Each of the countries and regions within which the Bank works have distinctive cultural and social -- as well as economic -- histories. Precisely because governance and institutional change are grounded in the distinct histories of specific places, summaries of experiences never do justice to the complexities of local institutional issues. In spite of all efforts at this historical distinctiveness the brief summary below cannot capture all the varied nature of these divergent regional experiences.

Efficiency of Resource Management

26. While each region has had considerable public sector work to improve the efficiency of government in its resource use -- civil service reform, privatization, or public expenditure performance -- in Latin America there are additional components of public sector work underway that are special to this region, most notably work on decentralization and urban management. In general this work comes within the first dimension --concern with efficiency -- and yet it also has many implications for improved accountability and openness.

Accountability

27. In many countries in Latin America, work on decentralization is demand driven. That is leaders are responding to real popular pressure for greater decentralization -- in Chile, Mexico, Argentina, Guatemala, and Brazil. In some instances the division of responsibilities between central governments and provincial governments over expenditures and resources are very complex. In Argentina, provincial governments incurred debts that accounted for, in 1986, some 6 percent of GDP. The vertical accountability, therefore, of local governments to central governments became as important as the external accountability of the executive to the congress. Now, at the request of the government, the Bank is helping Argentina strengthen the autonomy of its Central Bank and drafting a financial management and control law for its public sector.

28. Another component of accountability is in the public debate over the implications of alternative budget policies, especially by organizations and leaders independent of the government. In this respect, among others, the African Capacity Building Initiative is making a major contribution to governance. Its range of projects will mean strengthening research capacities for policy analysis both inside and outside the public sector as well as facilitating further development of groups such as professional associations of African economists. Since greater ownership of adjustment requires fuller and more informed public understanding of the issues, this kind of institutional development is centrally important.

29. Capacity issues for some governments in Africa, as well as some within each of the other regions -- Yemen, Brunei, Guatemala, El Salvador, Belize, Nepal, and Laos -- are often a central cause of efficiency and accountability problems. There may be too few public institutions with financial management, auditing, and accounting capacities. For some countries it is not an issue of fine tuning or improving public accounting and auditing so much as getting those skills and capacities in place in the first instance, and then positioning them so that they can be reliably called upon and their results widely accepted.

Openness

30. Concern for open economies has its counterpart in open governance -- and for similar reasons. Just as closed economies tend to harbor distortions, provide opportunities for unfair or inequitable treatment, or opportunities for rent-seeking or corruption, so does government in which policy choices and budgetary/administrative decisions are made in secret or without public debate. Competitiveness of ideas in public forum is much like competitiveness of products in market competition -- it lets the customer decide relative merit, provides a check on mistaken assumptions, clarifies choices and flags unintended consequences for economic policy choices.

31. There is much to be done to achieve greater transparency in financial accounting, procurement systems, and through auditing for results than has been

done to date. Further there is widespread agreement across a range of very different countries that auditing, procurement processes, and financial accounting must be improved as an integral part of improving opportunities for growth, investment, and fiduciary responsibility. Sometimes government accounts have not been audited because there is no political will to do so; in other cases, there are serious incapacities in the offices of auditor generals, and a reluctance to sub-contract private auditors. Private auditing firms are short of trained accountants. Training facilities at local universities are underfunded, poorly staffed, and utilizing outdated and outmoded curricula. The bias throughout is towards input auditing rather than giving attention to results oriented auditing. The scope for more work and research here is great; the results could be substantial. This area carries wide ranging implications for the private sector; for businessmen, it is an essential part of the enabling environment for investment. For donors, on the other hand, there is the knowledge that public support for official development assistance is contingent upon a belief that scarce ODA funds are appropriately and effectively managed.

32. Increasing access to information is important both for accountability and for predictability. It is also the case that as information technology has undergone vast changes with the advent of the personal computer, photocopying, fax machines, electronic mail, and telecommunications, this may be an area where technology will drive the rate of change. There are many governance and public policy questions with economic implications in the information technology area.

33. There are also aspects of openness which are part of the rule of law. Indeed, whether or not there is a rule of law requires at minimum that people know what the law is. The publication of official gazettes which the Bank has supported in Mauritania, Guinea, and Cameroon so that citizens know the law is a first step. (Yet in countries with widespread illiteracy, that initial step may be inadequate.)

34. On the other hand, there is much to be learned about this dimension and its effect on economic performance. The Asian experience is a useful contrast. During the 1980s, Asian countries as a whole grew by over 8 percent per annum

in real terms while most of the economies of Africa, Latin America, and Eastern Europe stagnated or declined. The recent experience in the newly industrializing countries of Korea, Singapore, Taiwan appears to indicate that openness is not essential for improved economic performance.

35. The role of information and need for improved auditing brings up the "principal-agent" problem.[2] The problem of information and transaction costs is centrally important; the agent invariably has different kinds of information about the operations of the enterprise which the manager struggles to acquire. The differential access to information makes the principals problem of monitoring and auditing for compliance difficult; done ineptly, it sets up perverse incentives. Agents will resist transparency; principals will continually search for methods of discovery. The challenge to governance, and to better management, comes in structuring organizations and processes which improve the quality of information exchanged.

Predictability and the Rule of Law

36. Both a legal framework and an independent judiciary capable of enforcing the law without regard to person are required in order to have the rule of law. Investment requires that basic legal safeguards are in place --for the security of the person, for enforceable contracts, for property rights. Each region of Bank Operations has projects supporting aspects of legal reform and assistance with putting in place the rule of law. Eastern Europe has seen considerable activity -- and will surely see more -- in legal reform in order to introduce private sector development. While in a wholly different context, the Lao People's Democratic Republic also recognizes that the development of a legal system supporting business development is a first step in its strategy to promote a private sector; the same is true, although again in a different setting, in Guinea-Bissau. Indonesia, which already has a sound legal system and large

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[2]/ See, for example, Thrain Eggertsson, Economic Behavior and Institutions, (Cambridge Univ Press, 1990) p. 40-45; 203-213. See also Pranab Bardhan, "The New Institutional Economics and Development Theory: A Brief Critical Assessment" in World Development, vol 17, no. 9, September 1989, p. 1394.

private sector, has identified four priority areas for legal reform: contract and credit, company law, accounting framework, and capital markets; dispute resolution; access to legal information, such as publications of court decisions, government law, and an official gazette. In Argentina, the Bank responded to an urgent need for assistance to bring certainty and transparency to legal processes.

37. As these examples illustrate, the rule of law is directly linked to both predictability and openness -- clarity in the rules and how they are to be applied. The rule of law is both cause and consequence of the legitimacy of government. Much of that legitimacy comes about because of the behavior of those in power towards the protection of life and property. Historically efforts to develop protection for life, liberty, and the pursuit of happiness has been interpreted by jurists to include the fruits of one's labor -- and is the underpinning of property rights.

38. The legitimacy of governance is generated over time by the belief among its citizens that those exercising power do so, within the law, rather than arbitrarily. There are linkages between predictability and legitimacy: if due process in the determination of law and its enforcement
is generally taken for granted, popular compliance is relatively easier to achieve.

39. Few issues matter more for people across a range of human endeavor than that of predictability and a rule of law. In a highly uncertain and ever changing world, living at risk because of the whims of arbitrary leaders exacerbates economic and social problems. A predictable rule of law is essential for investor confidence, and for a wide range of commercial activity to take place; it is also important for farmers, small businesspeople, market women, and entrepreneurs. Not knowing whether families, interests, or property will be at risk, nor what recourse is available if they are, can be a major cause for human flight or capital flight. An independent judiciary, with capacity to enforce its decisions, along with legally enforceable property rights, and personal security, are important parts of an enabling environment.

40. This subject has been of particular interest in Latin America where in some instances investment has been affected by uncertainty at many levels. Sometimes this uncertainty comes from the randomness with which regulations are enforced, sometimes as a result of extraordinary inflation rates, and sometimes from high rates of turnover in public office. People in Somalia, Ethiopia, Mozambique, and Angola have experienced unpredictable violence that implants an atmosphere of risk and uncertainty. Latin American governments in the last decade moved away from military governments because they came to see them as especially vulnerable and often eluding a rule of law.

41. As in Amin's Uganda, members of minority groups may be peremptorily singled out for punishment without either due process or opportunity for self defense. Sometimes there are even laws that endeavor to "legitimize" the forced forfeiture of property and security of person without trial in the event that one has been found "guilty of economic crimes".

42. When leaders actions are not within the law, legitimacy is eroded; when it erodes, those in power use ever increasing coercion to get compliance; those coerced, call into question the legitimacy of government; the costs of compliance increase.

43. There are, however, special problems in achieving a widespread sense of legitimacy in ethnically diverse countries. There is always tension between those who believe in rights narrowly adhering to individuals and those who put social reciprocity and obligations as more important. And there are those who argue cogently that too much attention to individual rights erodes social responsibility and abets an "instrumental" view of social relationships. For example, rural Africans recall that there were strong elements of accountability in precolonial times where relationships were less individualistic and instrumental.

44. Just as law embodies values, legitimacy draws on values and social forces as well as the law. In ethnically or religiously diverse countries there are, as a result, potentially conflicting loyalties, and hence only a fragile

legitimacy may exist. National boundaries may not reflect these loyalties; the potential for disintegration into civil disorder may be greater. For example, between 1945 and 1975, 226 conflicts took place in the world, of which less than one-third were cross border conflicts, and two-thirds were internal communal-ethnic struggles.

Leadership

45. Leadership matters throughout the performance of governance. It is often the factor most influencing the motivation for follow-through and implementation of policy. Building public support while simultaneously minding public sector implementation requires talented leadership at many levels. Problems in Bank projects that spring from commitment, require that attention be paid to the manner in which commitment is exercised within a specific country context. The country situations vary because the institutions that impact upon commitment vary.

46. This paper turns next to a more detailed discussion of key dimensions of governance. Part II will discuss the issue of accountability and openness. Part III will then turn to the rule of law. Finally, the paper concludes with some reflections on approaches to governance for development and a research agenda.

first-draft
May 7, 1991

II - KEY DIMENSIONS OF GOVERNANCE: ACCOUNTABILITY AND OPENNESS

48. As indicated in Part I of this paper, Parts II and III deal more narrowly with issues of accountability, openness, and the rule of law, as they relate to economic development. Each dimension of governance is defined, and its linkage to economic development and the Bank's mandate is outlined. The Bank's experience in the area is analyzed and some operational implications are drawn. The purpose is to illustrate what Bank experience and best practice has been, and to draw attention to those places where these governance issues are part of the problem of development effectiveness.

ACCOUNTABILITY

49. Accountability is defined as the ways in which decision-makers in a country are held to account for their performance by those affected by those decisions. Within governments, it means answering both up the chain of command to organizational leaders for task performance, and externally, to the wider public for program effectiveness. The range of ways used in different countries for holding officials accountable varies widely, depending upon history, institutional capacities and the public's access to and use of information.

50. This section discusses accountability at the macro and micro levels. At the macro level, the Bank's primary concern is with the efficient allocation and use of resources. Financial accountability and audits are traditional Bank concerns. This not only requires systems of financial accountability, both for the public and private sectors, but also the capacity and willingness to monitor and evaluate the overall economic performance of the government. At the micro level, the Bank's investment operations focus on the efficiency of the output and delivery of the goods and services that it helps finance. Accountability and hence, efficiency at this level can be enhanced for some services through greater competition (the ability of the public to exit to an alternative source), and for others through greater participation (the ability to exert pressure or exercise voice).

The Nature and Scope of Public Accountability

51. The objective of public accountability is to ensure the congruence between public policy and public actions and services and to promote the effective and efficient use of official resources. Public accountability refers to the entire spectrum of approaches, mechanisms and practices used by governments to ensure that their activities and outputs meet the intended goals and standards. It is useful to distinguish between macro and micro level accountability. At the macro level, governments at all levels (central, provincial and local) may be held responsible for their policies, actions and processes (public expenditures, audits, budgetary process, etc.) through a variety of mechanisms. At the micro level, public enterprises and agencies that deliver public services to citizens may also be held accountable either through the same mechanisms that prevail at the macro level, or through competition and participation. The two are mutually reinforcing.

52. Public accountability involves three inter-related groups who have a stake or interest in the outcome: (i) the public and customers of public services, who are interested in service providers being accountable to them; (ii) political leaders and bureaucratic supervisors of service providers, who would like the service providers to be accountable to them for a mixture of public policy and private/parochial interests; and (iii) the service providers themselves, with objectives and interests often different from the first two.

53. The phenomenon of "capture," - the tendency to engage in rent-seeking - is an important barrier to accountability. It is exacerbated by government monopoly of many public services, the limited capacity of the public to demand and monitor good performance, and the problems in measuring and quantifying the benefits of services. These factors make improvements in public accountability an especially complex and difficult undertaking. Nevertheless, for the Bank, public accountability in borrower countries assumes special significance as its resource transfers and development projects cannot make the desired impact in its absence.

54. The practice of public accountability has evolved in countries in parallel with their socio-economic evolution. It is possible to distinguish three types of accountability:

(i) Political accountability represents a mix of political (parliamentary) and administrative accountability. The government (ministries, the bureaucracy etc.) is accountable to the political

leadership. Ministers in some countries, for example, are accountable to the legislature. Civil servants, in turn, are accountable to ministers. Accountability is, in this context, a macro-level concept with a strong focus on government wide actions and processes. Since the legislature/ministers cannot possibly supervise the actions of each individual civil servant, it/they must rely on the internal controls of the bureaucracy.

(ii) Professional accountability grew out of the expansion of public services requiring technical expertise in their production and delivery. The experts (doctors, engineers, and other specialists) involved in these tasks are guided by their professional norms in being accountable for the services they provide. They exert considerable autonomy in defining the public interest (on the basis of professional norms) and in deciding on the nature and content of the services. The criteria of accountability here are heavily influenced by norms internally agreed upon by professionals acting on behalf of the public.

(iii) Legal accountability augments political and professional accountability, reflecting the interaction between the public and the bureaucracy, and the adverse effect on efficiency and effectiveness of services arising from the tendency to secrecy and anonymity in bureaucracies. By and large, this practice is confined to countries with an educated public and well-functioning legal systems. Legal accountability is based on the public's right to information from the government, its right to sue individual civil servants and public agencies, and to seek financial redress in a court of law for violations of the public interest.

55. The historical evolution of accountability reveals three interesting features. First, attention to micro-level accountability mechanisms was a function of the expansion of the role of the state and the resultant overload of macro-level accountability. Second, till recently, the focus in public accountability has been on inputs and not on outputs. In most cases the latter tend to be too diverse and complex to measure, while public expenditure can be easily measured and audited. Third, except for legal accountability, the primary concern has been with internal means of control. Political leaders, agencies and bureaucrats act as proxies for the public and hold those reporting to them accountable through control systems within the relevant organization. However, hierarchical control is not an effective mechanism of accountability, especially

when collusion between supervisory and subordinate personnel is likely, and when the complexity of operations reduces transparency. This emphasis on vertical or upward accountability has been at the expense of outward accountability. The key missing element here is the view of the public as customers who must be served. Thus, a key challenge for countries is to create their own macro-framework for accountability that can nurture and encourage customer orientation at the micro-level. Even if this were possible, it would not ensure micro level accountability without specific measures to strengthen it. Thus, macro and micro level accountability are mutually reinforcing.

Macro-Level Accountability

56. There are two key aspects of accountability at the national level that are directly relevant to the mandate of the Bank. The first is financial accountability. The second is accountability for overall economic performance.

Financial accountability requires three ingredients:

(i) A properly functioning government accounting system that supports expenditure control, budgeting and cash management. Such a system provides a finance ministry and department managers up-to-date information on program expenditures. A cash management system tracks revenues and expenditures and helps ensure budgetary control;

(ii) An external audit system, usually through an independent Auditor-General, that reinforces expenditure control by sanctions against misspending and corruption, and, at the same time, encourages value for money in government programs;

(iii) A political process, managed by a public accounts committee or equivalent organization, that reviews the results of audits and ensures that follow up action is taken to remedy problems identified by the Auditor General or equivalent agency.

57. Without a well-functioning system of financial accountability, the risks of corruption increase greatly. Corruption is clearly an issue of concern to the Bank not only because it could lead to a misuse of Bank financed resources but also because it more generally reduces the efficiency of resource use in borrowing countries (See Box 2A).

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BOX 2A

Reflections on Corruption

Corruption is the misuse of power for personal profit. Corruption occurs in all countries in many different forms. It tends to erupt and increase in any country when inequalities are acute, resources scarce, rules unclear, disclosure and punishment unlikely, and upward mobility is blocked. Efforts to reduce its incidence need first to identify the kind of corruption (graft, bribery, theft, conflict of interest, nepotism, bias, or favoritism), its frequency (pervasive, occasional, or intermittent), and its perpetrators (contractors, public officials, political elite, businessmen, foreign suppliers).

The causes of corruption relate to political and economic conditions within the society and their linkages to problems in the world economy.[5] As such, causes are as complex as types of corruption are varied. While distinguishing between symptoms and causes is important, sometimes symptomatic relief provides opportunities for needed social and economic change to set in motion more lasting "cures". For example, bribery of customs officials, or public officials allocating essential licenses can be mitigated by clear rules, disclosure, and effective enforcement. Further, the amount of licensing can be reduced and automatically maximized with clear rules. The longer term measure of civil service reform adds more long lasting relief. Only over time, and with major policy reform, can improved economic performance increase economic opportunities and thereby provide the environment and context for diminished corruption. Yet every generation will have to make its own struggle against its resurgency.

Competition, clear rules, and disclosure are important first steps. In addition, it should be said, many countries have sophisticated and/or strict laws addressing corruption. Yet the existence of legislation alone is insufficient. The problem may lie with a lack of dependable enforcement. Simultaneously with enacting legislation, the strength and independence of the judiciary has to be secured.[6]

Yet heads of government have amassed extraordinary fortunes in countries with serious poverty. National foreign exchange reserves were transferred to foreign bank accounts. Indicative of the abuse of public authority by those who are politically powerful, such behavior,

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5. This is the thesis of one of the more thoughtful books on this complex issue by Robin Theobald, Corruption, Development and Underdevelopment, (Duke Univ Press, 1990). See pgs 10-11;161-169.

6. See background paper, A. Rigo and H.J. Gruss, "The Rule of Law" March 1991, p. 24.

among other things, damages prospects for economic development. It unleashes cynicism which corrodes public trust -- and signals to others to do likewise. Private wealth accumulated amidst public squalor undermines legitimacy. Yet graft on this large scale is not possible without collusion between major private corporations and public agencies. Often the "commissions" are paid by foreigners --foreign contractors, companies, or consultants. Sometimes such activity is associated with foreign aid. These foreign companies allege that bribery is but one of the costs of doing business in a country. Financing necessarily flows through different agencies; a percentage "take" off the top is considered a fee by some, a kickback by others.

What, if anything, can donors do in these circumstances? In part, the recommendation for countries is also true for donors --implement the regulations that are already in existence. Insist upon meeting procurement and contracting standards, upon meeting audit requirements, study audit reports, pay attention to the manner in which disbursments are handled. Even with these safeguards, the problems are daunting. Aid coordination provides another venue for flagging the importance of supervision, audits, and attention to disbursement processes. Audits may be required, and not always performed, or where performed, they may not be read. Project supervision is difficult to maintain in the best of circumstances; when donor agencies are pressed to do more with fewer people, supervision suffers.

However, donors need to recognize their role in this problem. The use of donor funds to finance large infrastructure projects has helped intensify competition for such projects among suppliers and associated malpractices. The DAC Working Party on Financial Aspects of Development Assistance has been wrestling with the issue of the trade distorting effects of subsidies tied aid credits. With a view to developing farm trade practices and introducing the benefits of ICB on large projects.

Should the international community move towards clear guidelines on appropriate conduct for procurement and contracting? Should companies, contractors, or consulting groups identified as having participated in graft, bribery, or larceny be blacklisted among donors? Is now the time for international cooperation to limit opportunities for corruption -- a contribution towards the international rule of law?

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58. Till recently, the Bank's focus has been almost exclusively on the accountability systems that affect the financial performance of implementation agencies and the use of the borrower's resources. But even in this narrow area, the record is poor. Compliance with accounting and auditing covenants has been uneven. Audit reports received as of November 30, 1990 as a percentage of reports due in FY90 range from a low of 40 per cent for the Africa Region to 74 per cent for the Asia Region, with a Bank wide average of 58 per cent. There is a growing recognition that the problems encountered in these areas are not project specific but are symptomatic of weaknesses in country wide accountability mechanisms. The need for improved financial accountability at the national level is of particular relevance in countries where the Bank is undertaking adjustment lending and is, in effect, providing substantial resources directly to government budgets.

59. To address this issue, the Bank is pursuing a three-pronged strategy: first, it is trying to improve borrower incentives to comply with accounting and auditing covenants through stricter enforcement and the introduction of penalties for non-compliance. The penalties include not extending closing dates unless the Borrower is current in its obligations or a single short extension to comply with the covenant, conditioning further processing of loans to compliance with requirements on past loans and suspending disbursements, particularly against Statements of Expenditure when SOE audits have not been submitted.

60. Second, it is trying to encourage a more systematic review of auditing and accounting issues in project preparation, including a thorough assessment of accounting personnel and systems in implementing agencies, with a view to strengthening these. In addition, a number of measures are being taken to achieve better accounting and auditing results, including encouraging greater use of private auditors and contracting out for accounting and audit services.

61. Third, it is attempting to strengthen borrower capacity through country-wide reviews of auditing and accounting. A number of initiatives have been undertaken in order to confront the problem of weaknesses in national accountability mechanisms. In Ghana, an Economic Management Support Project aims to remedy deficiencies in public financial management in that country. The project would clear the backlog of government accounts, and introduce new accounting methods and software to improve the accuracy and timeliness of financial data. The Auditor-General's Office would be strengthened through provision of equipment and support of in-house training. Similarly, the Development Management Project in Mauritania helped to establish the Office of Auditor-General. Audit systems in the banking sector are being reformed in

Poland and Algeria, while the former has also requested technical advice on audits and evaluations of government programs and accounts. In January 1990, the Africa Region set itself a target of 12 projects or project components aimed at strengthening financial management capabilities of borrowers through FY92. The Asia Region established a Task Force on Auditing which also suggested the need for a more comprehensive approach to the problem.

62. To ensure efficient resource utilization, these country-level reviews need to focus not just on the narrow concerns of financial accountability of projects and public expenditures, but also on the legislative or external (to the government) review of ministerial or agency policies and programs (program accountability) and public access to information through the legislature or otherwise. Such a review process enhances accountability and is a deterrent to corruption and waste. Financial audits, with their emphasis on inputs, need to be assessed in terms of coverage, quality of staff, specific practices, timeliness, the review process, publicity/dissemination, and the mechanisms in place for follow up action. A review of the laws and regulations may show that secrecy and confidentiality of data are being enforced when this has no functional relevance. It is only through detailed assessments that it is possible to identify gaps and assess the efficacy and impact of the mechanisms in place.

63. Knowledge of the range of macro-level accountability systems and of the innovations being tried out in different parts of the world seem to be extremely limited in many borrowing countries. Auditor Generals tend to be conservative, and they tend to view their practices as internal to the government and highly confidential. Yet, the very useful survey done by EDI and CECPS suggests that there is substantial innovation underway in OECD countries with potential lessons for developing countries. These reforms are similar to earlier reforms of the Planning, Programming and Budgeting system with their emphasis on objectives, performance indicators and programmatic presentation of the budget. However, the underlying intent is quite different. Whereas the earlier reforms focussed on improved budget decision-making, the current wave of reforms seeks to raise the efficiency with which resources are used. The focus is on giving managers greater freedom to run their operations by clarifying and reducing the number of rules they must comply with and replacing this with a substantial increase in their accountability through objectives, specific targets and performance monitoring. This accountability is sometimes reflected in contracts, programs or memoranda of understanding (a device which a number of developing countries have also adopted in the context of parastatal reforms), which are negotiated by heads of government departments and chief executives of public enterprises.

This is accompanied by a movement away from a single year to a medium-term budgetary framework that provides managers with a stable resource stream.

64. Accounting systems are being strengthened in OECD countries, with increased emphasis on cash management and in some cases accrual accounting. Internal auditing is being strengthened to enable managers to improve their own financial and control systems. The audit function is now being widened to not only ensure financial probity but also economy, efficiency and effectiveness of expenditures, or what is called "Value For Money" (VFM) audits. In some countries, government services are being opened up to competition. Interdepartmental charges for common services (office accommodation, vehicles, printing, security) have been introduced with agencies free to charge the going commercial rate and users free to seek alternative private sources of supply.

65. The relevance of these innovations to developing countries will vary from country to country. Some of the Bank's borrowers are probably ready for reforms along the lines described above. However, in most countries, the basic accounting and auditing systems are not in place. Finance ministries should not be encouraged to allow greater financial freedom to managers unless government accounting systems are functioning properly. So the first question to ask is whether the system is generating accurate and timely information on receipts and expenditures and can this information be linked to budgeting. Similarly, only when financial audit systems are functioning well can VFM auditing be considered.

66. The Bank however, could do more to strengthen the monitoring and evaluation function. This is currently largely donor driven and project specific. Yet in many countries, departments are required by legislation to prepare annual reports on their activities. Some countries have performance monitoring ministries. OED has tried to encourage these activities, but little attention has been paid to a systematic effort to strengthen the monitoring and evaluation function in governments. This will need to be a gradual process, given the competing claims on resources, but it is not a function that should be neglected.

Decentralization

67. Decentralization can, in theory, lead to significant improvements in the efficiency and effectiveness of government, as pointed out in the study on "Public Sector Decentralization," produced by the Africa Public Sector Management Division.

68. Decentralization can improve accountability and openness in government. The devolution of planning and expenditure authority creates the potential for improved service delivery, targeting, and sustainability. In large countries, public access to decision-makers can improve dramatically with decentralization (See Box 2B).

69. However, if not carefully managed, decentralization can lead to a deterioration in the use and control of resources, especially in the short term. Devolution of authority for revenue generation and expenditure from the Central Government to local governments which lack capacity and experience, can produce wastage and corruption. Apart from the potential damage done to macroeconomic stability and expenditure efficiency, resources are arguably more open to capture by elite groups at the local level than at national levels. The problem becomes acute in cases where expenditure responsibilities have not been defined, and where party officials constitute an elite well-placed to appropriate benefits.

70. Predictability sometimes suffers with decentralization, with a multiplicity of decision-making entities replacing central authority. Conflicts between authority and responsibility can accentuate this confusion. In Pakistan, for example, provincial governments have important technical and sectoral responsibilities, but no control over revenue decisions. National-level officials decide funding levels, which fluctuate with little regard to local needs, making planning impossible, again with obvious deleterious effect on predictability.

71. Decentralization can offer increased accountability, but also presents new problems. Decentralization raises the issue of local governments' accountability to national authorities. In the late 1980s, Argentina's provincial governments were responsible for the largest and fastest-growing portion of the public sector deficit. National goals can be seriously jeopardized when local governments face inappropriate incentives and inadequate oversight from national agencies. Moreover, radical decentralization can seriously weaken the capacity of the central government to manage the economy through fiscal and monetary means.

72. Perhaps the most serious problem which confronts countries embarked on strategies of decentralization is that of weak administrative capacity at local levels. While decentralization is taking place in the context of a diminishing role for the public sector, most local governments do not have the capacity to fulfill even these reduced responsibilities. Planning, budgeting, and accounting all represent areas where vital skills fall short. The poorest municipalities,

BOX 2B

DECENTRALIZATION IN EASTERN EUROPE

Perhaps the most important phenomena widely present in Eastern Europe at the beginning of this decade are (a) political liberalization, and (b) recognition that macroeconomic adjustment and reform of the state are prerequisites to sustainable economic growth. Closely linked to both of these phenomena is a significant movement to decentralize the public sector.

Strengthening local government is widely viewed as essential to ensuring greater responsiveness and accountability in many infrastructure and service areas that have been dominated from the center in both delivery and financing aspects. Development of political and institutional means to hold local government authorities accountable to their constituents is important because much of the justification for public sector decentralization is based on the premise that many areas of infrastructure and services are provided more efficiently at the local level since beneficiaries can better express their demand for these services, control costs and hold local authorities accountable for their actions.

Decentralization of the public sector in Easter Europe requires fundamental reforms in the expenditure and financing responsibilities of local governments. Fiscal chaos could ensue if local revenue capacity is not enhanced and intergovernmental fiscal transfers are not controlled. A collapse of local infrastructure and services is likely if local expenditure assignment is not matched with revenue authority and local institutional capacity. Local government reforms must include, therefore, fiscal reforms at the national and local levels and local government institutional strengthening. These reforms also will be crucial to stimulating increased private sector productivity, not only through improved delivery of public infrastructure and services, and a prudent regulatory framework, but also because local governments will be key to implementing an effective policy of property rights through legal cadastres that provide security for the transfer of property.

Local governments will be key implementing institutions for the Bank's pipeline of proposed projects in Eastern Europe, primarily in the areas of infrastructure, the social sectors, environment, rural development and poverty alleviation. However, before these decentralizing countries may absorb effectively lending operations, local governments must be strengthened to discharge effectively their new and growing responsibilities. Key areas for institutional strengthening include: local taxation policy and administration (and consistency with national taxation policies); management of local enterprises (e.g. privatization and/or regulation in areas such as water supply and sanitation, transport, solid waste and housing); budgeting, accounting and audits; maintenance programming and implementation; investment planning and evaluation; and procurement practices.

Because decentralization in Eastern Europe comes after decades of tight, central control, the pace and scope of the decentralization process are issues of concern for the countries and for the Bank, and all recognize that there is no broadly recognized "road map" for public sector decentralization.

Therefore, the Bank's strategy for assistance to the decentralization process is broad and country-specific, but the short-term strategy is evolving in four key areas: (a) policy dialogue and possible inclusion of local government strengthening measures as part of SAL conditionality (e.g. the Hungary CEM is focussing on "Reform and Decentralization of the Public Sector"); (b) country and regional sector work on local government reform (e.g. regional work in FY91 and local government reform in Poland for FY92); (c) targeting technical assistance on local government reform (e.g. local government component of Infrastructure Technical Assistance Loan to Romania); and (d) highly selective project support through lending operations in areas critical to overall adjustment and reform (e.g. proposed housing project loan to Poland).

whose constituents stand to gain the most from improved delivery and targeting of social services, are precisely those least able to perform these functions.

73. Despite these potential and real difficulties, decentralization of government decision-making, power and revenue-generation is an increasingly common phenomenon in Latin America, Asia and elsewhere. As it affects the way in which governments manage their economies and the design of projects themselves, the Bank needs to understand better, and adjust its efforts to meet the challenges of decentralization.

74. The Bank's present approach to local government development relies heavily on financial tools to ensure efficiency, including cost recovery for municipal services. An upcoming study on decentralization in LAC countries points out the need for a more comprehensive strategy. The study suggests that greater attention be given to mechanisms such as hearings or surveys, which allow local preferences to be expressed or verified. In Mauritania, a project helped to establish the institutional framework for the creation of municipalities. In this instance, local elections followed, providing the public with one accountability mechanism. Other initiatives could focus on strengthening the oversight function of national government. Venezuela has successfully used an executive council (COPRE) to marshal ideas, try out policies and legislation, and develop guidelines and administrative models. Future efforts could build on these successful initiatives to overcome problems associated with decentralization.

Corporate Accountability

75. The focus so far has been on public accountability. Governments also have an important role to play in ensuring accountability in the private sector. This is a key contribution to the enabling environment by ensuring investors (shareholders) that companies will be accountable to their shareholders and to the communities within which they reside. This involves specifying in legislation the nature and frequency of financial reporting requirements and legal and other remedies open to shareholders when they perceive their interests not to be protected. As the state sheds itself of many productive investments in developing countries, this function becomes particularly important. [CAN WE CITE EXAMPLES OF BANK INITIATIVES IN THIS AREA? ALSO CHECK WITH BOB LACEY OR MIKE STEVENS ON WHAT ELSE WE CAN SAY ABOUT REGULATION AND ANTI-MONOPOLY ACTIVITIES.]

Micro-level Accountability

76. Micro-level accountability can reinforce macro-level accountability when two factors are at play. One is competition, or the extent to which the public has access to alternative suppliers of a given public service. The scope for the public to "exit" when dissatisfied with a service can have a salutary effect on the agency concerned, through a reduction in its revenues and a related threat to the careers or pay of its staff. The second is participation, or the degree to which the public can influence the quality or volume of a service through some form of articulation of protest/feedback (voice), whether or not an exit option exists. If "voice" makes the public agency more responsive, accountability is enhanced. In the National Irrigation Administration in the Philippines, the exercise of voice resulted in a greatly improved irrigation system. Often, however, exit is more efficient and hence more likely to be used in public services least affected by market failure, whereas voice becomes relatively more efficient as market failure increases. The public will exercise the voice option only when it believes the agency concerned will be responsive.

77. Exit may not be feasible when there are significant economies of scale (natural monopolies), or when there are legal barriers to entry (e.g. in some countries: air transport, education) or when there are spatial barriers for some segments of the public (an isolated village may be able to afford only one school or health clinic). The nature of the good or service may also prevent exit (e.g. defence expenditures, or environmental services).

78. The use of voice may also be constrained by several factors. First, there may be legal hurdles (as when there are legal impediments to the recognition of user groups or a denial of the right to sue the government). Second, restrictions on the public's access to information may constrain the use of voice. This may be through direct limitations on information or by limiting the scope of the media to challenge/publicize the poor quality or other weaknesses of the service. When services are differentiated, elites may use their more powerful voices to capture the better quality service; by the same token, when services are not differentiated (e.g. clean drinking water) those with a weak voice may gain from the voice of the stronger segment of the public. Fourth, income and education may limit the use of voice because information when available cannot be analyzed or when the cost of voice is too high for the poor. Finally, voice is likely to be used when the service concerned claims a significant share of a person's time or income.

79. A useful approach to the improvement of accountability is to devise ways and means to overcome these barriers to exit and voice. The policy induced barriers are more easily dealt with; natural barriers are more difficult to remove. Judged by these criteria, **services that the poor (weak voice) require and for which alternative sources of supply are difficult to find (low exit) will be the most difficult to deal with.**

80. Exit mechanisms: There are several possible exit mechanisms. Deregulation of services is an obvious option and one in which the Bank has some experience. In exercising this option, the impact on the poor needs to be considered and compensatory measures devised. Also, when the service is a monopoly, accountability is not enhanced unless there is in place an oversight and regulatory mechanism. **Contracting out** certain services to multiple private providers can be another option (e.g. garbage disposal, road maintenance, tax collection, cargo handling in ports). An important way in which this mechanism impacts accountability and performance is through its contestability effect. When incumbents are made to bid for contracts along with outside competitors, they will be more careful about their performance and their terms.[7]/ A more direct impact on accountability can be made through the use of **vouchers**. People who deserve special support for income or other reasons can receive subsidies for certain services while choosing the service providers that best meet their needs. Vouchers can be cumbersome to administer and work effectively only when customers are able to evaluate options and service providers depend on voucher receipts for a significant proportion of their revenues. **New technologies** can be used to augment exit (e.g. mobile courts, mobile schools and health or the use of VCRs or television for education). But these approaches could be very expensive.

81. Voice mechanisms: **Dissemination of information** about services can aid the public in demanding greater accountability from service providers. Periodic monitoring and evaluation of services can exert sustained pressure. For example, a poll of beneficiaries' views on the service or the gathering of data from both beneficiaries and service providers can be an effective surrogate for voice and less demanding and less costly than the direct use of voice. **Complaints procedures** and the institutional mechanisms of **ombudsman** are ways of providing voice when there is no need or incentive for collective action. "Hotlines" can be established to help the public respond fast to unsatisfactory services. These

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[7]/ For an interesting discussion of contestability analysis, see William J. **Baumol and Kyu Sik Lee: "Contestable Markets, Trade and Development"**, The World Bank Research Observer, Vol.6, No.1 January 1991.

mechanisms are in place in many countries, and a review of international experience shows that their utilization and impact vary widely; in particular, elites tend to make the most use of these services.

82. Participation of the public's representatives in the decision-making bodies of service providers or regulatory bodies is one way of enhancing "voice." Users representatives, for example, can be appointed to the Board of Directors or committees of these organizations. Where appropriate, users may hold equity shares of utilities so they have a stake in their management and performance. When legislation pertaining to utilities is being designed, public comment and participation of those interested in the proceedings could be encouraged. Negotiated rule-making by regulated agencies in many countries helps bring together representatives of an agency and relevant interest groups. While in others, legislation is planned as an inter-ministerial technical process with no public involvement.

83. Where direct participation of users in decision making is difficult or inappropriate, a consultation process can be instituted through public hearings, advisory panels, etc. When all else fails, legal action by consumer action groups is a possibility.

84. The exercise of voice is not only costly to the poor in terms of time and effort but it is also more risky than exit as the outcome is less certain. The poor are typically reluctant to invest in voice. Olson,[8] for instance, argues that given the problems of collective action -- free riders, the need for selective incentives, the near impossibility of organizing mass groups (the poor, the unemployed, consumers) to bargain for their common interests, in contrast to the relative ease with which some groups (smaller, better established, or with specific purposes) organize to push their interests -- make it unlikely that any society will achieve equity or efficiency through comprehensive group bargaining. It is more likely that small groups will exercise "lobbying and cartelistic power" for redistribution on behalf of their special interests, to push society away from equity and efficiency; i.e. it is easier to bargain over a slice of the pie than to join forces to make the pie bigger. These distributive coalitions (labor unions, special interest lobbies, industry cartels, collusive firms, etc.) maintain barriers to entry and exit, establish monopoly rents, and create rigidities that lower the ability of the economy to "adapt" to change and generate new innovations." This is a cautionary

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[8]/ Mancur Olson, The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities (New Haven: Yale University Press, 1982).

note to those who regard institutional pluralism as an end in itself. Some NGOs may fall into this special interest category but in the Bank's experience, they have been known to play an effective role in organizing the poor. In some cases NGOs may act as alternative service providers too. The media can also play a key role in strengthening the voice of the poor. The voice augmenting role of NGOs and the media reduces the cost of voice to the poor.

The Role of NGOs

85. During the last few years the Bank has worked to expand the involvement of NGOs in Bank-financed projects. In both FY89 and FY90, NGOs were significantly involved in 50 of the projects the Board approved. This was up from an average of less than 15 in the previous year. NGOs tend to be responsive to the needs of people in the delivery of services, often because of value commitments and also because beneficiaries' involvement with an NGO is entirely voluntary. NGOs can sometimes help make government programs more responsive by assisting with implementation, contributing to design, criticizing deliveries or strengthening beneficiary groups. The Bank's experience with NGOs has been generally positive to date. In some sectors, most notably agriculture and population, NGOs are contributing significantly to effective project implementation. NGO criticism, although sometimes unduly harsh, has nevertheless contributed to the redesign or improved implementation of a number of Bank-financed projects.

86. The role of NGOs needs to be more fully evaluated. But the existing evaluation literature (mostly sponsored by bilateral donors) shows that NGOs tend to be effective at reaching low income groups, especially in remote areas, and at working in a relatively participatory way. They tend to be weak in planning and administration. Increasingly, the evaluation literature indicates that NGOs' most important contribution is not service delivery but a catalytic role for social change. They begin work and advocacy on neglected social issues and develop new approaches which are sometimes replicated on a larger scale.

87. A number of developing countries have witnessed a mushrooming of private voluntary organizations (e.g. India, the Philippines, Bangladesh, Kenya, Zimbabwe, Senegal, Colombia and Chile to name a few), while some other countries clearly have not (e.g. C.A.R. or Malaysia) and depend much more heavily on governmental organizations and initiatives. Various factors contribute to the emergence of a strong voluntary sector, among them culture, level of development, and the stimulus provided by the influx of external NGOs after a natural disaster.

88. A powerful factor clearly is government hostility or encouragement. Enabling government policies include most basically the freedom of speech and association. Regulatory policies can also help or hinder NGOs. Many governments are suspicious of NGOs precisely because they are a channel to the poor. There is thus a tendency to coopt NGOs and make them mere extensions of the state or to create a dependency syndrome. Direct donor funding of NGOs can be an important means of supporting NGO activities. But it carries with it a number of attendant risks including shifting NGO accountability from their natural constituents to donors, and making them vulnerable to subtle pressures from governments who must approve direct funding of NGOs.[9] The relationship between the State and non-government organizations bears further research and reflection.

Popular Participation

89. "Voice" can also be enhanced through popular participation in the design and implementation of Bank financed projects. The Bank's experience in this area to date suggests that:

- participation can be important to the success and sustainability of many development activities;
- it is especially crucial for activities that deal with particular communities or depend on people's active cooperation, but it is also relevant to decisions about large scale infrastructure projects; and, that
- participatory approaches have been tested successfully in various sectors (notably, irrigation, forestry, livestock and agricultural credit; urban development and rural water supply, health and nutrition, environment and social investment funds).

90. The Bank has recently embarked on an effort to learn better how to foster popular participation in Bank-supported activities (See Box 2C).

91. If the power of exit and voice mechanisms in ensuring accountability is accepted, it follows that systematic attention to their analysis and potential should usefully be considered at the design stage of Bank projects which deliver services with public good characteristics. During project preparation, the barriers to accountability need to be identified and assessed, taking into

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[9]/ For an interesting discussion of these pitfalls, see Alan Fowler's "NGOs, Official Aid, Democracy and the State in East and Southern Africa," Overseas Development Review, March 1991, (CHECK REFERENCE).

BOX 2C

Popular Participation and the Bank-wide Learning Process

"We affirm ... that the economic crisis cannot be resolved ... without the full and effective contribution, creativity and popular enthusiasm of the vast majority of the people."

-- ARUSHA, 1990.

Popular participation is the process by which disadvantaged people influence decisions which affect them. The term "popular" refers not only to the absolute poor, but also to a broader range of people who are disadvantaged in terms of wealth, education, ethnicity, or gender. "Participation" means influence on development decisions, not simply involvement in the implementation or benefits of a development activity, although those types of involvement are important and are often encouraged by opportunities for influence.

The World Bank has learned from its experience that popular participation is important to the success of projects economically, environmentally, and socially. The most important lesson has been that participation is a question of efficiency, as well as being desirable in its own right. In one study, the Bank evaluated 25 projects five to ten years after completion. Strong beneficiary organizations (an instrument for facilitating popular participation) proved to be a key factor in determining project sustainability.[10] Another study of 68 Bank-financed projects found that the economic rate of return was twice as high for projects which had been sensitive to local social and cultural realities.[11]

The Bank's experience with participatory projects is limited, but growing. Participatory approaches have most often been adopted in projects designed to help particular communities -- agriculture, especially irrigation, forestry, and livestock; urban development and rural water supply; population, health and nutrition. Social investment funds are a promising way for governments to support community-initiated micro-projects. A recent review reveals that in virtually every participatory project the Bank has financed, beneficiary participation has contributed to project effectiveness.[12] Communities are more likely to have a stake in, contribute to, and maintain projects which respond to their needs, knowledge, and initiative.

But participation is also valuable for bigger projects. The Bank's experience with environmental issues and adjustment loans indicate that public consultation can improve design and build public support for large-scale investments and policy decisions. This approach is working, for instance, in Mexico's Hydroelectric project, India's Upper Krishna Dam project, and Ghana's Private Investment and Sustained Development Promotion Credit.

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[10]/ Operations Evaluations Department, 1985. Sustainability of Projects: First Review of Experiences. World Bank, Washington DC.

[11]/ Conrad Phillip Kottak, 1985. "When People Don't Come First: Some Sociological Lessons from Completed Projects," in Putting People First. World Bank, Washington, DC.

[12]/ International Economic Relations Division, External Affairs, September 5, 1990. Strengthening the Bank's Work on Popular Participation. World Bank, Washington, DC.

Operations and PRE are pursuing a modest program of action and learning, supported by SIDA trust-fund resources, designed to strengthen the Bank's support for popular participation where this would contribute to the development effectiveness of Bank-related activities. On the basis of a review of prior Bank analysis and experience on this issue, Operations and PRE are moving forward along the following lines:

(a) effective implementation of the community involvement provisions of the Bank's environmental assessment policy;
(b) continued efforts to involve NGOs, both upstream as well as downstream, in Bank-financed operations;
(c) efforts to ascertain that practice is in line with the Bank's operational directives regarding participation and to make appropriate revisions as new directives are issued; and
(d) a Bank-wide process of learning systematically about popular participation.

This fourth point, the learning process, is the main innovation. Learning is being stressed because there are relatively few large-scale participatory development programs in the developing world. It is important to learn in what situations popular participation is worth the effort, and, in those cases, how the Bank and borrowing governments can effectively encourage participation. The learning process has three goals: to develop and document 20 exceptionally participatory Bank-supported operations; to accelerate Bank learning from various initiatives in this area arising inside and outside the Bank; and to investigate what modifications may be needed in the Bank's operational practices in order for the Bank to encourage popular participation in appropriate operations more widely. To date, participatory projects have been the exception rather than the rule, sometimes stemming in part from the personal commitment of individual task managers.

In most situations, the binding constraints on popular participation are external to the Bank (the intrinsic difficulties of engaging low-income people in project decisions, for example, and reluctance on the part of some governments). But improvement in income and education, together with increased interest among borrowing member governments, are relaxing external constraints in some situations. While grappling with the problems of making government implementing agencies more people-centered, the learning process is focussing especially on ways the Bank's own operational practices could be more supportive of participatory approaches. This might require more emphasis on project quality vis-a-vis meeting project "timetables," and perhaps more staff time and resources per operation.

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account the nature of the service and of the public involved. While internal control systems are important and should be strengthened, accountability for performance will not simply follow because hierarchical controls are in place. Reinforcing accountability through a search for exit and voice mechanisms is essential, especially in poverty oriented projects where diversion of benefits is a real risk.

92. In projects, whose outputs/services are meant for reasonably well defined target groups, there is merit in eliciting feedback from intended beneficiaries on project services either at project completion or soon thereafter. The purpose is to generate information as a basis for both the government and the Bank to learn, respond and adapt so that performance can be improved. This approach has been deployed with helpful results in some cases [CITE EXAMPLES]. But in most cases, Bank and country evaluations are seen as an internal matter with no built in process for a more systematic feedback. OED evaluations try to remedy this but come late in the cycle. Ideally, the approach should be an open process and not a one-time affair, but undertaken periodically as a mechanism to ensure transparency and accountability.

93. Improved accountability from the use of voice and exit mechanisms can only work if it results in a change in the behavior of the service provider. This will not happen by itself and requires a change in its monitoring and incentive systems which need to be adapted in response to exit and voice options. Monitoring of the service provider must span efficiency, access, and quality of service instead of being limited to inputs and compliance with internal rules. This must be reinforced with incentives that reward responsiveness to customer or outward orientation.

94. Accountability at the micro-level will be sustained only when the government and society at large are concerned and wish to improve it. Comparative information on how different countries perform in respect of key public services can be a powerful tool to generate national and international interest in this area. Selected performance indicators based on good professional judgement can be assembled on these services from as many countries as possible for wide dissemination (including the WDR). (See Box 2D). It will provide the data for governments, scholars, media and the public at large to see where they stand in respect to the level and quality of their services. The Bank is well positioned to initiate this exercise.

BOX 2D

Improving Accountability and the Environment

The deteriorating quality of air, water and land resources in many developing countries is linked to problems of accountability and capacity. Government decision-makers in charge of natural resource management often contribute to environmental deterioration through poor management decisions. Poor decisions are a function both of inadequate incentives, and of an inability to project the actual effects of well-meant decisions or to evaluate alternative uses of scarce government funds.

Environmental resource management is further complicated by the multisectoral nature of many decisions. Water resources, for example, are affected by solid waste systems, storm water drainage, the demands of commercial, household and recreational users, and the requirements of ecological habitats.

Research currently underway in the Bank addresses this problem. The "Service Level Indicators for Capital" (SLIC) research sponsored by IECSE is seeking service level indicators for public facilities (sewerage, water, etc.) and for natural resources, based on measures of quantity, quality and reliability for both users and decision makers. Included in this research effort is a framework for applying Service Level Indicators through Benefit/Cost analysis. This extends the usefulness of these measures into investment decisions. These SLIC indicators are being implemented in Indonesia in a number of different Urban Development projects in Indonesia (see Pilot Study for the development of the Service Level Indicators for Capital/IECSE). SLIC creates a bottom-up measure of resource performance, provides an information base which allows users and managers to view how decisions are made and the effects they have, and establishes a transparent accounting framework for government service and natural resource decisions. based on the level of services they provide to users.

For example, service indicators for water resources can be related to the specific uses described above: water supply for agriculture, industry, households, recreation, and ecological habitat. Indicator sets for each of these purposes would be specified by aggregating relevant measures. Service levels for industrial or agricultural water supply users would be based on physical measures; for household water users or recreational users, service levels might be based on total health risk; for ecological habitat, service levels could be the number of viable ecosystems exposed to risk in the river stretch or habitat area.

By identifying and monitoring the specific environmental quality measures identified as important by decision-makers and users, SLIC will approve the effectiveness of infrastructure and natural resource management decisions, and help establish operations and maintenance priorities for public infrastructure. In addition, by measuring these indicators over time, SLIC should be able to establish trends in environmental resource quality, improving natural resource accounting and defining more precisely the relationship between natural resources and economic development. And as SLIC enables line managers to make better decisions, publicly available service level indicators can also enable users to hold service providers accountable for the level and quality of the services they receive, both from government facilities, and from other providers.

OPENNESS

95. Openness in economies is characterized by cross border transactions indicating a country's participation in the international economy. Openness in governance are those processes facilitating economic openness -- availability of information from public and private sources, tolerance for public debate and competitiveness over policy choices, most public financial and economic data that are a matter of public record and available for public scrutiny.

96. Open economies have their counterpart in open governance -- and for many similar reasons. Just as closed economies harbor distortions, provide opportunities for unfair or inequitable treatment, or opportunities for rent seeking or corruption, so does closed governance. Competitiveness of public debate provides a check on mistaken assumptions, clarifies choices, and can flag unintended consequences for economic policy choices.

97. In relation to accountability and the rule of law, openness has an instrumental character, as it is in some sense, a precondition for true accountability. In operational terms, openness involves: (i) transparency and access to information; (ii) capacity to analyze and disseminate information; and, (iii) the existence of institutions that allow the exercise of "voice" (or exit).

Transparency and Access

98. Transparency and access to information is a prerequisite for accountability, as is abundantly clear from the preceding discussion. This information may refer to specific aspects of a government's activity (budget, procurement, personnel, debt negotiations, etc.) or to general economic management and performance (output indicators, trade and employment data, etc.).

99. There are three relevant questions here. First, does the information exist at all? Second, is it of good quality? And third, is it available to those with a legitimate interest in it? The Bank has been active in helping make budgets more transparent, in strengthening procurement systems and more generally, together with UNDP and other UN agencies, in strengthening and improving data availability. (Issues of budgetary transparency are discussed more fully in the accompanying paper on public sector management).

100. Procurement is a critical aspect of project implementation. Procurement difficulties are symptomatic of governance problems, either of a capacity nature or reflecting the pressures and temptations governments are subject to when dealing with large contract awards. The FY89 ARIS report recognized that the best strategy was to address these issues at country rather than project level. Since then, a number of initiatives were launched "combining a country-specific approach to procurement problems, increased training for executing agency staff

launched to discuss country specific procurement problems and to review local procedures and institutions. In some countries, technical assistance has been provided to improve the institutional framework and introduce more efficient procedures (e.g. Uganda and Madagascar). In other cases, new procurement codes have been issued. In the Philippines, action was taken under a Debt Management Loan to streamline overall procurement rules and procedures so as to permit greater delegation of authority to implementing agencies and to establish standards to shorten contract award procedures. Work initiated under this project has been pursued under subsequent projects (the Fifth Highway project) and guidelines acceptable to the Bank are now available for local procurement of goods and consultants. This has facilitated an easing of regulations relating to contractors thereby increasing their willingness once again to accept government contracts.

101. Several North African and Middle Eastern countries do not require public bid opening, and permit bargaining even after bids have been opened. The Bank is attempting, in such cases, to review the rationale for existing local procurement regulations rather than simply requiring conformance to Bank guidelines. It is attempting through local seminars and discussions, to focus attention, for example, on the importance of procurement processes to the development of local contracting capacity and pointing to the value for a development perspective, of adopting revised national systems to conform to international norms. In almost all reforming Central and Eastern European countries, institutions were not familiar with local or international competitive bidding. However, these countries are now requesting and showing receptiveness to Bank technical assistance on procurement legislation and procedures. (Box 2E).

102. **Public disclosure of environmental assessments** is one instrument that the Bank is using increasingly to contribute to greater accountability and openness. This is particularly critical in ensuring that people involved in involuntary displacement by development projects (such as the Narmada and Upper Krishna river) are kept fully informed of the results of such assessments. Thus, under the Ecuador Municipal Development and Urban Infrastructure project (FY91) an attempt is made to ensure public review of environmental impact studies of infrastructure projects.

103. The collection and dissemination of data has been a focus of Bank activities for a long time. However, despite the importance of adequate economic information for the proper functioning of markets this is still a relatively neglected area in much of Africa. Central Banks which once produced excellent reports on the economy (as in Ghana) have ceased to do so. Given the renewed emphasis on the improvement of data in the context of the Bank's poverty agenda, this is an area which deserves much greater emphasis. China's post reform Statistical Yearbooks for example represent a substantial breakthrough in the availability of economic information on that country's economy.

BOX 2E

CHANGING PROCUREMENT POLICIES AND PRACTICES IN EASTERN EUROPE

The countries of Eastern and Central Europe[13] are rapidly accelerating their transition from centrally planned to market-oriented economies, a process involving profound changes, also in the field of public procurement. They are increasing their externally supported investment project operations, in cooperation with bilateral agencies and international financing institutions. During the past forty years, the countries have performed public procurement through direct allocation of resources, or negotiated contracts. They do not have a recent background in using open, competitive bidding procedures, and vary in their abilities to applying international procurement practices.

The countries lack the requisite public procurement laws and related legal systems, regulations and experienced procurement officers. New and comprehensive legal systems for public procurement are required at all levels of government: national and local, and would ideally apply to all sectors. At the same time, training of procurement personnel would need to be performed on an urgent and massive basis, to implement the new procurement practices. The delays in project implementation caused by inefficient procurement practices may result in opportunity, interest, and inflationary costs of considerable magnitude (10-20% of total project costs).

The World Bank has, at the invitation of several of the countries, advised their senior officials on the requirements for implementing the needed legal and policy changes, and to train involved personnel. Contacts have also been made with multi- and bi-lateral agencies which have a direct interest in the issues, with the objective of their participating financially and technically with the Bank in country and regional projects which would address the problems through technical assistance. Financing of such projects could also come from Bank loans, should the countries so request.

Analysis and Dissemination Capacity

104. The capacity of non-governmental organizations and institutions (professional associations, trade unions, business organizations, grass roots groups, research centres, universities and mass media) to analyze and disseminate information on specific and general aspects of government economic performance is also an essential component of "accountability." It is not enough to have access to information. Unless the capacity to understand, process and use it effectively is disseminated widely throughout society, information assymetries will lead to the concentration of power -- with the attendant risk of "capture," and lack of accountability. Of particular importance is the information processing and analytical capabilities of mass media institutions, since they have a most important role in disseminating ideas and in mobilizing public opinion. Legislatures also need to strengthen their policy analysis capabilities for they are frequently at a disadvantage in their dealings with the executive branch.

105. The Africa Capacity Building Initiative represents a potential instrument for strengthening this capacity of non-government institutions. The Bank's External Affairs Department has done much to improve access to economic information for developing country journalists. UNESCO is taking the lead in implementing a recent unanimous General Assembly Resolution which calls for an unfettered development of a free and pluralistic press. The Bank could work with UNESCO and the UN Information System to develop facilities to train economic and financial journalists in developing countries.

Openness and the Special Case of Military Expenditures

106. A recent area where the Bank is beginning to focus attention in public expenditure reviews is the high levels of military expenditure, particularly in relation to expenditures on health and education. That military expenditure is at the heart of governance issues is best summed up by the recent report of the South Commission:[14]

> "By 1980, developing countries' military expenditure on average amounted to 25 per cent of the world total. Their arms imports averaged $22 billion per year during the 1980s. It is true that arms purchases in the South tend to be highly concentrated in a few countries, notably in the Middle East, and hence average figures of expenditures are not very meaningful. But only a few developing countries can rightly claim that their military expenditure is proportionate either to any external threat or to the resources at their disposal. The direct human cost of well over one hundred

> cases of international and civil conflict in the South since the end of the Second World War has been a horrific addition to the daily ravages of poverty and deprivation. By 1980, more than 10 million people had been killed in wars fought in the Third World; many millions more had been maimed or injured."

107. The Report rightly goes on to note that not all conflicts could have been averted by action within the South. "Nor can one ignore the very real threat posed by armed insurgencies, terrorism, separatism, and fundamentalism, among other manifestations of violent conflict. Direct military threats have left no option to some developing countries but to increase military expenditure for self-defense." Calling for an international framework that would guarantee the security of all nations against external threats, the report poignantly notes the high costs of militarization:

> "Militarization has perverse implications for development. The diversion of resources to pay for instruments of war and repression retards progress in many countries. Just as deleterious is the growth of a military culture which is contemptuous of democracy, popular participation, human rights, or the principle of government accountability. It breeds corruption, the abuse of power and the consequent alienation of the people from the political system. These disturbing symptoms can be seen in many countries of the South today."

108. The level of military spending is the prerogative of individual governments. All countries have legitimate security needs and it is not for the Bank to say that these should not be met. Nor can the Bank be seen to be second guessing a government's perceptions of the military risk it faces and how it must address it. The Bank's role in this area must focus on two issues. The first is the consequences for the economy of any given level of military spending, since this could have a bearing on the credit risk the Bank is being asked to assume. The second relates to the fungibility of resources, particularly in cases of structural adjustment lending or local cost financing, where the Bank indirectly frees up foreign exchange resources that can then be used for military expenditures.

109. Military budgets typically lack transparency. They are usually one line budget transfers. They therefore escape scrutiny, avoid accountability and expenditure control and auditing, and usually involve substantial off-budget transactions. As a result, there is often a huge waste associated with such spending, particularly when it comes to purchase of hardware. The waste comes from inappropriate and costly weaponry (weapons that are grossly over-specified or are incomplete parts of an overall system or too sophisticated to maintain). This is possible because of ruthless salesmanship reinforced by generous trade credits and outright bribery on a lavish scale, the gullibility (and greed) of the military, or political leadership, and the reluctance of civilian financial managers to question military procurement.

110. The Bank should not get into details on military expenditures. Most countries would regard this as an infringement of their sovereignty and rightly so. What the Bank should be concerned about is the total impact of military expenditures on the budget and the balance of payments, as also that the country has systems of financial accountability in place to ensure that military expenditures are transparent and subject to serious scrutiny within the government.

Conclusions

111. The preceding review of the Bank's experience in the areas of accountability and openness reveals the following key priority areas of focus. To assist borrowers enhance accountability at the national level, the Bank needs to pursue vigorously the proposed country level reviews in the area of financial accountability, particularly with a view to strengthening accounting and audit capacity, and encouraging governments to develop appropriate mechanisms to take corrective action on the basis of audit results. Without a properly functioning system of financial accountability, the risk of corruption and misuse of resources is high. At the project level, without losing sight of the continuing need to emphasize upward accountability, the Bank needs to encourage outward accountability by exploring more systematically options for enhancing competition (exit) or participation (voice). Greater reliance on NGOs could greatly assist in enhancing accountability at project level, and in improving the sustainability of Bank financed projects. On openness, the Bank can assist governments improve the flow of economic information and increase transparency of decision-making, procurement and military spending. This would provide increased predictability and improved use of resources in the economies the Bank assists.

First draft
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III - KEY DIMENSIONS OF GOVERNANCE: THE RULE OF LAW

112. The academic literature on the rule of law is voluminous and the concept lends itself to endless discussions at jurisprudential level with limited practical relevance. The emphasis here is on a pragmatic view of the rule of law in the context of Bank operations.

113. Mr. Shihata has defined the rule of law as "a system based on objective rules which are actually applied and on functioning institutions which ensure the appropriate application of such rules."[15] Investment, it is generally assumed, will not succeed without a stable business environment, without a system which provides stability and predictability.

The objective of the stability and predictability associated with the rule of law is to create a climate where business risk may be rationally assessed and the cost of transactions lowered. It is this connection of the rule of law with the more efficient use of resources that justifies its consideration by the Bank as a factor in economic development. From the Bank's point of view, the rule of law is not an end in itself and it is only to the extent that it establishes a set of pre-conditions for economic development that it is legitimate to bring it within the purview of the Bank. As we will see below, the elements of the rule of law are varied and so are the views about them. Not all have the same bearing on the purposes of the Bank.

114. The concept of the rule of law has received numerous - sometimes controversial - interpretations, yet there is consensus that it is a positive and desirable principle for the organization of a modern society. This is so because the rule of law is said to assure that everyone - citizens and government alike - shall be subject to the same predictable norms instead of to the wishes of powerful individuals. It thus represents the antithesis to governmental arbitrariness. It makes it possible to rely on the permanency and equality of non-personal, objective laws rather than to hazard with transitory personal relationships and situations. The rule of law stands for the supremacy of law, equality before the law and the certainty of law. Its function is to create stability and instill confidence and the perception of fair and non-indiscriminatory treatment.

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[15]/ I. Shihata, Issues of 'Governance' in Borrowing Members. The Extent of their Relevance under the Bank's Articles of Agreement, Sec. M 91-131 (February 5, 1991), p. 42-43 (hereinafter "Issues of 'Governance'").

115. The substantive aspect of the rule of law is linked to concepts such as justice (e.g. the element of due process), fairness (the principles of equality) and liberty (civil and political rights). In the view of many, the formal elements enumerated earlier have to be complemented by substantive principles of the rule of law to create a "fair" legal system. In terms of the Bank's work, a "fair" legal system would have to be conducive to balanced development, e.g. a system which facilitates growth and responds to the needs of the poor. These would seem to represent issues the Bank is normally concerned with in its project and policy lending. They are outside the scope of this analysis, however, which focuses on the basic "processes of the formulation and application of rules."[16]

116. Many of the substantive elements have political connotations related to how governments and societies ought to be organized and are often associated with Western ideas of a particular social system. Political aspects are not addressed by the Bank and do not fall within its mandate.

117. In the following, we analyze each one of the five elements listed in "Issues of 'Governance,'" incorporate the Bank experience so far, and draw conclusions for Bank operations and the relationship of the rule of law with the other elements of governance.

(i) **A set of rules known in advance:** This phrase comprises three elements: the existence of rules as a set (denoting coherence), that they have been communicated (with precision, clarity and effectiveness) and that the rules be known in advance (non-retroactivity of laws).

118. In terms of Bank operations, communication and coherence are two elements with which we have been concerned. Many developing countries received formal rules for the communication of laws similar to those of the metropolis. There the obligation of governments to disseminate new laws was and still is limited to their publication in gazettes. The law is available but the citizens have the burden of acquainting themselves with the law.

119. Publication of the official gazettes in many countries has ceased. The Bank has assisted or is in the process of assisting several countries to restart at least publication of the gazette (Box 3A). It is also assisting in making the law more accessible and better known within the government itself.[17] However, in many developing countries, large segments of the population are

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[16]/ Issues of 'Governance,' p. 45.

[17]/ This is the case of the legal information system included in the Social Sector Management Technical Assistance Project in Argentina (Loan 2984 AR).

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BOX 3A

Communication of the Law

MAURITANIA: Development Management Project (Credit 1865 MAU)

The publication of the Mauritanian Official Gazette was done under a contract between the Government of Mauritania and a French printing company located in Bordeaux. This arrangement was however not effective and the Gazette was rarely published. Then the Government of Mauritania, with the assistance of IDA and the French Government, decided to print and publish the Official Gazette domestically. To do so, a contract was awarded to a private printer and the functioning of the Department of the Legislation (Services of the Presidency) were improved within the framework of the above-mentioned IDA Credit. The French Government provided technical assistance in the preparation of the Official Gazette using the French Official Gazette as a model.

The Official Gazette which had not been published for over two years, has now been published in French and Arabic on a monthly basis for the last two and a half years.

GUINEA: Second Economic Management Support Project (Credit 1963 GUI)

The Guinean Official Gazette was experiencing delays of up to two years in the printing of its issues. In order to correct this situation, the Secrétariat Général du Gouvernement (SGG) obtained, as part of this project, US$80,000 from USAID to finance printing of the Official Gazette for two years, and signed a contract with a private printing company to ensure its regular publication. In addition, the contract provided that the backlog caused by the two-year delay in the publication of the Gazette be gradually eliminated.

As of January 1989, the Official Gazette has been published fortnightly. Texts of a general nature and government decrees are published within a month of their signature. The backlog of previously unpublished legislation is being cleared.

The SGG is responsible for the distribution of the Official Gazette within the Government and the subscriptions and sales to public. It is expected that, as revenues from legal notices increase, the Official Gazette will be able to fund itself.

CAMEROON

Until mid-1988, the Journal Officiel was published twice a month by Imprimerie Nationale du Cameroon both in French and in English. Then it stopped when, due to the economic crisis, the budgetary amount allocated by the Presidency to Imprimerie Nationale was suppressed. The first Structural Adjustment Loan was signed with Cameroon in July 1989 together with an Economic Management Project. As part of the measures to be taken under the SAL, legislation needs to be enacted in respect of investment, labor relations and forestry matters just to give a few examples. For these measures, the issue of promulgation remains open. It could be done on ad hoc basis through private printers, but the costs are high and there is no continuity. As part of our expenditure reviews, we should ensure that certain basic tools of government communication remain available. Otherwise these legislative reforms may be known only to a few government officials and not to those for whom they are intended. They will thus be ineffective.

LAO PDR

In 1975 the National Congress of the People's Representative in the Lao People's Republic abolished the former constitution and all existing laws and regulations. In 1989 the government endorsed the establishment of a new economic mechanism, separating the state's administrative and regulatory function from production activities and increasing the role of the private

sector. Under a component of a UNDP funded project supporting the New Economic Mechanism, the Bank will assist the government to prepare and implement key economic and financial legislation, to train lawyers in business law and to establish a center of economic law. As part of such activities the project will make a proposal to the government to establish an official gazette to publish and promulgate new laws and regulations.

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illiterate, the media are ineffective and languages are diverse. Under these circumstances there are obvious limitations as to how much law can be known and learned by the average citizen and it is obviously necessary that law be as clear and explicit as technically feasible.

120. To the extent that economic policies need to be reflected in rules and it is expected that they will be complied with, governments will need to make these rules known through all possible means of communication at their hand. Rules are understood here in a broad sense and would include legislation, courts' decisions, guidelines, etc. When land is being expropriated, for instance, simple explanatory pamphlets outlining the rights of those affected and explaining how they can exercise those rights should be made available to the population at large. Information and knowledge by people of their own rights may effectively limit the arbitrary behavior of government officials and assist in creating the climate of predictability associated with the rule of law.

121. As regards the coherence of the rules, the Bank may have a useful part to play. When conditioning disbursements in specific operations on the enactment or modification of certain laws, it is essential for the success of the operation that the country follows its own rules. A decree, for instance, should not derogate from legislation. There should be no contradictory statutes. There are, for instance, countries whose constitution forbids private ownership of the means of production. In the context of private sector development operations, the Bank needs to ensure that the operation is based on a sound legal premise (Box 3B). In this respect, it would be advisable that, whenever possible, local legal expertise be brought into the action together with any expertise from abroad as may be needed.

(ii) <u>Rules to be actually in force:</u> It is not enough for a law to be on the books, it has to be applied, it has to be in force in reality and not only in the formal sense. More importantly, it has to be complied with. To identify the gap between the law-in-the-books and law-in-action permits to ascertain why laws are not actually in force even if they formally are. When a law is left in abeyance or is not respected the answer does not necessarily need to be a new law. An analysis of why the old law does not work will avoid placing yet another law on the books.

122. The reasons why laws are ineffective vary greatly. In many developing countries the fact that many laws are not applied is often related to their inadequacy to the local situation. They had been transferred from former metropolis or other "developed" countries and had not been adjusted to the local situation or updated to current developments in the countries concerned.

123. Often the results have not been satisfactory. For a law to be effective, one has to consider many elements leading to its observance. Such diverse factors as custom, geography, technology, and history play a role in inducing

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BOX 3B

Legal Inconsistencies in Eastern Europe and Africa

The centralized systems of state planned economies of Eastern European countries face a number of legal problems in their efforts toward economic reform and the development of market economies. Lately, these countries have been introducing reform elements for private sector development. However, contradictions and inconsistencies are often encountered. For example, several countries have started privatization efforts. In this process some have already amended their constitution to make provision for private property rights. Others have not yet changed their constitution to this effect, but, nevertheless, proceed with the privatization effort. In the context of Bank operations an effort should be made to address these issues which can hamper reform. Following are some examples.

In Romania, there has been considerable legislative activity. With regard to private sector development, the law on Restructuring State Economic Units as Autonomous Units and Commercial Companies was passed in September 1990; a draft law on Privatization (currently under consideration) will govern this issue. Other laws under preparation will cover bankruptcy, commercial and company law, foreign investment and SME development (to supersede Law No. 54 defining and permitting small enterprises, which was passed in early 1990). These laws are reducing the role of the government in productive activities while retaining its monitoring functions, introducing private ownership and encouraging foreign investment through joint ventures. The legal framework is, however, operating under the severe constraint of the clearly defined property rights. The Parliament has been given two years from the time of its inception to develop the relevant provisions.

By contrast, in Czechoslovakia, amendments were introduced to the Constitution effective May 1, 1990, recognizing all forms of ownership rights, and providing that they (whether state, cooperative or private) enjoy the same level of protection and that no form of property ownership has a privileged status. A law on Small Privatization was introduced effective December 1, 1990, while a law on Privatization is currently under consideration. (See Box 8 for details on Developing a Legal Framework in Czechoslovakia).

Another example which illustrates the effects of inconsistencies and contradictions in a legal system is the following: the socialist economic system has been protected by the rules of constitutional law, labor law, administrative law, as well as by the rules of criminal law. In the Soviet Union, "undesirable" economic behavior has been controlled through criminal or administrative sanctions for behavior which violates accepted socialist norms and undermines the economic system. There are several articles in the criminal and administrative codes of most republics which criminalize behavior that in a market system is rational and economically desirable. It seems that many of these articles will be eliminated in the next major revision of the codes. In the meantime, however, the existing criminal codes continue to stand and to hamper the economic reform effort. Prosecution under most of these articles continues, with thousands of convictions per year. Even if it is not feasible to amend the codes immediately, steps need to be taken to limit the effect of these provisions on those who wish to engage in new forms of legitimate business.

Although the Eastern European countries are the most striking example, similar examples can be found elsewhere. For instance, Guinea-Bissau is presently amending its Constitution, approved May 16, 1984, as part of a general political transition from a socialist state to a more "capitalist" state. An impediment to developing the private sector is Article 12 of the Constitution, which provides for state ownership of all land (leases are granted to private individuals), minerals, banks, insurance companies, etc. Article 13 also provides for state control of foreign trade and exchange transactions. Guinea-Bissau has begun the process of amending their Constitution to be more conducive to private sector development. One of the objectives of the legal technical assistance provided to Guinea under the Second Economic Management Support

Project is to coordinate the various donor financed pieces of legislation so that they dovetail as a whole. In the first Structural Adjustment Credit to Uganda now under preparation, the proposed conditionality includes the repeal of the Industrial Licensing Act of 1969 because it conflicts with more recent and liberal investment laws.

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obedience to laws. Because of these factors, the same law and its sanctions in different times and places with different physical and institutional environments will not induce the same behavior. Furthermore, societies evolve and laws may become obsolete. There is a certain inertia in the legal systems and they simply may not have been updated to take into account social, business or technological changes.

124. Another obvious reason why laws fail to be applied is the absence of competent administrators of the legal system. The law is not only a set of rules but it encompasses procedures and institutions for implementing these rules. To the extent these are lacking, laws most likely will remain on paper; they will not be effective nor enforced.

125. The Bank must be sensitive to the variables which affect the success of the transfer of legal institutions and the application of the laws. It must also be aware of the limitations of sanctions to induce the radically changed behavior which is needed for development. Punishments best enforce already institutionalized law. They function merely to nudge the occasional deviant into conformity. In many instances, it would be more appropriate to use incentives and roundabout measures to achieve results, normally, at lower costs than punishment and to the relief of over-burdened courts.

126. As regards legal institutions, the Bank may assist in improving the efficiency or competence of judiciary systems to reduce the costs of economic transactions (see Section (iv) below). In advising governments to adopt new laws, the Bank should be fully aware of the limitations of the government concerned in implementing them. As regards enforcement of the laws, some aspects of it have a clear bearing on economic development and have been the subject of Bank operations; for instance, improvement of tax collection, and changes in security laws to permit financial institutions to foreclose on debt and mortgages (Box 3C).[18]

(iii) Mechanisms exist to ensure the proper application of the rules and to allow for departure from them as needed according to established procedures: The concept of the rule of law requires furthermore that all government officials act within the ambit of the law. All state power ought to be exercised under the authority of law. The proper application of the rules by government officials is the essential element of establishing legality and - in conjunction with the idea of justice - legitimacy. To act within the law implies that the executive branch of the government bases its actions on the statutory power from which the government officials derive their authority and that the exercise of authority is within the boundaries set by the law.

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[18]/ See also below p. 33.

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Box 3C

Enforcement

In Guinea under the Private Sector Promotion Credit, the deficient functioning of the judicial system and the legal void on bank sureties has been identified as major constraints for banking activity in the country. Banks are unable "to enforce their rights as creditors through foreclosures or other court-approved actions, due in particular to debtor-judge collusion and rampant corruption".[19] This operation is a modest start to address these problems and it will be followed by training of the judiciary and legal professions in banking and commercial matters and by improvements in material working conditions.

In Sri Lanka, the Association has been working in two operations in the financial sector to reform the laws allowing financial institutions to foreclose on collateral pledged under loans. Sri Lankan law had prevented direct execution by institutions, who were forced in each case to go to court to get a judgment before they could move against the property. This protection for debtors stemmed from historical concerns about unscrupulous money lenders and did not match the needs of a modern economy. On the advice of the Association the law was changed to permit direct execution. The result is a law which establishes a better balance between the rights and obligations of debtors and creditors.

In the Philippines as part of the Financial Sector Adjustment Loan, the Bank not only asked that the holding period for repossession by debtors of pledged property be shortened to a more reasonable period, but the conditionality included revising the 1905 bankruptcy law to make it less punitive on debtors and more rehabilitative, in the interests of both creditors and debtors.

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[19]/ Report, p. 5207 GUI, para. 55.

However, the legislation authorizing government actions cannot prescribe in all circumstances precise and clearly-defined standards particularly in the context of a country undergoing a rapid development, where changing circumstances require a certain flexibility in dealing with new phenomena.

127. Thus, while the proper application of the rules should ensure predictability, the need for flexibility seems to contradict the first premise. It is the difficult choice between laws which require the officials to act in a particular way ("bright-line rules") and those which delegate discretionary power to the bureaucracy. Traditionally, the rule of law called for narrow grants of discretion. But the complexity and variety of issues to be dealt with have led to increasing delegation of authority to the executive branch based on broad standards. Discretion secures flexibility and responsiveness to different situations which could not have been predicted by the legislatures. Discretion represents a counterweight to legal formalism.

128. Discretionary power is not absolute power. Discretion in law is always limited. The most basic guidelines for the exercise of discretion require that any exercise of powers be based on reasons, that these reasons be applied consistently, fairly, and impartially, that they be intelligibly related to a framework of purposes, policies, principles and rules, and that, in matters of procedure of substance, there be compliance with general considerations of morality.

129. The issue, however, is how this discretionary power is exercised by the administrative bodies in developing countries. The civil service in many developing countries (and some developed countries) is often overstaffed, poorly trained and lacking motivation. In many cases, civil servants are underpaid and responsibilities of individuals are not clearly specified. There is an over-abundance of rules and regulations, creating "red tape." In some cases, administrative decision-making is centralized and the establishment of functioning administrative institutions has been neglected. Often, internal review mechanisms are weak. "The combination of unclear and loosely-applied standards, monopolized authority, wide discretion, and non-targeted incentives lead to a relatively undisciplined bureaucracy in which negotiations are commonplace."[20] As a result, decisions by government officials are viewed quite often as arbitrary or illegal, in particular in those cases where discretionary power is abused.

130. As with every exercise of power, there is a need to ensure the respect for these limitations and to secure the correct exercise of discretion. Thus, there is a need for mechanisms to ensure the proper application of laws and rules that regulate how to depart from them. Several different forms of checking

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[20]/ C.W. Gray, Legal Process and Economic Development, 19 (1989).

administrative action and avoiding the abuse of discretionary power have been adopted in various legal systems ranging from the review by independent civil and criminal courts to specialized administrative courts and ombudsmen.

131. In addressing the issue of functioning and effective institutions, the Bank has assisted borrowers to improve their civil service and to establish well-defined administrative structures. Support of civil service reform has focussed on better training for civil servants, pay structures and the need to ensure that the financial remuneration of civil servants is adequate to allow them to properly execute their functions. The Bank is advising governments on how to improve their administrative decision-making processes and to establish administrative structures which clearly assign authority and responsibility.

132. At times, the proper application of the rules is hampered by an overabundance of - in some instances - contradictory or obsolete rules and regulations which overwhelm the bureaucracy. The Bank is assisting countries to review, update and simplify their legal systems.[21]

133. Such reforms of legal systems will improve the administrative capacity of the government to regulate the economy and to reach administrative decisions based on a clear set of new and relevant laws. However, the Bank has to be conscious of the fact that "technical considerations of economy and efficiency, rather than ideological and political preferences should guide the Bank's work at all times."[22]

(iv) <u>Conflicts in the application of the rules can be resolved through binding decisions of an independent judicial or arbitral body:</u> The existence of an independent judicial or arbitral body which can render binding decisions with respect to conflicts in the application of the rules is an essential element of the rule of law concept. The law loses its conflict-resolving and confidence-inspiring function if there is no independent and credible judicial system which safeguards that contractual arrangements are respected and that the law is applied uniformly by the executive.

134. With regard to the first aspect, it is obvious that the confidence in the enforceability of agreements and commitments is instrumental in the proper functioning of an economy and the conduct of economic activities. If there are

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[21]/ A practical example is Ghana. The legal and regulatory framework governing private sector activities is being reviewed by the government in order to eliminate obsolete laws and revise other laws to reflect the policy change from a command economy to a free market system. This follows the changes of the regulatory framework for the financial sector which has already led to encouraging results (Box 3D).

[22]/ Issues of "Governance," p. 57.

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BOX 3D

Reform of the Regulatory Framework

GHANA: Financial Sector Adjustment Credit (Credit 1991 GH)

Banking activities in Ghana have been governed by laws and regulations enacted in the 1960s and early 1970s with a number of amendments and decrees issued on an ad hoc basis since the enactment of the original legislation. Several serious omissions in this body of legislation, together with weak bank supervision, led to the concentration of risk in the portfolios of banks, inadequate capital and reserves, inflated profits and unrecognized loan losses.

In connection with the IDA-financed Financial Sector Adjustment Project, the Government of Ghana established a committee of legal experts to review the existing legislation, draft the changes necessary to improve the regulatory framework and introduce prudent standards to ensure the viability of the banking system. Risk exposure limits as a percentage of capital have been set on a bank's exposure to a single customer or related group. A minimum capital-adequacy ratio has been established, taking into account the quality of the bank's assets as well as its off-balance-sheet risks. Banking supervisors will have the ability to mandate even a higher capital-adequacy ratio, when, in their opinion, conditions warrant. Banks which do not meet the minimum guidelines are not allowed to pay dividends. New regulations specifying the format and content of audit reports and the minimum scope of audit reviews have been introduced together with uniform accounting and auditing standards and prudent reporting requirements. The accounting standards include guidelines for loan portfolio review and classification, the treatment of interest on non-performing loans, and provisioning for potential loan losses. Monetary penalties for violations of laws and regulations are strengthened and will be periodically revised to serve as a deterrent to illegal and imprudent acts.

POLAND: Structural Adjustment Loan (Loan 3247 POL)

In Poland, the Government's Economic Transformation Program (ETP), pursues structural reform towards the establishment of a market economy. The SAL will support reform initiatives mainly in the areas of: (i) enterprise restructuring, privatization, private sector development, with emphasis on appropriate legislation to define the "rules of the game" (including privatization, demonopolization and competition), the establishment of an adequate institutional framework for enterprise restructuring; (ii) financial sector reform, with emphasis on improved banking regulation and supervision, introduction of adequate accounting and auditing standards, etc. and (iii) social safety.

VENEZUELA: Public Enterprise Reform Loan (Loan 3223 VE)

The Loan will support institutional and policy reforms directed at reducing the dominance of the public sector in the economy. The objectives of the program include: rationalization of laws, regulations, policies or practices which impede competition, market discipline, and private investment in key sectors where public enterprises dominate; definition of mutual responsibilities and increase of transparency of the owner/company relationship between the Central Government and public enterprises, etc.

SRI LANKA: Economic Restructuring Credit (Credit 2128 CE)

The Economic Restructuring Credit (ERC) supports the Government's efforts aimed at stabilizing the economy and implementing structural reforms. In addition to addressing the country's serious internal and external imbalances, the size of the public sector, its claim on resources and the efficiency with which it uses its resources, the ERC also focuses on the development of the private sector through improvements in the existing regulatory framework and incentive system and through transfer to the private sector of activities and assets now being managed by the public sector.

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unreasonable delays and high costs in enforcing laws and agreements between private parties, the efficient conduct of economic activities is hampered. Thus, a recent Bank study on Indonesia states: "In the commercial law field the Court system is widely perceived by investors, domestic and foreign, to be inadequate: procedures are slow with cases taking many years to resolve; the courts are overburdened and understaffed; little or no specialization occurs with all types and sizes of cases going to general courts and judges; creditors complain of unreasonable difficulties in enforcing credit and security interest, and finally, there is a belief that factors other than the merits often decide the case. Few investors consider the formal Court system a reasonable forum for a predictable, or prompt, settlement of a problem."[23]

135. With regard to the second aspect - i.e. the check on government actions - it is also evident that a strong judiciary can provide an effective shield against the concentration of arbitrarily-exercised executive power.

136. The state of the judiciary in a number of developing countries is precarious. Even in those countries where there is a nominally-independent judiciary, the courts are usually overworked and dispute resolution takes an unduly long time. Often, the courts lack proper facilities and there is an urgent need for improving the training of the persons involved in the administration of justice. Despite all this, arbitration proceedings outside the court system are not well-developed.

137. This is an area in which the Bank has began to be active (Box 3E). There are several operations under preparation that will assist member governments in the training of judges in economic and business law and may go as far as recommending certain division of labor in the court system so that commercial matters would be handled by specialized courts.

138. In assisting to make the court system more efficient and competent the Bank may wish to look beyond the basics of training and of providing adequate physical facilities. For instance, many developed countries have in the past encountered the problem of a judiciary too unwieldy, expensive and slow to handle disputes. The answer has not necessarily been to improve on the courts but to expand extra-judicial means of settlement by permitting commercial arbitration.[24] Another alternative is to search what caused the growth of

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[23]/ Indonesia: Priorities for Commercial Law Reforms for Private Sector Development, Revised Draft (1990) (hereinafter called the Indonesia Report), p. 40.

[24]/ For example, the Indonesia Report concluded that strengthening the arbitration system and arbitral bodies could improve contract enforcement and avoid some of the constraints in the judicial system.

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BOX 3E

Improving the Judiciary

BANGLADESH: Financial Sector Adjustment Credit (Credit 2152 BD)

The court system in Bangladesh took an average of 10 to 15 years to dispose of suits brought by financial institutions against defaulting borrowers. The result was that transaction costs were extremely high and collection rates were very low. With the assistance of the Association and the International Monetary Fund, Bangladesh enacted a Financial Loan Courts Act in 1990 which established special commercial courts in the major economic centers of Bangladesh, whereby financial institutions could bring actions against defaulting borrowers and the loans could be adjudicated. Progress, which to date has been highly favorable, is being monitored under the Financial Sector Adjustment Credit and involves the establishment of courts, appointment of judges and disposal of cases.

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disputes by updating or clarifying archaic or uncertain legal situations. The business world has also responded by rationalizing business practices through the development of standard forms and patterns of doing business. The courts themselves may help by mass handling of
certain commercial matters, e.g. garnishment and collection of debt. These are areas within the mandate of the Bank in as much as functioning rules and institutions, including an effective dispute-settlement mechanism, are essential for economic development.

(v) <u>There are known procedures for amending the rules when they no longer serve their purpose:</u> As noted above, the rule of law is instrumental in creating a climate of predictability and stability - as the antithesis to governmental arbitrariness. Rules that are constantly changing cannot fulfil this function. Neither can rules that are arbitrarily repealed, amended or waived. The perception of arbitrariness and subjectivity is created by ad hoc decisions whereby the creation, amendment or invalidation of laws is undertaken without known and established procedures. Laws created this way lack legitimacy, i.e. the perception by the affected that they have been established through "the right process". Furthermore, it will lead to a general disobeyance of the law beyond the particular rules. It affects the credibility of the whole legal system (Box 3F).

139. The requirement of having procedures in place for amending or repealing laws when they no longer serve their purpose is limited to just that, namely, the existence of such procedures. It is the prerogative of the country concerned - and outside the mandate of the Bank as stated above - to decide how the legislative process is organized including whether a separate legislative body should exist. What matters is that the public is aware of the process through which laws can be amended, repealed or waived.

140. The Bank's involvement in this area is not yet well defined. In the context of attempts by borrowers to introduce legal reforms, the Bank has stressed the importance of having appropriate procedural rules in place for enacting and/or repealing laws. In order to improve the technical capabilities of the countries concerned in drafting procedural rules and regulations, the assistance financed by the Bank has supported governments' legal offices, i.e., Attorney General, Ministry of Justice, etc., and consisted of training and technical assistance (Laos, Guinea and, under preparation, Angola and Mongolia).

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141. The foregoing analysis of the procedural and institutional elements of the rule of law has focused on their contribution to establishing a "good order." Good order understood in the sense of having "a system in place, based on abstract <u>rules</u> which are actually applied and on functioning <u>institutions</u> which

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BOX 3F

Developing a Legal Framework

The Case of the Legal Framework of the Czech and Slovak Federal Republic

Following the political changes that occurred in Czechoslovakia, a sweeping legal reform started aiming at the creation of an appropriate legal framework and environment for private sector development and a market economy. In particular:

The Constitution was amended effective May 1, 1990, to recognize equal rights to all forms of ownership, i.e., state, cooperative, corporate, and individual ownership.

Contractual relationships are governed by three different codes: the Civil Code (containing, inter alia, all contractual matters among individuals or between individuals and legal entities); the Economic Code (containing all contractual matters between legal entities domiciled in Czechoslovakia, characterized by the heavy predominance of the State in determining contractual economic relations); and the Code of International Business Transactions (governing contractual relationships between entities or individuals or both where one contracting party is not resident of Czechoslovakia). The Economic Code was amended, effective May 1, 1990, so as to provide for greater freedom of contracting and initial coverage of monopolistic practices and unfair competition. The Government intends to end the trichotomy in provisions governing contractual relationships. To this end, a new Civil Code and a new Commercial Code are being prepared to replace the above three codes. However, the new codes are not expected to be ready before 2-3 years.

A new law on State Enterprises, effective May 1, 1990, suppresses the earlier system of self-management, gives greater autonomy and management power to the director of an enterprise, permits the break up of large enterprises into smaller units and makes possible the transfer of state enterprise assets to a joint-stock company. A new law on Joint-Stock Companies, effective May 1, 1990, provides a comprehensive regime for the incorporation and operation of joint stock companies. In the area of foreign investment, amendments to the law on Enterprises with Foreign Property Participation improve the regime for joint ventures with foreign companies while amendments to the law on Economic Relations with Foreign Countries, effective May 1, 1990, facilitate the founding of branches of foreign trading companies and service businesses in Czechoslovakia and the development of foreign economic activities by Czechoslovakian corporate bodies and natural persons. A new law on Corporations became effective May 1, 1990.

Important changes have been made to the law on the Use of Land and Other Agricultural Property to permit, among other things, private sector entry in agriculture. Amendments to the Labor Code provided for greater mobility of labor. Amendments to the Laws on Income Tax and Turnover Tax are being considered. Amendments to the law on Economic Arbitration improve the regime for settlement of contractual disputes.

A new law on Private Enterprise by Citizens, by which individuals were authorized to establish private enterprises and carry out business activities previously under the monopoly of State Enterprises and Cooperatives, became effective May 1, 1990. The law on Transfers of State Owned Assets, on transferring some items owned by the state to the ownership of physical or legal entities became effective December 1, 1990. A law on Privatization was recently submitted for approval.

GHANA: The Legal and Regulatory Framework Governing Private Sector

The legal and regulatory framework governing private sector investment activities in Ghana consists of a set of laws and regulations which were enacted

at different times and in each case reflecting the prevailing political climate, for example:

- The Foreign Exchange Control Act in 1961
- The Industrial Relations Act in 1965
- The Labor Decree in 1967
- The Manufacturing Industries Act in 1971
- The Investment Code in 1985

Although some of the old laws have been properly amended from time to time (like the Foreign Exchange Control Act in 1986), it is fair to state that overall, these laws have not been changed:

- to harmonize conflicting provisions;
- to reflect the "new" attitude of the authorities with respect to private investments; and
- to capture, in particular, the changes in the area of foreign exchange transactions.

As a consequence, there is a certain confusion on the part of the private sector and even among the various agencies of the Government as to the applicability of the different laws. If, for example, important changes with respect to foreign exchange transactions are only conveyed to the public by circulars issued by the Bank of Ghana, the distribution of which is somewhat limited, and if these circulars are in contradiction to - at least on paper - existing laws, the perception is created that the authorities can change "the rules of the game" at any time.

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ensure the proper application of such rules." [25] The existence of such a system is needed for economic development; in particular, the economic reform policies introduced by many of the Bank's members and supported through Bank operations cannot be implemented effectively if these reform measures are not translated into workable rules and applied by functioning institutions in a proper and appropriate manner. Thus, the elements of the rule of law discussed above address these processes of the formulation and application of rules and constitute the procedural framework and institutional system which - if adhered to by the governments concerned - lead to stability and predictability and elicit compliance with the rules.

142. The rule of law and the various other elements of governance are closely interrelated and are somehow reflections of a common theme viewed from different perspectives. There is no doubt that by simplifying existing rules and limiting discretion in certain decisions the Bank has assisted in reducing the opportunities for corruption. The publicity that Bank has insisted on in the administration of certain processes such as procurement has increased transparency in decision-making. Also the development of communication systems for making the laws known helps in making governmental bureaucracies more accountable.

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[25]/ Issues of "Governance," p. 43.

First draft

IV - TOWARDS AN APPROACH TO GOVERNANCE FOR DEVELOPMENT

> **"You cannot make a tree grow faster by pulling it from outside; it has to grow from its roots." - Claude Ake[26]**

143. The Bank's involvement in issues of governance is not new. As a leading development institution which lends to developing member countries, it has grappled with these issues from its inception, and they enter every aspect of its work. Indeed, as is clear from the preceding section, it is already supporting a number of activities that have a direct bearing on hitherto neglected dimensions of governance, such as accountability and the rule of law. What is new is that it has till recently not focussed intensively or systematically on this, in part because of a legitimate concern that such a focus would cause it to drift into dangerous waters and cross the thin divide that defines its legal mandate. What is also new is that with a serious crisis of governance in many borrowing countries, never in its history have issues of governance seemed to be so closely linked to its development mandate. The external environment has changed, and the Bank cannot but be responsive to that change. How should the Bank respond within the limitations of its charter?

144. From the preceding sections, four key messages emerge:

145. First, issues of governance are both highly complex and highly diverse. The complexity arises from the multi-dimensional nature of the subject, as well as the unique imprint that the history of each country leaves on its governance. The diversity is both among different regions of the Bank and among individual countries within each region, and for the larger or ethnically diverse countries, even within each country. The political economy of Kerala state in South India could not be more different from that of Bihar in eastern India, despite similar political structures and institutions and similar economic regimes. Thus, governance is not a subject that lends itself to standard or

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[26]/ "Sustaining Development on the Indigenous," Long Term Perspective Study of Sub-Saharan Africa, Background Papers, Volume 3: Institutional and Sociopolitical Issues. June 1990.

simple prescriptions. The complexity and diversity call for a highly differentiated response that is based on a thorough understanding of the country's political economy and its institutions.

146. Second, from available research, there appears to be no clear link between systems of governance and the dimensions of government that are of concern to the Bank. Successful and flourishing democracies, while open societies, may have weak financial accountability and high levels of corruption. Their legal systems may be so clogged that they are failing to provide the minimum level of services that are essential for development. Despite formal democracy and the rule of law, the access of the poor to government or legal services may, in practice, be limited. In any event, both its mandate and its development experience indicate that the Bank must and should work with a wide range of governments to improve development. Authoritarian regimes which lack openness, may nevertheless, because of the quality of leadership or cultural traditions (as in the East Asian NICs), have high standards of accountability and high degrees of predictability. And, in many instances, they have reduced poverty and delivered quality social services to a wide section of their populations.

147. Third, improving governance is a complex and long-term endeavor. It may take generations to build effective bureaucracies or legal systems.[27] It has taken centuries of painful struggle for citizens to wrest accountability from their rulers in the developed world. While the advent of the Information Age may have compressed these time horizons, nevertheless, progress in this area tends to be, in North's words, "overwhelmingly incremental." For it to succeed it must be firmly rooted in the culture and society of that country and cannot be imposed from outside. The Bank can assist the process of change; it can even help build commitment through its policy dialogue and through its economic and sector work. But it cannot substitute for the commitment to better government that must come from within the country concerned.

148. Fourth, while the Bank has pursued with vigor a wide range of governance issues relating to public sector management, it has till recently paid less attention to certain basic issues which are essential preconditions to successful development: (i) improved accountability at national and local levels, including sound systems of financial accountability; (ii) participation by beneficiaries in the design and implementation of projects; and (iii) the rule of law.

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[27]/ Deborah Brautigam, "Governance: A Review" 1991.

149. There are at least five reasons why the Bank cannot afford to ignore issues of governance:

150. First, good government is inextricably linked with both the returns and the sustainability of the investments that the Bank helps finance. OED studies show that while four-fifths of Bank projects seem successful at completion, only half of those that seem successful are sustained over time. The main lessons we have learned in the 1970s and 1980s are that good projects can be undermined by bad governance. Inadequate O & M efforts, through distorted spending priorities or the corruption of departments responsible for O & M can erode the value of past investments. Severe macro-economic imbalances can eat into the returns on productive investments. Absence of the rule of law, or lack of physical security, can drive away the investment that is needed to generate a supply response to adjustment policies. Lack of popular participation in project design and implementation can significantly reduce project benefits. In sum, the Bank's own operational experience demonstrates the critical importance of good government.

151. A second reason is that if the Bank is seen to lend to countries where poor economic performance is clearly linked to large scale corruption or widespread human rights abuses, it may risk its capacity to raise resources for other countries which are trying to address the key issues of development, including that of governance.

152. A third reason is that the Bank must jealously guard its reputation for technical excellence and financial probity. If a significant portion of its portfolio is seen to be having problems of sustainability or difficulties with financial accounting and auditing, then it could be risking that reputation. It must continue to impose high standards on itself and its borrowers when it comes to basic issues, and this could well imply assisting the borrower address not just the symptom but the underlying problems.

153. Fourth, the external environment is changing rapidly, as several donors move towards political conditionality. While the Bank's mandate is unaffected by this, it is possible that its programs in several countries will be affected in various ways (as they already are in some countries) as for example through difficulties in raising cofinancing or meeting the financing requirements of adjustment lending.

154. Finally, in its own practices the Bank needs to ensure that it is part of the solution to problems of governance and not part of the problem. In many

countries, the Bank is now a major source of finance, policy advice, and technical support to governments. There are circumstances in which it can weaken institutional capacity in its borrowers or undermine ownership of programs by not paying sufficient attention to the context within which it is operating in that country. Similarly an overloaded reform agenda that ignores fragile implementation capacity can do more harm than good.

155. The Bank must approach the issue of governance with careful calculation, great caution and due humility. It must at all times be extremely conscious of the sensitivities of borrowers and of the local cultural context within which the Bank operates. Inevitably, this must involve a country-specific approach and making judgements. But without a measured and restrained approach, there are severe risks of "ad hockery, opportunism and inconsistency in Bank policies in this area[28] with long term consequences for the Bank's reputation for technical competence and independent judgement. The issue on the table is how the Bank should marry the careful approach that is called for with the obvious need to "address" issues of governance.

156. These facts caution against a formal Bank policy on governance. Although the Bank has considerable experience in this area, experience does not by itself constitute expertise. The Bank has still a great deal to learn on governance. Moreover given the complexity and diversity of issues, a great deal more work and experience is required before we understand why some approaches will work in some countries and not in others, and in certain situations and not in others. As the Bank learns more self-consciously about governance in its day to day operational work, and enhances its research effort on the subject, it will gradually improve its capacity to do more formal policy work on the subject and clarify its positions on the critical issues.

157. Governance should not become another Special Initiative. Concerns about governance need to be integrated into the Bank's work program, and the Bank needs to improve systematically its own understanding and knowledgeability about the functioning of governance. The staff are highly receptive to the underlying issues; that receptiveness will be eroded by imposition of operational guidelines, codes of conduct, etc., prior to much more understanding of the complex relationships among dimensions of governance as they impact on economic performance.

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[28]/ Carol Lancaster in a note for the Africa Region, February 1991.

158. In the rest of this section, we discuss first what are the main priorities for the Bank's work on governance. We then examine how those priorities should be reflected in country strategy and dialogue, economic and sector work, lending and aid coordination. The implications for the way the Bank itself functions will then be reviewed.

Priorities for the Bank's work

159. As indicated above, the Bank's primary focus in the area of governance has been on issues of public sector efficiency, with a major emphasis on public expenditure management, civil service reform, the strengthening of core economic agencies and public enterprise reform. That agenda has been largely driven by the need for structural adjustment. More recently, decentralization issues and tax reforms have gained in importance, particularly in Latin America. As is clear from Parts II and III, of late there has been increasing attention paid to issues of accountability, openness, and the rule of law. However, these remain relatively neglected areas. The question the Bank continuously faces as the development agenda broadens inexorably, reflecting the complexity of the real world, is how to prioritize its work. Given the diversity of country situations, the answers are never straight forward. Priorities have to be set within the context of each country situation.

160. In each country, priorities must be centered around the creation of an enabling environment for accelerated development and poverty reduction. For the private sector, this means that the state must create a climate of predictability and stability, in part through a system of objective laws that are applied fairly and efficiently. The enabling environment is needed not just for the "organized private sector" to flourish; it is needed for more equitable and sustainable development. That in turn requires greater public understanding of policy choices. This understanding can be attained through greater participation in the development process; it is also enhanced by increased effectiveness in the delivery of public services.

161. What this means at the micro or project level is ensuring through Bank interventions a greater emphasis on "outward" accountability in addition to "upward" accountability, i.e., accountability to the people who are directly affected: the beneficiaries as well as those adversely affected (due to environmental or other reasons). Providing choices or alternatives must also be a high priority. Competition is the most effective means of improving the quality and level of services. But where choices cannot be generated, enhancing voice is the next best option. These options need to be systematically explored.

It is when governments understand the constraints on exit and voice and design projects to minimize those constraints that they will be closer to ensuring long term sustainability of investments in public services.

162. Upward accountability is as essential as outward accountability. The low level of development of financial accounting and auditing systems in many of our borrowers is a significant impediment to the creation of an enabling environment. In the public sector, these systems are essential to ensure that resources are allocated and spent efficiently, that corruption is minimized, and that corrective action is taken when there is abuse. Ensuring that such a system is in place must surely be an essential precondition for the Bank to be able to do effective business with a country. And yet, there are many instances where systems have been allowed to run down to breaking point, or where they are not serving their functions effectively.

163. Accounting and auditing systems are equally critical for the private sector. This is not only to meet the needs of private sector managers but also to ensure good corporate governance including accountability to shareholders, as well as accountability to the communities within which corporations are residing. Again, there has not been much attention paid to corporate accountability despite the substantial reorientation of the Bank's work towards private sector development.

164. A further prerequisite to an enabling environment is, as indicated above, the "rule of law", as defined in Part III. Without a sound and well-functioning legal system, business risks cannot be rationally assessed and transaction costs could be a significant deterrence to private investment. Good government, in part through the rule of law, lowers risk and transaction costs by reducing uncertainties relating to investment, contracts, and property rights.

165. Thus, in setting priorities in relation to other claims on resources in each country, one approach would be to ensure that the basic elements of an enabling environment for broad-based development: a participatory approach to development at the project level which ensured outward accountability and a "customer/beneficiary" orientation, systems of financial accountability that minimize waste and corruption and ensured good corporate governance, and a functioning legal system that ensured the rule of law. In countries where these basic elements are in place, public sector reform along the lines currently being undertaken would be appropriate. In the absence of these basics, there is a risk that other reforms are being built on weak foundations. Thus, sophisticated reforms in public expenditure policy may yield poor results if

accounting systems are so weak that such reforms cannot be monitored or implemented. Similarly, reforms of laws in the statute books may come to naught if they are not enforced or if the legal system is so clogged up with a backlog of cases that timely resolution of disputes in courts is ruled out. Or privatization efforts may not succeed if the absence of the rule of law has pushed transaction costs to a level where it deters investors. In practice, it may be possible to simultaneously pursue the new focus on basics and ongoing preoccupations with efficiency issues in the public sector. That is a judgement that borrowers and the Bank's regional managers will have to make as they look at the size of the reform agenda in relation to implementation capacity.

166. A strong emphasis by the Bank on prudent financial management and attention to auditing and accounting may bring to the surface deeper problems of governance. Thus, for example, sophisticated systems of financial accounting and auditing could be established, but the government may not absorb or use the results to good effect. A legal framework could be created but the lack of an independent judiciary could undermine its value. Where the absence of the fundamental prerequisites to an enabling environment are due not to weaknesses in capacity but to lack of political commitment, then there is a different kind of governance problem. Commitment, however, can be generated, or dissipated over time. The point for the Bank is to be better able to understand that which leads to greater commitment (or the reverse) so that the Bank is aware of the environment within which it is working.

167. The implications of the foregoing analysis for the Bank's work program are reviewed below:

Country Strategy and Dialogue

168. In developing country assistance strategies, issues of governance are implicitly factored into the analysis. A renewed emphasis on all the key elements of an enabling environment would however, greatly strengthen the strategy and help prioritize the Bank's activities through a consideration of issues along the lines just discussed. The Bank's role on governance issues can be seen at four levels:

169. ♦ Assisting governments in reforms that they have identified, or assisting them to identify reforms when they express a "felt need": the Bank is currently facing a growing demand for assistance from Eastern Europe as they make the transition from command to market economies for assistance in creating the legal infrastructure, assisting set up systems of accountability and transparency.

There are similar demands for assistance with decentralization reforms in Latin America. Governments that are simultaneously pursuing economic and political liberalization have a strong need for institutional reforms which is reflected in this demand led growth for support for such reforms:

170. ♦ Convincing governments of the need for reform: the Bank is currently using a range of instruments including policy dialogue and economic sector work to persuade governments of such a need; how some of these approaches may be strengthened or modified is discussed below, taking into account the legitimate sensitivities of governments;

171. ♦ Reducing Bank involvement in egregious cases where poor economic performance is clearly accompanied by significant corruption or human rights abuses: there are currently a number of Bank country programs where lending has ceased or been reduced to core programs reflecting poor economic progress over a sustained period accompanied in some cases by civil war or other factors that represent gross misgovernment. The issue here is ensuring that such decisions are taken free of external political pressure, but based on the Bank's own objective assessment related to its primary concern with furthering the economic development of the borrower; and

172. ♦ Promoting through its economic and sector work and other vehicles a long term vision for an enabling environment for economic development that embraces the concept of good government, including accountability, transparency and the rule of law, and some of the major elements that promote good government such as "education for all", a vibrant private sector including NGOs, and a well-informed public which all contribute to strengthening overall accountability.

173. In determining country strategy, the Bank's approach to issues of governance will be defined by some of the above considerations described depending on specific country situations. Many bilateral donors are considering going further and linking the volume of lending to the quality of governance. There is considerable pressure to develop appropriate performance indicators, and some donors have urged the DAC Secretariat to take a lead in this area. While some are in favor of ranking countries by commonly agreed indicators established within the framework of the DAC, others, recognizing that comparisons between countries would be highly subjective and invidious are proposing that performance benchmarks be established for each country taking into account its special situation, and progress towards good government should be judged by achievements against those benchmarks.

174. This preoccupation with governance performance indicators is not relevant for the Bank given that the Bank concern is with governance as instrumental for economic performance rather than as a good in its own right (this latter view may be legitimate, however, for bilateral donors.) IDA allocations are determined primarily by an assessment of performance and policies for growth and poverty alleviation. The quality of governance is inevitably factored into judgements about the quality of Bank dialogue, the strength of the policy framework and economic performance since they influence the eventual outcome. In the case of IBRD, creditworthiness considerations are preponderant, but once again these are driven by the quality of economic performance and judgements about the sustainability of policies. The Bank therefore needs to continue to judge effort and effectiveness in the sphere of development.

175. In assessing development performance, the Bank is now paying increasing attention to issues of poverty and sustainability. Governments that are concerned about their poor and are doing something to reduce poverty need to be encouraged. Sustainability of projects after project completion is an equally good test of the quality of development management; it is most likely to be achieved in those instances where beneficiaries have been participants in project design and implementation. Many donors are aware of these linkages. As such, the Bank will also need to encourage governments to undertake participatory approaches to project preparation and implementation.

176. Sustainability of policy reform is part of the challenge of structural adjustment; here too processes for improving local ownership of these policies need to be encouraged. A large number of countries undergoing adjustment are proving to be "prolonged adjustors" or "repetitive" adjustors. In some cases, more informed analysis of the political economy of adjustment, and its institutional prerequisites, would have thrown light on issues of ownership, understanding of the program, and its sustainability. In Uganda, for instance, under Obote II, good policies lost support (Box 4-A). The Bank is currently un-systematic in its attempts at serious political economy or institutional analysis of borrowing country conditions, and as the Uganda example illustrates, this may make it prone to mistakes of political judgement or to understate the importance of the environment facing Bank-financed activities. Moreover, as noted in previous Bank reports, and most recently in RAL-II[29], the Bank's country strategy and adjustment lending efforts would be better informed by a much more serious effort at understanding the political economy of borrowers. The

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[29]/ Report on Adjustment Lending II: Policies for the Recovery of Growth", Report No. R90-49, March 26, 1990.

adjustment process can itself undermine or enhance the government's political commitment. Thus RAL-II notes: "Although the Bank must rigorously avoid interfering in politics, the cost of failure is too great for the borrowing countries as well as for the Bank to ignore the potential contribution of a better understanding of the political economy of adjustment." The implications of this for staff training, economic and sector work and research need to be explored.

177. Ultimately, unless the Bank is willing to reduce lending substantially where performance is so poor that development is drastically affected, this exercise is unlikely to be taken seriously. There is no need for additional criteria for allocation of IDA resources; merely the effective enforcement of existing criteria, resisting inevitable pressures to "move money" or "deliver projects". There is much greater consciousness of this need in recent years, particularly as IDA resources have become scarce. Moreover, as heightened awareness of the need to improve the quality of the portfolio has spread, a serious effort has been made to develop an implementation culture that attempts to shift staff incentives away from simply delivering new operations.

178. If governance issues are to be systematically integrated into the Bank's country strategy, they should be discussed with borrowers in a broader context -- one including a review of the Government's overall development performance. This broader context could include, for example, issues of macro economic adjustment, lessons from country implementation reviews, and issues of sustainability.

179. It is desirable that the Bank insist on certain minimum standards of management responsibility, financial reporting and procurement relating to programs and projects it supports. On governance, as noted above, the focus needs to be on the basics: systems of accountability that enhance development effectiveness, and legal systems that enforce property rights and responsible financial management. Where these basics are not present, the Bank could offer to assist.

180. There is one particular issue relating to country strategy and dialogue that have become a source of concern with the Bank's borrowers. It relates to the level at which issues of governance are discussed with borrowers. The concern arises from the prospect of relatively junior Bank staff raising issues of great sensitivity with senior government officials. Staff clearly need to exercise judgement and restraint since the level at which dialogue takes place should be a function of the governance issue at stake. There will be highly

sensitive issues of governance which the Bank may wish to raise in situations where these are severely impacting on economic performance. Determining who, and how, these issues are to be raised requires the judgement of senior management. However, issues of a technical level or related to projects would be appropriate for discussion by the task manager concerned.

Economic and Sector Work

181. Issues of governance are already being covered in ESW (as shown in the previous sections). Public Expenditure Reviews and Public Sector Management and Institutional Development Reviews have touched on governance issues in a number of countries including Malawi, Tanzania and Zambia. [CITE EXAMPLES FROM OTHER REGIONS] As long as these are dealing with institutional or technical issues such as accounting and audit systems and do not get into more sensitive areas, such analysis is useful in promoting good government. Where sensitive issues are concerned, the Bank can find other ways of conveying the message to governments. There are several areas where the existing best practice in ESW could be usefully replicated or innovative ESW be attempted:

(i) Where the legal framework for development is inadequate, the Bank may wish to undertake legal sectoral reviews to assist countries develop a strategy for establishing a legal system that is supportive of development (see Indonesia legal review). [CITE REFERENCE]

(ii) Assessments of the enabling environment for private sector development (eg. Uganda Private Sector Assessment). This enabling environment might include attention to the private-not-for-profit sector represented by NGOs, and approaches for increasing public information about, and participation in, economic decision-making.

(iii) When the Bank is working within sectors in borrowing countries, it should consider undertaking institutional assessments in order to better appreciate how sectoral decisions are made, and what might be done to strengthen institutional capacities within that sector to enhance performance.

(iv) Strengthen the role of public expenditure review work in order to achieve greater transparency in budget allocations. This analysis should include all government expenditures including those that are sometimes treated to special status, such as military expenditures. Such analysis should focus on the productivity likely to be generated from different kinds of investments, their opportunity costs as well as other economic consequences. (See Uganda Public Expenditure Review, 1990 [CHECK IF THIS IS BEST EXAMPLE]). Military expenditures can be white elephants and need to be treated like any other white elephant in Bank public expenditure work.

Procurement and Accountability

182. The Bank currently undertakes assessments of accountability systems, examining the processes within borrowers for auditing and procurement. These assessments should be strengthened. (MATERIAL TO BE PROVIDED BY COD).

Lending

183. A key issue in work on governance of the kind described in Parts II and III is the type of lending instrument that would be appropriate. There can be no hard and fast rules of course, but the Bank's experience with institutional development suggests that building or strengthening institutions has its own cycle, which is quite a bit longer than the traditional Bank investment project cycle. It calls for a comprehensive understanding of a country's institutional problems and the political, economic and social context within which those institutions function. Thus, in many cases, structural adjustment operations may be inappropriate, although they may play a role in affirming commitment to such reforms. The approach to technical assistance may itself have to change. While this paper cannot address the financing issues in changing approaches to technical assistance, it is the case that both the time and resources devoted to preparation and the product mix and project cycle warrant attention.

184. Direct Bank assistance for efforts such as civil service reform, strengthening key economic agencies, strengthening accountability, transparency and the rule of law through technical assistance and institution building components in regular projects are the more direct way of supporting good governance. Indirect ways include such initiatives as the Africa Capacity

Building Initiative which through its emphasis on creating centers of excellence increases the level of understanding within the educated elites of key issues of development. Similarly, broadly conceived approaches to human resource development also contribute to improvements in effectiveness, productivity and good governance.

185. But most important of all, concern for good governance needs to be more systematically integrated into all operations, focussing on obstacles that weaknesses in governance create for the attainment of the objectives under each operation. This approach includes attention to opportunities for encouraging participatory approaches to development, an outward customer oriented approach in project design, creating opportunities for choices among suppliers of public services. The strengthened poverty approach of the Bank along with its concern for women in development and the environmental focus are also encouraging good governance. These efforts draw the attention of governments to issues they might be tempted to ignore and help create and give voice to new constituencies.

Aid Coordination

186. Mr. Shihata's paper has focussed on the issue and noted that the Bank should not act on behalf of donor countries at these meetings. Issues of governance are arising more frequently at these meetings, and the Bank's preparatory work needs to focus on those issues of relevance to development such as described in this paper. In the preparatory work for the meetings, it would be important not to focus exclusively on the problems of the recipient, but also pay attention to the role of donors when their practices contribute to poor governance. This is particularly the case when intense commercial competition for aid financed projects leads to unfortunate investment decisions. As noted above, the DAC is attempting to develop ground rules for these situations, including increasing reliance on ICB (see Box 2-? above). It is also looking to the Bank for judgements on the appropriateness of certain large projects as a means of reducing the number of aid-financed white elephants. An important role for the Bank is to "blow the whistle" on such operations.

187. Given the constraints the Bank faces in terms of staff resources, there is a strong case for using its leadership position in aid coordination to encourage other donors to assist in some aspects of legal reform that may be beyond the Bank's short-term comparative advantage.

Implications for Bank Practices

188. There is awareness in the Bank of the need to be part of the solution to problems of governance and not part of the problem. The following issues are of relevance. Given the technical complexity of the preparatory work for adjustment operations and the speed with which borrowers require resource transfers, there is a constant danger that the Bank inadvertently weakens governance by weakening ownership of programs which are seen to be externally imposed. Can the Bank do better? To change this practice would involve both better understanding of the political economy of our borrowers (as discussed above) and a preparation cycle for adjustment operations that is far longer than is currently the practice. This would allow time to involve both those responsible for implementing the program and those adversely affected by it in the design and preparation of adjustment operations. A consultative process can help improve governance, and give governments greater confidence and willingness to undertake macro-economic reforms. Current best practice is close to this approach (note the recent experience in Ghana and Uganda). It is easier to do with repeat operations than the first adjustment operation, simply because of the need for a quick transfer of resources at the early stages of the adjustment cycle. Greater selectivity in structural adjustment lending would also help.

189. Second, given that greater popular participation in projects has been demonstrated to improve its results, the Bank, as noted above is attempting to learn how to do this more frequently and well. There may be inherent tensions, however, between popular participation and the Bank's project cycle. Some go so far as to argue that popular participation in Bank supported projects may be an oxymoron. In one view, participation requires not only a much more complicated approach for staff but also additional finance and additional staff time. Others argue that participation may not require additional resources but a redistribution. While a task manager may have to spend more time and money upstream, participation may enable fewer resources downstream. Still others argue that the Bank already places too much attention to upstream activities to the neglect of supervision. Staffing constraints are serious. Popular participation may require additional local staff and more headquarters staff in resident missions. Greater use of anthropologists and sociologists, preferably locally hired, would assist in a better understanding of the cultural constraints to greater participation. Staff incentives may need to be geared to reward those who are particularly good at participatory development. Funding is another concern. The Bank tends to disburse large amounts of money over short periods. Participation requires small amounts of money over long periods. The Bank may not have a comparative advantage in participation at community

levels. It may have such an advantage in large scale investment projects and adjustment operations.

190. Third, staff concerned about sustainability and effectiveness are turning increased attention to fostering an implementation culture. Best practice includes simple project design, discourages creation of autonomous project implementation units, encourages use of government structures to implement projects, implies increasing supervision, suggests up-front action and conditionality rather than delayed dated covenants, recommend recruitment of key staff by appraisal and study fiscal effects of projects. This list itself shows an awareness of how the Bank can contribute to better or worse governance.

191. Fourth, it is arguable whether the Bank is as open and accountable as it would like its member governments to be. The Bank is accountable to its shareholders and to its borrowers. But it may not be sufficiently open and transparent to the beneficiaries of its projects and to the public at large because of concerns about government confidentiality. Ways to encourage openness would be to encourage more formal consultations by observers in things we finance such as public hearings, parliamentary reviews. We could make all Board documents public after a certain interval and require that all CEMs and other sector work be available (for sale) to the public.

192. Lastly, it is not clear that the Bank has a comparative advantage in this area of work. To address some of the new areas of governance, new skills will be needed. LAC Region, for instance, has already hired a number of auditors and tax specialists to assist its work on accounting systems, decentralization and tax regimes. Similar other skills, such as institutional specialists, MBAs, lawyers may be required. There needs to be flexibility in the way this is approached and it is beyond the scope of this paper to estimate how this is done. The Bank should not attempt to take on too much and should aggressively pursue other agencies in the UN system and bilateral donors to provide technical assistance.

Research on Governance

193. In the course of preparing this paper, issues surfaced on which the Bank's staff had but limited information. The richness of the data and experience of the Bank on economic development contrasts sharply with its limited information and knowledge about the political economy and development management aspects of its work. There are three different kinds of research agendas needed for further understanding of governance. The first kind of research agenda, and arguably the

least troublesome, is that noted above --research to deepen the knowledgeability of staff so that they may better perform the work they are currently doing, especially country assistance strategies and economic and sector work. A second kind of research is knowledge creation -- generating new insights into relationships and their implications for economic performance. Here it could be said that as the Bank has in its collected economic data some of the rich empirical material needed for better understanding the relationships between economic and improved governance. Empirical research to date has been starved of the kind of comparative data the Bank has; understanding of the multi-variable analysis on a disaggregated basis of the relationships between various improvements to governance and their implications for enhanced economic performance would be a contribution to knowledge.

194. More information is needed as background for the preparation of country assistance strategies, or, for enhancing economic and sector work. It would also be useful in order to better grasp the prerequisites for increased commitment and sustainability. One of the areas currently receiving little Bank notice is that of institutional economics and some of the state of the art work in development management within particular sectors. These areas should be high priorities if there is to be any follow-up work on governance in the Bank. The underestimation of transaction costs, and the lack of analysis of organizational problems within sectors, means projects and programs with less chance of success than needs to be the case.

195. There are, in addition, other areas needing research if the Bank is to be better informed about governance and better positioned to respond to country needs. For example, would there be utility in better understanding of the complexities in the relationships between economic development and some of the dimensions of governance. Country case studies are needed which detail the manner in which specific interactions between aspects of accountability, law, and openness affected economic performance. Research on decentralization and its economic, institutional, and financial implications are needed. As noted decentralization is being demand driven in many countries; sometimes these changes are occurring before their financial and economic implications are widely understood. Last, and surely not least important, ethnic diversity is an extremely complex problem for many borrowers and yet there is far too little known about how this diversity is impacted by different economic outcomes. It can no longer be assumed that economic growth alone reduces ethnic tensions; yet it may be possible that care in the design of social services can reduce tension, or create an enabling environment for less socially generated violence.

196. Finally, it should be noted that while the Bank's involvement in issues of governance is not new, it is inevitably ongoing. Not only are there many aspects of each of the issues raised on which work has yet to be done but governance is often evolving in response to both domestic and external events. Governance in many Bank member countries is currently changing -- more rapidly in the past five years than in the previous decade. Identifying an appropriate and balanced role for Bank leadership in the midst of that change is the challenge.

GOVERNANCE: A REVIEW

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GOVERNANCE: A REVIEW

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Terms of Reference

The terms of reference (TOR) for this paper requested a review of the political science, development management, and economics literature which bears directly upon the issues of governance--specifically openness (including problems resulting in part from lack of openness e.g. corruption), predictability, and accountability (including institutional pluralism and participation). In particular, the TOR asked:

1. What does recent work in political science, development management, or institutional economics have to say about these three variables?

2. Is there any empirical work on these variables which points to their impact upon economic performance?

3. Which aspects of the rule of law are included within these variables?

I. INTRODUCTION

> There is a persistent tension in the social sciences between the theories we construct and the evidence we compile about human interaction in the world around us. It is most striking in economics, where the contrast between the logical implications of neoclassical theory and the performance of economies (however defined and measured) is startling. . .We have paid a big price for the uncritical acceptance of neoclassical theory.
>
> Douglass North 1990: 11, 131

A. GOVERNMENT AND ECONOMY

Classical economists assumed that government mattered for economic performance, yet many neoclassical economists assumed away the role of the state, and of political processes, in their models of economic processes. If governments are assumed to be neutral, then economic performance can be assisted through simply "getting prices right." And yet, as Douglass North argued in the epigram that opens this section, economic performance contrasts sharply with "the logical implications of neoclassical theory." Governments are not neutral, and their role is critical in providing the environment in which the "right prices" can provide the proper incentives for producers and investors.

This paper examines three dimensions of the exercise of power and authority (accountability, openness and predictability) in a review of recent literature in political science, development management, and institutional economics. It makes no claim to be exhaustive, but to rather serve as a window into a field which is built upon analysis of the relationship between government and economy. It explores when, and how, a government's accountability, openness and predictability matter, and how the different ways in which governments use their power and authority create enabling or disabling economic environments.

For the purposes of this paper, governance is defined as the exercise of power and authority by governments as they interact with the public. Governance is concerned with the authoritative processes of formulating, promulgating, and enforcing rules and policies regulating social and economic interaction, "the exercise of political power to manage a nation's affairs." [World Bank 1989: 60]. Political science and public management literature provide some guidance about what governance is and indicate that it is critically important, but the literature is less sure about causality: Why is poor governance so common in some parts of the world? How does effective governance develop?

Governance rose to the forefront of discussions of development at the close of the 1980s. *Glasnost* in the Soviet Union focused new attention on openness as a critical element in governance. Political openness in the Soviet Union and in Eastern Europe created new space for citizen's demands for accountability, and for changes in governance when economic and social needs were not met. The rapid democratic transitions among Latin American authoritarian governments during the past decade served as an additional stimulus for changes in the exercise of power and authority in countries where a lack of predictability frequently held back productive investment, and inadequate accountability helped create large disparities in wealth.

In Africa, domestic calls for greater openness and accountability were joined by international donors. The World Bank's 1989 Long Term Perspectives Study (LTPS) on Africa highlighted a deep concern with governance as a development issue: "Underlying the litany of Africa's development problems is a crisis of governance." Addressing political issues as openly as it did, the LTPS created a stir in the development community. The LTPS linked governance to issues of leadership authority and legitimacy. It addressed the absence of balance of power, the lack of official accountability, the control of information, and a failure to respect the rule of law. The LTPS spoke in favor of "independence for the judiciary, scrupulous respect for the law and human rights at every level of government, transparent accountability of public monies, and independent public auditors responsible to a representative legislature, not to an executive." [World Bank 1989: 192].

The World Bank is mandated to address only those governance issues which affect the performance of its borrowers' economies. Although governments exercise their power and authority in different ways, they all affect economic activity. Skill and capability are preconditions for effective governance. This paper focuses on those aspects of governance, in addition to competence, that appear to affect economic performance: accountability, openness, and predictability. These variables affect economic performance through their impact on fiscal integrity, on the rule of law, and on the creation of an environment conducive to productive investment.

B. ORGANIZATION OF THE REVIEW

The review is organized into five sections. Before moving into the newer literature on governance, the review offers a context for more recent work by presenting first a brief sample of the more classic work on governance and then an historical overview of the development of governance in Western Europe. The second section reviews recent work on governance issues in political science, development management and institutional economics. The third reviews governance and the rule of law, and the fourth addresses the empirical impact of governance on economic performance. A second paper will offer operationally useful suggestions derived from research in these three fields.

In keeping with the limited focus on three aspects of governance (accountability, openness and predictability), we do not address issues of the form of government. Although there is some empirical research on hypothesized relationships between form of government and outcomes of growth and development, the evidence to date is mixed. Indeed, one of the puzzles we explore here will be, as Lindblom phrased it: "how it is that many nondemocratic governments seem to be as strongly motivated to guard the welfare of citizens as democratic governments." [1977: x].

II. GOVERNANCE IN HISTORICAL PERSPECTIVE: EAST AND WEST

A. BACKGROUND TO THE CONCEPT OF GOVERNANCE

Discussions of governance may be divided between normative and positive theory, the "ought" as opposed to the "what is". This distinction has ancient roots. In Asia, theories of governance can be traced to Confucious' philosophy of the moral institutions underlying social order, in particular, the "rectification of names".[1] Mo Tzu's (c. 470-c.381 B.C.) influential critique of Confucius used a utilitarian argument: states are established to end disorder, and thus the centralized authority of the ruler must be absolute: "According to the Mohists, the state exists because it is useful. But according to the Confucianists, it exists because it ought to exist." [Fung 1948: 73].

Mencius (c. 371-c. 289 B.C.) elaborated the Confucian idea of governance by arguing that the people had the right to overthrow a leader who lacked the necessary moral qualities: such an act was not regicide; since the ruler did not live up to the responsibilities inherent in his title, he was not really a ruler. Mencius further elaborated the idea of two kinds of governmental authority: wang, or the sage-king, and pa, or the warrior-king. One bases its power in morality, the other in force.[2] This dichotomy between normative and positive traditions of governance continues; the positive tradition is reflected in institutional economics, reviewed below.

Max Weber's nineteenth century work on rational-legal states underlies many Western ideas of governance. As the founder of sociology, Weber's views on how to analyze the modern state began the search for more scientific analysis. He pointed to the process of rationalization, arguing that modern states differ from primitive states in their reliance on hierarchy, in the base of the leadership's legitimacy, and in their monopoly of the use of legitimate force. But both Weber and Confucius stressed that public administration cannot be divorced from its society: "bureaucracy that actually works is part of a process of increasing secularization, organizational complexity, economic development and literacy." [Sandbrook 1985: 155].

Weber addressed the development of governance in modern states from his perspective on Western Europe. Writing nearly a century later, Gunnar Myrdal's 1968 Asian Drama: An Inquiry into the Poverty of Nations introduced the idea of "soft states" versus "hard states" in an influential addition to the modernization literature, which focused on the problems of state-building in developing countries. The "hard state" sets priorities and carries them out. Norms and practices keep bureaucrats and politicians separate. The "soft state" finds officials regularly circumventing laws and regulations. Civil

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[1]For Confucious, each "named" social role (ruler, father, son, minister, etc.) contains a description of the proper behavior for that role. If a person did not live up to that behavior, he could not claim the role. Thus a son must be filial, a father paternal, and a ruler must offer moral leadership to the nation. Social order depended on everyone fulfilling his or her social role, on the "rectification of names." The heaviest responsibility fell on the leader: if he fulfilled his duty, then the chain of rectification and social order would be in place; if not, social chaos would result.

[2]Contemporary Chinese thought continues this distinction: "a democratic government is a wang government, because it represents a free association of people, while a Fascist government is that of a pa, because it reigns through terror and physical force. [Fung, 1948, p. 75].

servants and politicians secretly collude to thwart policy implementation, and corruption riddles the system. The "hard state" is a state in control of its regulations and policies. Its civil service operates by Weberian rational bureaucratic principles: universalism, detached and routine decision-making, hierarchical supervision, and information systems that maintain continuity and predictibility. Control, capability and volition separate "soft states" from "hard states."

Later writers ammended Myrdal's work by adding analyses of the history of governance under colonial rule, and the influence of colonial institutions on the development of accountability in post-colonial states. The preconditions for "bureaucracy that actually works" are controversial. Hyden argued that effective governance develops under pressure from an entrepreneurial class, which shapes the administration of government so as to support a secure investment climate [1983]. Sandbrook echoed this point, in his discussion of preconditions for British industrialization: "security of property and life, predictability in administration, a compact and unified national market and a protected international trade" [1985, 30]. To shed some light on this question, we briefly review the development of governance in Western Europe.

B. HISTORICAL PERSPECTIVES: EVOLUTION OF GOVERNANCE IN WESTERN EUROPE

Relations between rulers and ruled differ in every country. History, custom, law, society and political economy affect the way in which the ruled in a country hold rulers to account for their performance, the relative openness of a socio-political system or an economy, and the degree of predictability in government decision-making and interaction with the public. The concept of governmental accountability in Europe developed slowly as a result of evolving relations between rulers and elite, stimulated in the past several centuries by ideas of personal freedom and government responsibility rooted in the Enlightenment. In contrast, many East Asian governments trace their own roots of accountability and predictability to the influence of Confucious and the development two thousand years ago of rational-legal bureaucracies, based on Chinese models.

In Britain, the Magna Carta signaled the first formal attempt by social elites to elicit accountability from their monarch. Early European states resembled many third world countries today. Caught between cumbersome taxation systems and their need for revenues, they borrowed heavily and operated under chronic deficits: financial crises brought Spain to bankruptcy five times between 1575 and 1647 [Eggertsson 1990: 342]. The need to raise revenues to pursue state activities (wars, in particular) brought monarchs into repeated struggles with the barons and dukes on whom they relied to extract surpluses from the peasantry.

Historically, accountability in Europe was wrested from personal rule of royalty by the pressure of domestic elites: "The admission of the right of parliament to legislate, to enquire into abuses, and to share in the guidance of national policy, was practically purchased by the money granted to Edward I and Edward II." [Stubbs 1896: 599 in North 1990: 114]. Taxation evolved from a unilateral act by the crown, to a right that involved reciprocity. Concerned by their lack of control over revenues, other European elites demanded institutions like Britain's Parliament which would eventually bring the monarch's budget out of the household and into national accounts: in France, it was the development of the Estates General; in Spain, the Cortes. The evolution was slow: only in 1782 was it possible in Britain for Parliament to clearly separate the crown's personal account from general government accounts. [Theobald 1990]. The political and economic impact of financial crisis pushed institutional changes, and these took different forms:

> The case has been made that relative economic success or failure of the countries of Europe in the past 200 or so years is related to the resolution of the financial crisis in the early nation-states. In some instances the crisis was resolved through representative government, the distribution of powers, and independent judiciary, and other institutions supportive of secure property rights. In other cases a centralist bureaucratic tradition evolved, and dissipating property rights structures became institutionalized. [Eggertsson 1990: 344-345.]

In late eighteenth century France, after the failure of the experiment of a national bank, the elite absorbed the lessons of the British "fiscal revolution" forced by Parliament: "Informed members of the public insisted on the need to subject economic policy to public discussion and to design institutions that would limit the crown's discretion over finance. The discussion of how to design such institutions led to the Revolution [of 1789]." [Root and Ingberman: 26, in Eggertsson: 348].

Elite mobilization forced accountability from leaders who had regarded tax revenues as personal property. But institutions based on the principle that the bureaucracy should serve the public rather than a narrow group of elites are only a 19th century phenomenon in Europe, as opposed to the long Asian tradition of the moral ruler who is responsible for the welfare of all his people. British public servants only began to receive salaries in 1816, and the principle of merit rather than "spoils" as the primary vehicle for recruitment and promotion in the European public services evolved only in the past hundred years. [Theobald 1990: 27; Hyden 1983: 58]. Both movements enhanced predictability and accountability in European governments.

The brief sketch above illustrates broadly how institutions supporting predictability, openness, and accountability developed in Western Europe. These institutions are likely to have developed in different ways in other parts of the world. In many cases, these institutional forms were transferred directly to developing areas during periods of colonial rule. But in the transfer as part of a system based on rule by powerful external actors, the colonial civil service was never directly accountable to those whom they ruled. Even when legislative assemblies were introduced as part of the "tutelage in parliamentary democracy" they were filled in the first instance with colonial civil servants. In the post-colonial period, these public institutions, superimposed on political and economic systems in which they had no roots, continued to lack accountability. In many cases, government bureaucracies failed to continue as impartial, autonomous institutions, but were captured by "clan pressures", politicized as "booty" [Hyden 1983: 60], and in short, reverted to the kind of patrimonial states common in early Europe. "L'état c'est moi" rings all too true in many post-colonial nations today.

Furthermore, the European colonial practices and experiences were very different if one compares, for example, Spanish conquest of South America with British rule in India, or French rule in Africa. The Spanish colonial period took place much earlier, penetrated society more deeply, and resulted in different institutional patterns. The British in India imposed an additional layer on a civilization with a preexisting system of national institutions and a centralized bureaucracy. The French, along with other colonialists, created a complex overlay of government bureaucracies and a centralized state apparatus in Africa, imposing central leadership over many groups which had developed institutions for communal, but not national, governance.

The tragedy of mismanagement and corruption can often be related to this colonial imposition of states and bureaucratic institutions, rather than their natural evolution through a process of citizen

demands for accountability and ruler adjustments [Lonsdale 1986, Hyden 1983].[3] Peter Ekeh points to the reputation for honesty among local ethnic associations in Africa, and contrasts this with corruption in local governments. Associations based on a moral economy of reciprocity, responsibility and duty contrast sharply with imposed government structures, a "profane amoral world based on instrumental relationships premised on the accumulation of rights rather than duties." [Theobald, 1990: 9].

The slow process of building relationships of accountability between states and their societies parallels that of developing standard operating procedures and other tools of rational-legal bureaucracies that lead to greater predictability. Institutional economists, in particular, stress the slowness of change: "The single most important point about institutional change, which must be grasped if we are to begin to get a handle on the subject, is that institutional change is overwhelmingly incremental." [North 1990: 89]. Effective support for the economy rests in part on state capabilities and in part on the system of incentives for those who govern. Institutions such as bureaucracy, courts, military, etc. must both be rooted in a local culture and have reached a level of complexity and efficiency which enables them to "make the action of the state effective" [Badie and Birnbaum 1983: 35]. Recent literature in political science, institutional economics and development management provides further insight into these issues.

III. THEORIES OF GOVERNANCE IN POLITICAL SCIENCE, INSTITUTIONAL ECONOMICS AND DEVELOPMENT MANAGEMENT

What does recent work in political science, development management, or institutional economics have to say about governance, specifically openness (including problems resulting in part from lack of openness e.g. corruption); predictability, and accountability (including institutional pluralism and participation)?

A common theme linking these three bodies of literature is their concern over the framework for decisionmaking in the allocation of scarce resources. Institutional economics is often historical, although an important branch addresses contemporary "principal-agent" problems. Its scope of inquiry is broad, nothing less than "the nature of political and economic institutions and how they change" [North 1989: vii]. Marrying political science and economics, institutional economics attempts to extend neoclassical price theory by tracing the evolution of the institutions--norms, rules, values and patterns of behavior--that affect the performance of economic and political systems. Neoclassical economics assumes full information and costless transactions; it ignores property rights, or assumes that they are fully defined. Institutional economics emphasizes that "when transaction costs are positive, the distribution of political power within a country and the institutional structure of its rule-making institutions are critical factors in economic development" [Eggertsson 1990: 248].

Political scientists study the processes, principles and structure of government and of political institutions: bureaucracies, political parties, popular participation, economic regulations, procedures for controlling conflict and for regulating succession [Huntington 1968: 1]. They analyze both concrete and theoretical issues of power, authority, and legitimacy in the context of the struggles over scarce resources, the distribution of assets and the allocation of production surpluses, that often shape the interaction of

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[3]With this in mind, donors should think twice about the implicit hope that externally imposed reform and reorganization of bureaucracies will somehow lead to their rationalization.

rulers and ruled.

Development management brings both schools down to earth by exploring their operational side: improving efficiency in the allocation of resources, and expanding participation in allocation decisions. Development management writing generally takes a more micro perspective, focusing on projects, programs, and policies within the context of public and private sector decision making and resource allocation. As a multidisciplinary field, development management draws on economics, management and organization theory, as well as sociology and political science [Sharma 1978; Bhaduri and Rahman 1982; Chatterjee and Gokhale 1974].[4]

In general, analysts from all three schools argue that contemporary governance problems cannot be understood outside of a political and historical context, the context which gives political "mismanagement" its underlying logic and which creates the environment in which economic activity operates:[5]

A. ACCOUNTABILITY

The literature defines accountability in several ways: political accountability, public accountability and legal accountability. [Paul 1990]:

(1). political accountability, or "the relative ability of divided peoples to organise in order to choose a ruler or government, to remind king or president of their promises, and to get rid of them if they fail or refuse to abide by their mandate." [Lonsdale 1986: 130]. This involves, *inter alia*, institutionalized methods by which citizens can review government activities, question government ministers, review public expenditure audits, and remove officials who abuse the public trust.

(2). public accountability: Includes "the spectrum of approaches, mechanisms and practices used by the stakeholders concerned with public services to ensure a desired level and type of performance. It thus covers not only the policies underlying accountability, but also the institutional system that operates in a country to motivate service providers (agents) to deliver the desired level of performance." [Paul 1990]. Public accountability involves both answering up the chain of command to superiors, and outward to the public.[6]

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[4]Much of this field has gained its strongest intellectual development through leading institutions and writers in India, notably the Indian Institute of Administration at Ahmedabad.

[5]The lessons of this review point clearly to the need to retreat beyond the recent literature to its base in the classics of political theory for insights into governance in developing countries today. "There are no very explicit modern theorists of good government (as opposed to good organisation) in contrast with the dense seventeenth or eighteenth-century Germanic tradition of *polizeiwissenschaft*." [Dunn, 1986, 173?] The freshest insights come not from recent texts on political development, but from the works of Weber, Hobbes, Hume and Hegel, De Tocqueville and the commentators on Confucius and Mencius.

[6]See also S. J. Eldersveld, V. Jagannadham, and A. P. Barnabas, The Citizen and the Administrator in a Developing Democracy (Illinois: Scott, Foresman, 1978).

(3). legal accountability: Citizens and groups can hold public agencies and civil servants legally responsible for their actions. Civil suits against the state are possible; a penal code regulates both public and private behavior, and laws are enforced through adequately funded institutions which are independent of the political system. Political corruptions occasions real risks and penalties, and individuals and groups that uncover abuses or demand accountability are legally protected.

Political scientists discuss political accountability in a context of legitimacy, power, and authority. The relationship between legitimacy and leadership is important in political scientists' conception of accountability. According to Weber, legitimacy of national leaders rests on three possible bases: constitutional legitimacy; charismatic legitimacy, and traditional legitimacy.[7] The effectiveness of governance is based in part on its level of legitimacy; greater efficiency comes from the promotion of voluntary compliance with laws and regulations rather than the reliance on coercion, threats, fear and personal loyalties.

Accountability is also, as Lonsdale puts it, "the problem of power", and the proper balance between consent and coercion. Governments that lack legitimacy often use less efficient means of control: suppression of civil liberties, coercion and sometimes violence. Their military budgets may absorb a large portion of the nation's scarce resources, and often for use against their own people. The absence of legitimacy occasions instability and eventually, may lead to violent overthrow of the government: Romania, Liberia and Somalia, for example. Rousseau's idea of a social contract between rulers and ruled describes a bargain with mutual responsibilities, but it also implies that failure of the ruler to live up to his side of the bargain removes his mandate, much as the Chinese philosopher Mencius argued. "Effective power can scarcely avoid submitting itself to some test of accountability." [Lonsdale 1986: 128]. Corruption and power frequently coexist in much of this literature. As Lord Acton reminds us: "Power tends to corrupt, and absolute power corrupts absolutely."

Authority, or the "rule of obedience" substitutes for direct control and coercion in political systems. Efficient governments establish authority as a low marginal cost method of shaping public behavior [Lindblom 1977: 22]. Often embedded in a constitution, authority provides recognition that governments have the right to require or to forbid certain behaviors, and that they have the means to ensure obedience.

Eventually, no matter whether the system is based primarily on authority or on force, the ruled hold their rulers to account. When poor economic performance reaches crisis proportions--i.e. famine--legitimacy is lost, in Africa today just as in China two thousand years ago. Prior to that, however, there are always multiple stakeholders who press governments to be accountable--to them. Julius Nyerere's stark question "must we starve our children to pay our debts?" finds a reflection in Lonsdale's observation that "(t)heir accountability to Western bankers appears to oblidge African rulers to repudiate their responsibility for the African poor" [1986, 132].

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[7]While constitutional legitimacy depends on formal law to support accountability, traditional legitimacy depends on social pressures as much as on codified rules. Richard Joseph suggests that "In addition to the establishment of ombudsmen, leadership codes, special tribunals and other well-tried but often unsuccessful initiatives, African countries have to explore customary ways of compelling accountability that enabled chiefs, village heads and councils to govern their communities while being held accountable for their actions." [Joseph, 1990, 203].

For political scientists, accountability thus has several related components: (1) the existence of constitutional or legislated protection of the public interest through a code which regulates both public and private behavior; (2) the enforcement of such laws through specific institutions which receive adequate budgetary allocations and are independent of the political system; (3) a set of social expectations reflected in an implied social contract between rulers and ruled which provides the social underpinnings of enforcement and compliance. Finally, although the meanings and practices of accountability follow changes in societies, "it is found where rulers readily delegate authority, where subordinates confidently exercise their discretion, where the abuse of power is given its proper name and is properly punished under a rule of law which stands above political faction." [Lonsdale 1986: 128, 135].

The nature of a leader's legitimacy both affects, and is affected by how she or he exercises power. Hence the existence of constitutions and formal law alone cannot explain the presence or absence of accountability. Some political scientists immersed in the African experience believe that political accountability depends "almost entirely on the ability of civil society to curb the hegemony of the state." [Chabal 1986: 13], while others argue that the Asian experience demonstrates that in order to be accountable to society at large for the country's economic performance, the "hard" state may insulate itself from particular interests in civil society, rent-seekers, special interest groups, even labor [Haggard 1990]. Latin American states experimented perhaps more than others with controlled participation and limited accountability through corporatist structures that gave specific interest groups: labor, peasants, business, etc. a formal role in government decision processes. Many of these states are now experimenting with decentralization, in the hope that this will enhance governmental accountability to society at large.

In contrast to those who assume that the problem of governance in Africa and related areas is due in part to an "all powerful state" [World Bank (LTPS) 1989: 61], Joel Migdal's analysis of "strong societies and weak states" argues that states with low accountability and legitimacy are engaged in a struggle for survival; they are weak states. Weak states have not effectively centralized and institutionalized their authority. The struggle to do so leads to the politicization of the bureaucracy and a lack of effectiveness, accountability and control. When bureaucrats and leaders attempt to consolidate the rule of law, their offices are in danger of capture by particularistic interests:

> Scholars and aid officials alike have singled out bureaucrats in the Third World for their slothfulness, lack of will, and absence of commitment to reform. These scholars have paid scant attention to the calculus of pressures these bureaucrats have faced that have made them so "lazy" or "uncommitted." Success for public policies neither waits around the corner in a "new breed" of implementor, nor will it be found in an exclusive focus on new management techniques. In fact, the politics of administration in weak states lies at the heart of problems with policy implementation." [Migdal 1988: 242].

One result of this struggle is the fear by government officials of independent economic power in societies they already see as overwhelmingly strong. Rent-seeking as the basis for wealth keeps control of financial resources ultimately with the state. Separating the state from private sector accumulation provides the basis for building a separate economic arena and ultimately, creates the constituency that enforces government accountability:

> In Africa, the state is the prime (though usually not the only) channel of accumulation, except in some extreme situations where the structures of

> accumulation have absorbed the state (Liberia under Presidents Tubman and Tolbert, Sierra Leone under Siaka Stevens, Ghana under Dr. Busia and General Acheampong, Nigeria at the end of the Gowon regime, Zaire under General Mobutu). . .Where there is a greater distance between accumulation and power, there develop autonomous indigenous business classes separate from the bureaucracy (as in Nigeria, Kenya, Senegal and Cameroon) and capable of strengthening civil society" [Bayart 1986: 115-116].

Development management addresses accountability largely from a service delivery viewpoint, generally avoiding the broader question about accountability in basic decisions regarding budgetary allocations, taxation, or whether or not to have the service in the first place. Some development management literature highlights privatization as a method to force accountability through market discipline. Samuel Paul elegantly develops this theme through his argument that government accountability can be enhanced for some services through greater competition (the ability of the public to "exit" to a private sector source) and for others through participation (ability to exert pressure, or exercise "voice"). The choice depends on the nature of the service. [Paul 1990: 4].[8] White cautions that privatization may not enhance accountability or efficiency if the service is a monopoly, is not purchased, or if oversight and regulation are not in place [1989: 148].

The development management literature stresses the potential for concrete improvements through training, motivation, and proper technology. Public accountability, in this view, depends in part on "appropriate and effective accounting systems within or outside the government, on people who are trained and motivated to manage and operate these systems and on the availability of hardware and other ancillary systems, such as working telephone links, necessary for the collection and dissemination of data and the processing of information." [Corkery 1990: 10].

1. Institutional pluralism

Institutions can refer to rules, conventions and norms, or they can refer to organizations. Institutional pluralism generally refers to a diversity of autonomous organizations outside of the government. This diversity creates a "market" of institutions in addition to the state: NGOs, business associations, unions, youth and women's groups, and other intermediate organizations. Although these organizations may not have an explicitly political role, pluralism has long represented the idea of empowerment for diverse groups of people vis a vis the government. This leads many to regard official tolerance for institutional pluralism as a vital precondition for effective power sharing and representation and for the institutionalization of accountability: "Because it raises questions about the control of power and its purposes, accountability must also be concerned with political organisation. For if power is not to some extent shared there can be no effective base from which it may be controlled, nor any protected right to discuss its purposes." [Lonsdale 1986: 128].

A plurality of institutions outside of the government may offer significant opportunities for informal representation, enabling people to "reach up" to governments. Governments at a minimum must listen to their people. Chabal notes that "[t]o heed the view of war veteran's associations, the army, students, ethnic leaders, market women, trade unions, marabouts, peasants or capitalists is one of the

[8]Paul draws, of course, on Albert Hirschman's well known book Exit, Voice and Loyalty.

requirements of effective government. . .There is, however, no causal link between the mechanisms of formal representation and the effectiveness of government." [1986: 14]. Dunn echoes this in his comment that accountability and representation are only weakly connected: "the representation of legitimate social interests is neither a necessary nor a sufficient condition for the beneficient exercise of governmental power" [1986: 162].

In contrast to Dunn's position, Vanhanen's statistical analysis of the relationship between representative governments and economic performance posits representation as an evolutionary outcome of Darwinian natural selection for market-based economies:

> (T)he emergency of private property and enterprises would create new economic interest groups and provide economic basis for their political actions. They would certainly demand representation in political decisionmaking. As a consequence of new pressures it would become rational to extend political rights of individuals and groups and to extend competition in elections. [Vanhanen 1990: 172].

Vanhanen's statistical analysis suggests, however, that in the long term, effective political participation and "popular accountability" depend more on an equal distribution of economic power resources (wealth and assets), and education than on any other variables. [1990: 191, 195].

Institutional pluralism plays a role in addition to its ability to prepare for electoral representation. We are using a definition of governance that involves not the actions of governments alone, but also their interaction with their nongovernmental partners. De Toqueville recognized that a plurality of non-governmental institutions creates a vital arena, adding options for voice, aggregating citizen demands, helping to prevent the concentration of power, and keeping governments accountable [De Toqueville 1966]. In Ghana, for example, the Bar Association mobilized support against the Rawlings government's extra-judicial procedures, helping to stem the erosion of the country's legal institutions.

From the institutional economist perspective, North argues that scope exists to affect the evolution of institutions in a positive direction: "To the degree that there are large payoffs to influencing the rules and their enforcement, it will pay to create intermediary organizations (trade associations, lobbying groups, political action committees) between economic organizations and political bodies to realize the potential gains of political change." [North 1990: 84]. Yet the promotion of pluralism has its dangers. Rational choice economist Mancur Olson argued in The Decline of Nations that pressure by economic interest groups in industrialized nations led to policy decisions that lowered economic performance, and those who study the Asian NICs argue that the autonomy of the state from social groups enabled it to conduct economic policy free from redistributive pressures.

The cases of the authoritarian but developmental NICs raises important questions about the fundamental nature of accountability and its relationship to pluralist systems based on representation and pluralism: does accountability refer more importantly to a process, or to an outcome? Most political scientists educated in the Western European tradition link accountability directly to electoral

representation, even though the literature does not support clear causality.[9] If rulers are ultimately accountable to their people for the performance of the economy, as Mencius believed, then a measure of accountability exists even in non-pluralist authoritarian states, without representation, but with honest rulers, low corruption, and equitable income distribution.[10]

2. participation

Political scientists use participation as an umbrella concept embracing several processes and behaviors generally linked to the exercise of voice to affect government decisions. Participation can occur at a variety of levels, on the national or regional level, at the local level; it can link citizens to decision making at projects and in villages. Lindblom's hierarchy of political participation demonstrates the variety of acts included in the exercise of voice. Some are clearly electoral, but others are linked to a broader vision of participation as citizen action.

In Lindblom's hierarchy, electoral participation includes regular voting in national and local elections, actively working for a party or candidates during an election, attending political meetings or rallies, giving money to a party or candidate during an election, or membership in a political club or organization. Community participation involves activity in organizations involved in community problems, working with others to try and solve some community problems, contacting a government official (state or local) about some issue or problem; and forming a group or organization to attempt to solve some community problem. [Lindblom 1977: 140].

Whether electoral or not, participation creates channels by which people influence their leaders. Claude Aké criticizes the "delinking of leaders from their followers, which, among other things, has led to a dissociation of public policy from social needs and a lack of accountability and self-corrective mechanisms for public policy." [1990: 15]. Aké argues convincingly for a definition of participation that involves not simply reacting to policies and programs, but of shaping them: "One is not just exercising a right of assenting or dissenting from outputs or options that are already predetermined by processes over which one has no control whatsoever." [1990: 16].

Participation can also mean the withholding of assent, economic boycotts, or public gatherings to voice alternative views, or demands for accountability. The respected father of passive resistance, Mohandas K. Gandhi, underlined this mode of political participation in his statement: "It is an inalienable right of people to withhold cooperation. . .If Government should betray us in a great cause. . .we cannot do otherwise than non-cooperation." [Gandhi 1957: 482].

The absence of participation affects legitimacy and may ultimately call stability into question.

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[9]Dunn argues that "(v)irtually all serious modern political theory which is in any sense directed at issues of practical reason (which aspires to guide political conduct and not solely to explain past circumstance) is concerned with the relations between representation and good government" [p. 161].

[10]Chinese philosophers suggest that the question might matter only when the performance of the dictator fails to serve the people.

One cause of the simmering rebellion in Senegal's isolated southern Casamance region is local resistance to the promulgations of a highly centralized and unresponsive state which lacked effective local channels for popular influence into policy. Botswana provides a contrast, where locally elected councils have "substantial power. . .over community development and services," and "where opposition party control of some local councils has mitigated somewhat the effect of continuing one-party dominance at the center and so enhanced commitment to the system. [Diamond, Linz and Lipset 1989: 30].

In keeping with their concern for practical applications, some development management writers argue that improving the responsiveness of organizations to local communities enhances accountability: "accountability is not achieved by formal procedures but comes out of the interaction between managers and community members." [White 1989: 160]. This interaction must be based on formal instruments of power held by community groups: "to the extent that they contribute to salaries, or influence promotions, or determine work priorities, local communities or groups can compel field staffs to be more responsive to their concerns." [Uphoff and Esman 1984: 148].

White outlines other steps to enhance project and program accountability that substitute for hierarchical control:

> mobilizing local organizations to hold managers and staff accountable; setting up procedures so that proposals by beneficiaries are part of the ongoing information system in the agency; meeting in work groups where staff have access to external professionals; instituting process documentation so that all can learn from the actual steps taken; and relying on pilot projects and experiments to test out new ideas [White 1989: 179-180].

The development management literature documents the important role participation plays in increasing the effectiveness of project and program decisions, not simply through accountability, but in increasing the appropriateness of project investments.

Can the development of community-based popular organizations constrain abuses by government agencies? Theobald argues that not enough data exist to support or refute this view, but he warns that problems exist in "attempts to base structures of accountability on local communities: needs of communities as expressed through their organizations must be reconciled with national needs and in the event of conflict the latter will prevail." [1990: 155]. Korten suggests that authoritarian national governments in the Asian NICs were tempered by multiple local rural organizations, member-controlled and offering efficient channels for local-national communication. [1990: 75]. He goes on to argue that voluntary organizations can channel public concern into political pressure on nonaccountable governments when other channels are missing. Responsible government depends in part on accountability--on checks and balances, but also on the values of those who hold power and the consciousness of those who do not [1990: 168].

B. OPENNESS

The Soviet struggles to institutionalize *glasnost* focussed international attention on openness as a governance concept. While *perestroika* referred to economic restructuring and greater reliance on the market to allocate goods, *glasnost* came to mean a relaxing of controls on information flows, on

expression and association, and on political participation. Openness, thus, has several meanings, but they all refer to relaxation of government controls on the flows of commodities, ideas, information and participation.

(1) Economic openness

Economic openness refers to competitive economies with limited restrictions, a liberal trade regime, and a variety of cross border transactions. In an open economy, goods and resources are allocated primarily by market forces. Entry into the economy is not restricted by government fiat or by other artificial barriers. Unimpeded flows of financial and economic information are fundamental to the effective working of the market, and underpin economic openness.

(2) Political openness

Political openness refers to political competitiveness, contestability, tolerance for diversity, and policy making dependent "on votes and other expressions of preference." [Dahl, 1971, 3]. Included in political openness are contestable leadership and institutionalized procedures for political "exit" (generally through fair elections). Access to information and freedom of expression are fundamental to the responsible exercise of voice; a wide range of government information is accessible through published gazettes and other public records, and confidential classifications are strictly limited.

(3) Transparency

Transparency constitutes a third dimension of openness. Governments can promote transparency even when the system is not open in the economic or political sense, although experience suggests that the high degree of governmental discretion in command economies may impede transparency. Transparent systems have clear procedures for public decision making; they publish budget information, including military expenditures, and minimize "caisses noires" and other hidden budget categories. Subsidies are clearly stipulated; appointing, promoting and dismissing personnel done according to stated, objective criteria; and procurement procedures are regularized and publicized.

Distinguishing these separate aspects of openness is necessary in order to relate "openness" to economic performance in the fifth section of this paper. Many aspects of openness can be traced to capacity problems, rather than failures of governance: Funding for compiling economic statistics may be absent; auditors may not be available; those available may not be well trained. Mechanisms that impede information flows may not signal deliberate closure, yet these can affect performance. One kind of openness may be present and others missing: closed polities but extensive foreign investment and sophisticated market information systems characterize some of the Asian NICs. While committed to a degree of economic liberalization, many of these countries were not willing to allow wide public access to sensitive financial date. Nor were they willing to embrace greater tolerance for divergent political perspectives. In short, economic openness does not readily translate into political openness. Yet even the Asian NICs (Korea, Taiwan) provide some evidence that sustaining open economies in the long term appears to require political openness: guarantees of certain political freedoms such as speech, association and the media, as spelled out in the United Nations Universal Declaration of Human Rights:

> Article 19. Everyone has the right to freedom of opinion and expression; this right includes freedom to hold opinions without interference and to seek, receive and impart information and ideas through any media and regardless of frontiers.

Article 20. Everyone has the right to freedom of peaceful assembly and association. [United Nations 1983: 1-3].

Political openness includes the institutionalization of channels of communication between citizens and officials, as opposed to personalized channels, which empower special interests and provide opportunities for corruption. Openness in this sense correlates with expanded options for specialized interest groups, mass media, and other non-governmental institutions which provide checks on public officials and enhance accountability.[11]

In another dimension of openness, Albert Hirschman's discussion of exit, voice and loyalty notes that systems which punish wavering loyalty lower the quality of information that reaches the leadership, and close themselves to important feedback that would improve accountability. [Hirschman 1970]. Closure also multiplies opportunities for corruption.

(4) **Corruption and Openness**

Theobald's thoughtful review of corruption [1990] in less developed countries summarizes and distills arguments developed in a wide range of research on corruption. Defining corruption as "the *illegal* use of public office for private gain," [1990: 15], Theobald reminds us that, as in all processes, there are costs and benefits--even to corruption. Citing Leff's argument that in less developed countries, corruption lubricates markets, increases predictability through lowering risks, offers a form of insurance, and softens quota and license distortions by creating a market for their allocation, Theobald nevertheless concludes that the costs of corruption outweigh its presumed benefits. Most damagingly, it erodes legitimacy and confidence while affording unproductive consumption.[12] Theobald's discussion of anti-corruption mechanisms illustrates a range of assumed causes:

(1) purges and campaigns (with limited outcomes);

(2) legal administrative measures and specialized, independent bodies established to investigate corruption: Theobald notes that "such bodies depend upon administrative resources which. . .are in extremely short supply. . .adequate buildings, typewriters, filing cabinets, telephones, motor vehicles, secretaries, competent investigators who are highly motivated and skilled. . .they ultimately depend on the commitment and good intentions of those who hold political power." [p. 143];

(3) depoliticization of the government (often through military coups): some military governments have been less corrupt than the civilian governments they overthrew, but the reverse has also been true. One has only to remember Bokassa in CAE, Doe in Liberia, Macias in Equatorial Guinea, Acheampong in Ghana, and Mobutu in Zaire;

(4) moral rearmament or a moral revolution: often the case in Communist revolutions, and

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[11]The information revolution created a new dimension to cross border information flows, expanding the options for "openness" beyond the press and radios, to personal computers, fax machines tape recorders, and videos.

[12]For one of the latest contributions, see M. S. Alam, "Some Economic Costs of Corruption in LDCs", Journal of Development Studies, vol. 27, October 1990, pp. 89-97.

very difficult to sustain for more than a generation without strong coercion;

(5) civil accountability: the synergistic development of the private and non-governmental sectors, a free press, citizen groups, and the growth of social expectations that the government must be accountable to the people, redefined acceptable behavior by public officials and induced pressure to lower corruption in European governments

(6) privatisation: reduction of government controls and regulations, sales of public enterprises to the private sector have potential to reduce abuses, except, perhaps, in cases such as Malawi, where political elites are at the same time private sector elites. [Theobald 1990: 140-165, passim].

Lack of openness is clearly not the only factor involved in corruption. Weber noted that regular salaries are one distinguishing characteristic of rational bureaucracies, as they provide for more effective government control over officials. In Africa in particular, chronic fiscal crises, and problems with regular payment of salaries, remove officials from that government control while also providing strong incentives to supplement income from corruption. Civil service reform may assist the process of building rationalization in bureaucracies.[13]

Using the case of Nigeria, Diamond argues that bureaucratic employment became a major avenue of wealth through political corruption, distorting entrepreneurial incentives, and putting an "economic premium on political power." A vicious circle resulted, based on a scarcity of productive economic options and exacerbated by a restrictive state which controlled the economy. Echoing Hyden, Diamond stresses that only with the development of market-based production opportunities would entrepreneurs have alternative bases of wealth; only then, might the emergence of an entrepreneurial class force the attachment of "real risks and penalties. . .to the pursuit of wealth through political corruption" [Diamond 1989: 384, 403].

High rates of social change create a climate where corruption can thrive. During change, social mores are loosened and people become available for previously unaccepted behaviors. But change may also mean that previously "acceptable" behaviors become "unacceptable." Theobald's useful review traces the gradual discontinuation of behaviors now considered corrupt in Europe, but once considered quite normal. In part, this evolution came about through the development of alternative economic bases outside of both the aristocracy and the government, as well as through the development of a rational-legal bureaucracy based on predictability.

C. PREDICTABILITY

Predictability refers to the ordering of government behavior via the "acceptance of formally established rules." [Hyden 1983: 60]. It implies standard operating procedures, institutionalized rules, non-personalized decision making, with modest levels of discretion, and regularized procedures for establishing and implementing policies. In systems with high predictability, rules and regulations are clearly promulgated and applied indiscriminantly, lines of authority are clear, and capriciousness, at a minimum. The civil service is insulated from politics rather than penetrated by it; when political leadership changes, the civil service acts as a stabilizing source of continuity.

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[13]c.f. World Bank, Public Sector Management.

Political scientists discuss predictability in terms of regularized patterns of interaction, the successful institutionalization of rules, norms, and procedures, and the related concept, stability. Huntington set the terms for the modern discussion of post-Weberian rationalization in Political Order in Changing Societies, arguing that "the most important political distinction among countries concerns not their form of government but their degree of government." [1968: 12]. Huntington argued that social and economic change bred instability, creating a "political gap" through destroying traditional institutions without creating "new bases of political association and new political institutions combining legitimacy and effectiveness." [1968: 5]. He pointed out that

> political institutions have moral as well as structural dimensions. A society with weak political institutions lacks the ability to curb the excesses of personal and parochial desires. . .Morality requires trust; trust involves predictability; and predictability requires regularized and institutionalized patterns of behavior. Without strong political institutions, society lacks the means to define and to realize its common interests. [p. 24]

The problem for political scientists, as Thomas Callaghy so aptly put it, is that while we know that development requires "strong political institutions," and governmental transformation, it is "very difficult to accelerate the shift from personalized to bureaucratic administration." Callaghy laments that "no theory exists on how such shifts occur, much less about how to accelerate them" [1989: 132]. Douglass North would answer that they occur slowly, and accelerating them could have unintended consequences.

The work of North an other institutional economists can help other social scientists think carefully about the origins of the legal and political institutions that create predictability through defining clear property rights.[14] States interact with their societies over the definition (and redefinition) of property rights and the provision of public goods: infrastructure, standard weights and measures, which lower transaction costs [Eggertsson 1990: 247]. Economic development depends critically on these state actions, and states will define property rights in different ways depending on the "distribution of political power within a country and the institutional structure of its rule-making institutions" [1990: 248]. When property rights, and the gains from investment in productive property, are assured, then price incentives will have their expected supply response. Eggertsson adds: "Without the state, its institutions, and supportive framework of property rights, high transaction costs will paralyze complex production systems, and specific investments involving long-term exchange relationships will not be forthcoming." [1990: 317].

Institutional evolution in a nation involves the development of accountability and predictability. Both are rooted in property rights, including personal rights. North goes further, to argue that while effective economic organization depends on rules: "competition, decentralized decision making, and well-specified contracts of property rights as well as bankruptcy laws," effective political organization also

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[14]Eggertsson, in a recent review of institutional economics, isolates three questions guiding his own inquiry: (1) "How do alternative sets of social rules (property rights) and economic organizations affect behavior, allocation of resources, and equilibrium outcomes? (2) Why does the form of economic organization differ from one type of economic activity to another, even within the same legal framework? (3) What is the economic logic behind the fundamental social and political rules that govern production and exchange, and how do these rules change?" [1990, pp. 4-5].

needs "bankruptcy" rules to allow easy exit. [1990: 81].

Finally, institutional economics helps explain why different policies, such as those suggested in structural reform packages, lead to such different and seemingly unpredictable results: although outwardly, the new rules may seem the same in Taiwan and in Tanzania, local enforcement, behavioral norms, organizational forms and interests, and property rights--the institutions that underpin economic responses--all differ, and changes in institutions--particularly in informal institutions--occur very slowly.

Development management writers draw on the social sciences to offer guidance to practitioners. For example, a reading of Weber's ideas on the norms of professionalism that underlie predictability in the "rational-legal state", might enrich a discussion of public management training. Based on universalistic rules and a management hierarchy, rational-legal bureaucracies create order and predictability in society. Like the Confucian "rectification of names", positions have job descriptions, those who sit in the chair are answerable for their performance to their superiors. But unlike Confucious's ideal government, the legitimacy of the rational-legal state rests not on moral leadership, but rather on its adherence to routine, its impersonal nature, and its accountability. In short, it looks rather like the Legalists' "rule of law".

IV. THE RULE OF LAW AND GOVERNANCE

> Little else is required to carry a state to the highest degree of opulence from the lowest barbarianism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.
>
> Adam Smith, 1755[15]

> A market is not just an economic mechanism; it is a legal regime.
>
> Paltiel 1989: 266

Discussions of the rule of law and governance are among the oldest existing philosophical debates. Confucian thinking stressed moral institutions as the basis of government, but the rival Legalist school argued that governments should be based on a fixed code of law [Feng 1948: 31].[16] The Legalists viewed law as an impartial instrument, developed by leaders, and necessary not so much for controlling leaders as for controlling both the people and office holders.[17] This distinction between normative and positive views of law finds reflection in Western legal theory as well.[18] Several thousands of years later, Gandhi, a lawyer, captured the attention of the world with his philosophy of nonviolence and passive resistance. His central message was that the Indian masses needed to demonstrate to the world--and to themselves--the illegitimacy of foreign rule, a rule that was fundamentally not accountable to the people.

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[15]From a paper written by Adam Smith in 1755, quoted in Edward Canan, "Editor's Introduction" to Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (London: Methuen, 1950), p. xxxv, and cited by Bates, 1989, p. 3.

[16]Confucius, forced into exile from his position in the Chinese bureaucracy by political intrigue in 495 B.C., was China's most famous political refugee. A well-order society, he argued, depended on the fulfillment of duties and responsibilities inherent in social roles: ruler, minister, father, and son, for example. If the ruler fulfills the "way of the ruler" he would have legitimacy; for society to prosper, all must fulfill their roles.

[17]For the Chinese Legalists, even service delivery accountability rests on this positivist vision of law: once an individual is given an office, "the functions pertaining to this office have already been defined by law. . .the ruler need not, and should not, bother about the methods used to carry out his work, so long as the work itself is done and well done. If it is well done, the ruler rewards him; if not, he punishes him. . .if the ruler is strict in his rewards and punishments, incompetent people will no longer dare to take office even if it is offered to them. Thus all incompetents are eliminated." [Feng, p. 161].

[18]See John Rawls, A Theory of Justice, for example, for a discussion of normative versus positive approaches to law.

The "rule of law" may be defined as "the subordination of the behavior of state officials to rational, predictable, and publicly recognized procedures." [Paltiel 1989: 266]. Governance is intimately related to the rule of law; the rule of law underpins accountability, predictability and openness. Most systems based on a rule of law have been also constitutional systems. Constitutions acted to reduce the unilateral authority of rulers through separation of powers, to create checks and balances, to spell out property rights protected from and by the state. Exceptions do exist; Lindblom points out that in Cuba, "Revolutionary Justice is based not on legal precepts but on moral conviction." [1977: 129].

The rule of law is an essential precondition for predictability. Impartial administration of justice, freedom of citizens from arbitrary personal interference, and effective procedures of due process are necessary for predictability. Law "provides continuity and essential predictability that are critical to reducing uncertainty among contracting parties." [North 1990: 95]. Some institutional economists argue that instititutionalizing the rule of law may necessitate certain kinds of government structures: "In modern nations, [credible commitments by the state to stable property rights] seem to require an effective separation of powers." [Eggertsson 1990: 348].

The next section discusses three aspects of the rule of law: the content of formal codes, regulations, and laws; the process of their formulation, promulgation and enforcement; and the separation of judicial functions from other government functions. The rule of law thus encompasses both content (the nature of the laws themselves) and process.

A. CONTENT

What obligations does the law require? What rights does it protect? The development of the content of law establishes the legal standards against which both public and private sector actions are measured. It regulates the market system through establishing "exclusive property rights", "the sanctity of contract" and "common standards" all of which underpin market exchanges [Cerny 1990: 206].

1. Property rights.

Property rights are rarely defined by economists yet their importance is never doubted. The definition problem is serious, however, as one's "property" includes one's labor. Property rights are fundamental in the rule of law underpinning market systems and command economies. The structure and enforcement of ownership rights determines economic incentives, and their stability and predictability. As economies develop, legal institutions and property rights evolve to support transactions that increase in complexity and impersonality. Mercantilist economies, with highly liquid investments, differ from industrial and post-industrial economies, which require secure property rights and "political and judicial organizations that effectively and impartially enforce contracts across space and time." [North 1990: 121].

China provides a particularly compelling example of the connection between an independent rule of law, a well functioning market system, and governance. In China, both the content of laws and their enforcement are weak. Before December 1978, "laws--administrative, criminal, civil, or commercial--were largely nonexistent." [Paltiel 1989: 260]. The post-Mao introduction of new laws failed to establish predictability in enforcement, nor to draw clear distinctions between ad hoc administrative decrees and formal legislation. Party control substituted for the rule of law: Hua Guofeng admitted in 1980 that "there are no systematic and practicable administrative rules which define limits

of power and responsibilities and lay down administrative procedure." [Hua, in Paltiel 1989: 261].

Paltiel argues that in China, where law and property rights are weak, Chinese entrepreneurs seek to enhance security and reduce their risks through finding governmental patrons to protect their business activities. This clientalism, he suggests, becomes "the functional substitute for property rights." [1989: 257]. Weak property rights exacerbate a situation of personalized bureaucratic relations: "the heavy hand of the Party's disciplinary methods undermines contract, law, and property, thereby reducing calculabilty and adding an element of political risk to every business transaction." [1989: 267]. Ultimately, the strengthening of clientalism "subverts the impersonal operation of predictable rational-legal norms within the state. Instead of the abstractions of hierarchy and market, human relations become the essential matrix of economic behavior." [1989: 272]. Entrepreneurs spend their energies seeking special exemptions and bargaining with bureaucrats, rather than upgrading productivity and efficiency.

2. Political/Human rights.

The rule of law is essential to protect the rights of citizens in their efforts to force accountability from governments. In Latin America, "crucial individual and collective rights were made effective before the convocation of competitive elections, the organization of effective interest representation, and the submission of executive authority to popular accountabilty." [O'Donnell and Schmitter 1986].

Yet the relation of political rights to governance is not necessarily direct. Dunn argues that "The presence or absence of effectively guaranteed civil and political liberties does not in itself ensure the prevalence of good or bad government. . .the most important contribution of government to popular welfare in time of peace is furnished by the conduct of economic policy. . ." [Dunn 1986: 169].

Historically, in the long term, political rights and personal or human rights appear to be necessary to underpin market systems. Free movement of goods, freedom to establish businesses, security from arbitrary expropriations--property rights--are all related to the protection of personal liberties. Property, as ti is the fruit of one's labor, is an aspect of human rights. Barzan, in fact, argues that "the distinction sometimes made between property rights and human rights is spurious. Human rights are simply part of people's property rights. Human rights may be difficult to protect or exchange, but so are rights to many other assets." [1989: 2].[19]

B. PROCESS

Process involves effective communication of the content of the laws. It involves predictable methods for changing the content of the laws, so that ad hoc decrees do not continually change the legal and regulatory environment, rendering both people and their property insecure. And it involves the effective enforcement of law via adequate budgets, salaries, staff, and workable institutions. Governments may enact and promulgate laws, which are never enforced. Larry Diamond provides the

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[19]The rights of women to own property are restricted in some countries, particularly where women are considered to be their father's or husband's property. The implications of Barzan's argument is especially provocative in those instances.

example of the 1979 Nigerian constitution, replete with provisions for a code of conduct and specific enforcement mechanisms:

> The code required every public officer to declare all his assets at regular intervals to the Code of Conduct Bureau, which was empowered to monitor compliance and refer charges to the Code of Conduct Tribunal. The latter, a quasi-judicial body, had the authority to impose serious penalties on offenders, including vacation of office, seizure of assets, and disqualification from public office for ten years. But neither of these bodies ever worked as intended, because the National Assenbly, upon which the constitution made their activation and supervision dependent, buried the enabling legislation. Without this legislation, the bureau was unable to hire any permanent officers, or to investigate suspicions and complaints...Crucial regulatory functions, upon which the legitimacy of the Second Republic heavily depended, were left open to manipulation, sabotage, and abuse by the politicians. [1989: 384-385].

The Nigerian example suggests that the judiciary should have independent control over its budget. Others suggest that internal safeguards are insufficient to ensure the rule of law; systems need non-governmental watchdogs. Korten argues that "The judiciary is a passive instrument. It can act only on those cases that are brought before it--either criminal suits brought by government or civil suits brought by citizens. Public interest legal organizations from the voluntary sector are essential to the protective role of the judiciary." [Korten 1990: 187]. Others might answer that courts can play a more active role, through writ of certiorari, they can pull cases from elsewhere in the system up to review.

C. INDEPENDENCE OF THE JUDICIARY

Historically, many European political scientists and jurists have argued for the central importance of an independent judiciary in ensuring the rule of law. In some systems a separation of powers is related to judicial independence, but not in all. Wilsford argues that the

> French judicial system is characterized by executive control at all levels. . .the executive seeks to consolidate its influence on judicial decision making by promoting those that agree with it politically and moving those that disagree to less desirable posts. . .Lack of judicial independence was institutionalized in the 1958 constitution. Article 64 makes the president the sole guarantor of judicial independence. . .There is no independent, sovereign agency that protects [these rights] for the citizen <u>from</u> the State. [Wilsford 1989: 147, 144].

This discussion would be incomplete without a warning on the problem of unequally distributed property rights [Lindblom 1977; North 1990]. Governments play a significant role in determining both the structure of laws and their enforcement. Depending on the motivation of government actors, the institutional base of property rights may be politically derived and dependent on clientalist or patrimonial ties. Thus, the rule of law may operate smoothly and still suppress broad-based growth. As Perrow warns, in a related vein, "Beware of efficiency arguments that do not ask: efficiency for whom, and at what cost to others?" [Perrow 1986: 278].

V. DOES GOVERNANCE MATTER? GOVERNANCE AND ECONOMIC PERFORMANCE

> Development models are not simple packages of policies; they are configurations of political, institutional, and historical events.
>
> Haggard and Cheng, in Deyo, p. 128

Empirical work on the relationship between governance and economic performance reveals a mixed record. There appears to be, however, evidence that (1) the impact of government on economic performance is more substantial than some economic theory acknowledges, and (2) failure to meet minimal performance levels can cause both publics and investors to withdraw confidence.[20]

The possibility that political interventions are determinant in the "black box" within which economic policies are made now enjoys a growing concensus. Governance may be the independent variable determining "who gets what, when, and how." [Lasswell]. Sandbrook's prescription for effective governance in Africa highlights the responsibility borne by the state in creating the conditions under which markets and entrepreneurs can effectively function:

> First and most fundamental, the general socio-political and legal framework must be conducive to market relationships. An environment of security of property and predictability is basic to encourage investment; in turn, this requires political stability and a minimum degree of social harmony. Otherwise, capitalists cannot calculate that an investment today will bear fruit tomorrow. A legal code that protects the prerogatives of the owners and is officially respected (and hence calculable) is another element. . .Also vital is the protection of the institution of private property through such steps as: limiting the claims of employees, abolishing traditional land tenure, safeguarding the sanctity of contracts, and guaranteeing full compensation in the event of nationalization. [Sandbrook 1985: 33-34].

Yet empirical research relating specific aspects of governance to economic performance is quite scarce. Most of the political science literature reverses the dependent and independent variables, examining the impact of economic conditions on the development of democratic institutions. Those who do address the issue of government and economic performance tend to examine regime-types (authoritarian, patrimonial, democratic, etc.) rather than the narrower elements we are concerned with here (accountability, openness, predictability). Their conclusions support the practical view that in its earlier stages, economic growth is correlated with adherence to known policies: good fiscal management,

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[20]The Chinese political philosopher Mencius argued more than two thousand years ago that governments based on "wang" must take the lead in building the economic base for supporting their people. The ultimate symbol of the failure of governments to protect the people came from famine, and in the minds of the Chinese, famine signalled the withdrawl of the mandate from the ruler, and the end of a dynasty.

skillful use of government instruments to manage the market, competitive enterprise systems that reward performance, broad-based education, and support for the rule of law. These policies show up in both authoritarian and democratic regimes.

A. ACCOUNTABILITY AND GROWTH

Lonsdale summed up the uncertainty surrounding accountability when he noted wryly that "Accountability is thus the measure of responsibility. . .Whether it also guarantees social justice and economic development is an altogether thornier question" [Lonsdale 1986: 128]. And Dunn concluded that "The synthesis of political accountability with economic prosperity is a contingent and permanently reversible historical achievement. It is not an institutionally guaranteed causal property of any form of regime." [1986: 173].

The Asian NICs (Korea, Taiwan, Singapore) provide a useful foil for this discussion. Although for the most part nondemocratic, these governments draw much of their legitimacy from deeply held social norms, based on their responsibility for the performance of the national economy. The powerful capacity of these governments to select and implement their chosen policies, together with the integrity of the government bureaucracy explains much of their economic success, which in turn enhances legitimacy. They are accountable to their people for economic performance.

The skill of the NIC governments is so evident that some observers, comparing Africa to the NICs, argue that poor governance in Africa is partly a function of comparatively limited skills and capacities in economic management and policy design. Yet skill levels are also a function of political decisions. Governments decide where to allocate scarce resources: to education, or to parastatal subsidies, for example. They create the conditions under which skills can be effectively used. In addition, many of the developing world's most skilled citizens are in political exile. Faced with political repression, norms of corruption and rent-seeking, and patronage politics, many talented individuals wait outside their countries for improvements which will enable them to return and effectively serve the public interest.

1. Participation and institutional pluralism and growth.

Is participation related to economic performance? Stephan Haggard argues that low formal participation: limits on party representation, interest group formation, and labor organization allowed political space for these governments to move rapidly in devising, adjusting, and implementing growth-oriented policies without significant societal pressures. Each of the Asian NICs he examined was marked by

> political systems in which the economic policymaking process was relatively insulated from direct political pressures and compromises. In all cases, legislatures are historically weak or nonexistant and other channels of politically access and representation tightly controlled. [Haggard 1990: 262].

Others note, however, that grassroots participation may have blunted the lack of openness at the top. In Taiwan, for example, a network of local farmers organizations allowed people to influence many of the decisions affecting them [Korten 1990].

Other evidence suggests a correlation between participation and broad based growth. Morris and Adelman's extensive study of nineteenth century development examined 35 institutional and economic variables for 23 countries, comparing paths of development from 1850-1914. Their conclusion found "no universally recommended paths of economic growth," although empowerment and participation figured strongly in the second of their two generalizable findings: "Progressive agriculture is necessary (but not sufficient) to sustained industrialization; increased political power to nonelite groups is essential (but not sufficient) to government policies that spread growth widely." [1989: 1428].[21] On the other hand, L. G. Reynold's analysis of economic growth from 1850 to 1950 in forty Third World countries suggested that "the single most important explanatory variable is political organization and the administration of government." [Reynolds, cited in Adamolekun, 1990: 91].

Huntington and Nelson introduce some complications into these findings in their argument that effective land reform, one of the key components to later economic equality, is best introduced under "noncompetitive and nondemocratic governments," i.e. those with low participation:

> If participation has expanded to the point where medium sized landowners play an active role in politics, land reform becomes difficult or impossible. Parliaments are the enemy of land reform, and a modest body of political participants is likely to have the interest and the means to obstruct the approval and implementation of such reforms. What is needed for reform in these circumstances is the limitation of participation and the centralization of power in an autocratic ruler. [1976: 76].

2. Legitimacy and Growth.

Finally, legitimacy and growth are also related. Research by Diamond, Linz and Lipset remind us that "Regimes that begin with low legitimacy also find it difficult to perform effectively, and regimes that lack effectiveness, especially in economic growth, find it difficult to build legitimacy." [1989: 10]. Legitimacy, while not spelled out as a governance variable in the terms of reference for this review, clearly affects economic performance, if only through the greater cost and lower efficiency of government control through coercion and violence rather than through consent.

B. OPENNESS AND GROWTH

With the possible exception of Japan with its contestable political system and respect for civil liberties, the Asian NICs achieved their remarkable economic performance with carefully circumscribed economic openness, and very little political openness. The NICs are distinguished by strong commitment to education, an "emphasis on and nurturing of a rigorously educated elite." [Johnson: 152]. In addition, they created a politically instulated bureaucratic elite, with planning concentrated in semi-autonomous

[21]Interestingly, for Mencius, the economic basis of kingly (wang) government rested on equal land distribution [Fung, p. 75]. Unequal distribution led to unequal growth, which might eventually lead to peasant uprisings that could bring down a dynasty.

institutes and councils.[22] And in the early stages, they generally manifested neither political openness, nor conventional separation of powers. The KMT in Taiwan was run until recently on strict Leninist lines. As for Korea:

> Amid Kennedy administration pressure to go civilian and respect human rights, the ROK promulgated a new constitution in 1963. Harvard scholar Rupert Emerson journeyed to Seoul and advised Koreans, in classic American fashion, to disperse power through a strong legislature, a two-party system, and various checks and balances. Five years later Samuel Huntington published a book that cited the ROK for precisely the opposite: he applauded the regime for its accumulation of central power and its stability amid rapid economic and social change. Huntington's concern for order transcended liberal categories: the problem was not to hold elections but to create organizations. [Cumings in Deyo 1987: 72].

In other senses, such as transparency, openness is often relevant to growth, or at least its absence opens a system to abuse, without counterbalancing controls. As Haggard argues in the case of Marcos' Philippines:

> [The] high level of executive discretion combined to weaken auditing, oversight and planning. Institutional checks on spending were effectively removed. . .The government could destroy firms through prejudicial policies, discretionary 'taxation', extortion, and the redefinition of property rights. The result was increasing uncertainty, loss of confidence, a decline in productive investment, capital flight, and finally, open political opposition. [1990: 218].

Yet high levels of discretion are not always correlated with poor growth. Haggard and Cheng remind us that in Taiwan, the "Investment Commission retains wide discretion, negotiating all investments on a case-by-case basis" [Haggard and Cheng 1987: 116]. Perhaps the difference lies in the autonomy of the Investment Commission, and its position outside of the executive, while in the case of the Philippines, it is the executive itself that is autonomous.

(1) Corruption and Growth.

In less developed economies, Leff argued, corruption provides economic benefits; in effect, it increases predictability through lowering risks, offering a form of insurance, and softening the distortions of quotas and licenses by creating a de facto market for their allocation.[23] Most analysts

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[22]The Economic Planning Board, and the Korean Development Institute in Korea; the Council on International Economic Cooperation and Development, in Taiwan.

[23]In the lengthy period before both external and internal pressures push the development of rational bureaucracies Weberian ideal-type universalistic norms, Leff suggests that corruption can "lubricate administrative rigidities" cutting through restrictive business regulations and eliminating red tape. [in Theobald, p. 112] As Theobald concludes, corruption "assists capital formation; it fosters entrepreneurial abilities; allows business interests to penetrate the bureaucracy and, lastly, permits the logic of the market

agree however, that corruption is on the whole, a negative weight on development, wasting national resources, undermining stability and administrative capacity, and postponing the evolution of bureaucracies based on universalistic criteria. [Theobald 1990]. But perhaps the most serious consequence of corruption is that it erodes the confidence of citizens in government--it undermines legitimacy. As that happens, governments encounter even greater problems acquiring strength to enact policies and to implement them.

Corruption obviously affects the ability of the state to husband and allocate scarce resources, but there is some evidence to show that problems of corruption eventually recede as alternative avenues to wealth occupy the attention of entrepreneurs, and affective and kinship ties are replaced by more impersonal relationships. The Rhee regime in post-WW II South Korea was notable for its "visible corruption", for example [Haggard and Cheng 1987: 116].

C. PREDICTABILITY AND GROWTH

Economic policies always encounter uncertainties. These uncertainties are greatly worsened, however, when there is great capriciousness or instability surrounding either the way policies are made or by whom they are made. Predictability is essential for long-term capital investment. Market-based economies depend on legal regimes composed of property rights and the sanctity of contracts. A legal system and government administration in harmony with the market enhance predictability, calculability and efficiency [Lindblom 1977; Polyani 1944]. This relationship reduces transaction costs, and makes possible the interactive economic management needed for economic performance.

A major vehicle for this predictability is well-defined and protected property rights. Institutional economics argues that economies need incentives to operate close to the technical production frontier; incentives depend on the structure of property rights, which is determined primarily by the state. Secure property rights enhance stability and predictability:

> The structural frontier of an economy will depend on the following factors: (1) the degree to which decision makers bear the full social costs and benefits of their actions; (2) The degree to which present and future ownership rights are clearly defined and secure and the extent to which disputes over ownership and contractual performance can be settled in an orderly manner and at a low cost. Secure property rights encourage investors to increase the economy's stocks of productive capital; (3) The degree to which the structure of property rights contributes to the lowering of both the cost of measuring valuable margins of assets and commodities and the cost of transferring from one owner to another the ownership rights over resources; (4) The degree to which the state directly assigns ownership rights to assets to the uses of highest value in situations where high transaction costs prevent voluntary exchange. [Eggertsson 1990: 326-327].

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to insinuate itself into transactions from which public controls attempt to exclude it" [Theobald, p. 116].

Predictability counts. When property rights are incomplete, easily abrogated, or unstable, economies suffer. Acts of the predatory state alter investment in profoundly costly ways, affecting choice of technology and inputs, production processes, discount rates, and time profiles [Eggertsson 1990: 341]. The nature of investment, and sometimes its very presence or absence, depend on investors' reading of the likelihood of appropriation through decree or through suddenly adjusted "taxation":

> [S]ome political systems create incentives that place the structural production frontier close to the technical production frontier; other political systems do not. Usually, a political change is required to move the structural production frontier closer to the technical frontier, and therefore, a benefit-cost evaluation of economic reforms must include both the costs of political change and the costs of maintaining (enforcing) each system. [Eggertsson 1990: 319-320]

North and Thomas state their view quite simply: "Economic growth will occur if property rights make it worthwhile to undertake socially productive activity." [North and Thomas 1973: 173, 8]. The specification, protection and enforcement of property rights (including property rights over one's own person) is a task for governments. Although many believe that to link questions of torture, and other human rights abuses, to economic performance is to debase them (if no correlation can be found, then can we disregard egregious examples of their abuse because it does not affect GNP?), a basis exists for their inclusion in discussions of the rule of law and the development of stable property rights that will support long term growth with equity. Work to date on women in development--a human rights issue--supports this relationship. Distorted labor markets (in which distortions arise through discrimination) impact adversely upon growth.

Predictability is about stability, both stability of regulations and law, and political stability, although Mackie cautions that "It is not easy, however, to determine what combination of [political] factors is favorable to growth. One cannot even conclude that political stability alone is a sufficient condition, although something like it may be a necessary condition." [Mackie 1987: 283]. Finally, some specific examples exist in the literature of the economic cost of a highly discretionary bureaucracy. In the Philippines, for example, the corporate tax code was "riddled with special exemptions. The system thus depended heavily on regressive indirect taxes and trade taxes that reinforced the bias against exports" [Haggard 1990: 248].

In the final analysis, it should be clear that research attempting to correlate economic performance to governance variables must necessarily use a relatively short time frame. The recent economic performance of Chile, Taiwan and South Korea took place with very low levels of political openness, and their market economic systems seemed to work in the absence of pluralistic political systems. In the past few years, however, all three countries have made significant transitions toward more open, competitive and participatory political systems, suggesting that sustaining as opposed to establishing market based growth may require the development of political representation.

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: March 25, 1991

TO: Distribution

FROM: Coralie Bryant, PRDPD CB

EXTENSION: 3-1264

SUBJECT: Paper for Governance Task Force

Sarwar has asked that I send you the attached paper on governance (reviewing the literature in political science, development management, and institutional economics) by Deborah Brautigam. This paper will be discussed along with the paper on accountability by Samuel Paul, and the paper on the rule of law (distributed March 22) by Andres Rigo and Hans Jurgen Gruss at the Governance Task Force Meeting on Monday, April 1, 3-5 p.m., Room S13-005.

Attachment

Distribution:

Messrs./Mmes. Adamolekun (AFTPS), Beckmann (EXTIE), Campbell (LATIE), Chaudry (LATPS), Dia (AFTPS), Einhorn (FODDR), Gruss (LEGAF), Harris (CODOP), Heyneman (EMTPH), Isenman (PRDDR), Kohli (EMTDR), Khanna (EXC), Lacey (EDICD), Lamb (PRDPD), Landell-Mills (AFTDR), Lateef (EXTIE), Nankani (LA1IN), Okonjo-Iweala (OPNSV), Pachter (EXTIE), Paul (CECPS), Pellegrini (EMTIN), Rigo (LEGAF), Ritchie (ASTDR), Sagasti (EXTDR), Schiavo-Campo (AF3CO), Shakow (EXTDR), Shirley (CECPS), Socknat (ASTPH), Wai (AFREA), Winkler (LATPS)

CBryant:cb

GOVERNANCE: A REVIEW

Deborah Brautigam

Policy and Review Department, Policy Development
The World Bank

ZERO DRAFT

March 19, 1991

GOVERNANCE: A REVIEW

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Terms of Reference

The terms of reference (TOR) for this paper requested a review of the political science, development management, and economics literature which bears directly upon the issues of governance--specifically openness (including problems resulting in part from lack of openness e.g. corruption), predictability, and accountability (including institutional pluralism and participation). In particular, the TOR asked:

1. What does recent work in political science, development management, or institutional economics have to say about these three variables?

2. Is there any empirical work on these variables which points to their impact upon economic performance?

3. Which aspects of the rule of law are included within these variables?

I. INTRODUCTION

> There is a persistent tension in the social sciences between the theories we construct and the evidence we compile about human interaction in the world around us. It is most striking in economics, where the contrast between the logical implications of neoclassical theory and the performance of economies (however defined and measured) is startling. . .We have paid a big price for the uncritical acceptance of neoclassical theory.
>
> Douglass North 1990: 11, 131

A. GOVERNMENT AND ECONOMY

Classical economists assumed that government mattered for economic performance, yet many neoclassical economists assumed away the role of the state, and of political processes, in their models of economic processes. If governments are assumed to be neutral, then economic performance can be assisted through simply "getting prices right." And yet, as Douglass North argued in the epigram that opens this section, economic performance contrasts sharply with "the logical implications of neoclassical theory." Governments are not neutral, and their role is critical in providing the environment in which the "right prices" can provide the proper incentives for producers and investors.

This paper examines three dimensions of the exercise of power and authority (accountability, openness and predictability) in a review of recent literature in political science, development management, and institutional economics. It makes no claim to be exhaustive, but to rather serve as a window into a field which is built upon analysis of the relationship between government and economy. It explores when, and how, a government's accountability, openness and predictability matter, and how the different ways in which governments use their power and authority create enabling or disabling economic environments.

For the purposes of this paper, governance is defined as the exercise of power and authority by governments as they interact with the public. Governance is concerned with the authoritative processes of formulating, promulgating, and enforcing rules and policies regulating social and economic interaction, "the exercise of political power to manage a nation's affairs." [World Bank 1989: 60]. Political science and public management literature provide some guidance about what governance is and indicate that it is critically important, but the literature is less sure about causality: Why is poor governance so common in some parts of the world? How does effective governance develop?

Governance rose to the forefront of discussions of development at the close of the 1980s. *Glasnost* in the Soviet Union focused new attention on openness as a critical element in governance. Political openness in the Soviet Union and in Eastern Europe created new space for citizen's demands for accountability, and for changes in governance when economic and social needs were not met. The rapid democratic transitions among Latin American authoritarian governments during the past decade served as an additional stimulus for changes in the exercise of power and authority in countries where a lack of predictability frequently held back productive investment, and inadequate accountability helped create large disparities in wealth.

In Africa, domestic calls for greater openness and accountability were joined by international donors. The World Bank's 1989 Long Term Perspectives Study (LTPS) on Africa highlighted a deep concern with governance as a development issue: "Underlying the litany of Africa's development problems is a crisis of governance." Addressing political issues as openly as it did, the LTPS created a stir in the development community. The LTPS linked governance to issues of leadership authority and legitimacy. It addressed the absence of balance of power, the lack of official accountability, the control of information, and a failure to respect the rule of law. The LTPS spoke in favor of "independence for the judiciary, scrupulous respect for the law and human rights at every level of government, transparent accountability of public monies, and independent public auditors responsible to a representative legislature, not to an executive." [World Bank 1989: 192].

The World Bank is mandated to address only those governance issues which affect the performance of its borrowers' economies. Although governments exercise their power and authority in different ways, they all affect economic activity. Skill and capability are preconditions for effective governance. This paper focuses on those aspects of governance, in addition to competence, that appear to affect economic performance: accountability, openness, and predictability. These variables affect economic performance through their impact on fiscal integrity, on the rule of law, and on the creation of an environment conducive to productive investment.

B. ORGANIZATION OF THE REVIEW

The review is organized into five sections. Before moving into the newer literature on governance, the review offers a context for more recent work by presenting first a brief sample of the more classic work on governance and then an historical overview of the development of governance in Western Europe. The second section reviews recent work on governance issues in political science, development management and institutional economics. The third reviews governance and the rule of law, and the fourth addresses the empirical impact of governance on economic performance. A second paper will offer operationally useful suggestions derived from research in these three fields.

In keeping with the limited focus on three aspects of governance (accountability, openness and predictability), we do not address issues of the form of government. Although there is some empirical research on hypothesized relationships between form of government and outcomes of growth and development, the evidence to date is mixed. Indeed, one of the puzzles we explore here will be, as Lindblom phrased it: "how it is that many nondemocratic governments seem to be as strongly motivated to guard the welfare of citizens as democratic governments." [1977: x].

II. GOVERNANCE IN HISTORICAL PERSPECTIVE: EAST AND WEST

A. BACKGROUND TO THE CONCEPT OF GOVERNANCE

Discussions of governance may be divided between normative and positive theory, the "ought" as opposed to the "what is". This distinction has ancient roots. In Asia, theories of governance can be traced to Confucious' philosophy of the moral institutions underlying social order, in particular, the "rectification of names".[1] Mo Tzu's (c. 470-c.381 B.C.) influential critique of Confucius used a utilitarian argument: states are established to end disorder, and thus the centralized authority of the ruler must be absolute: "According to the Mohists, the state exists because it is useful. But according to the Confucianists, it exists because it ought to exist." [Fung 1948: 73].

Mencius (c. 371-c. 289 B.C.) elaborated the Confucian idea of governance by arguing that the people had the right to overthrow a leader who lacked the necessary moral qualities: such an act was not regicide; since the ruler did not live up to the responsibilities inherent in his title, he was not really a ruler. Mencius further elaborated the idea of two kinds of governmental authority: wang, or the sage-king, and pa, or the warrior-king. One bases its power in morality, the other in force.[2] This dichotomy between normative and positive traditions of governance continues; the positive tradition is reflected in institutional economics, reviewed below.

Max Weber's nineteenth century work on rational-legal states underlies many Western ideas of governance. As the founder of sociology, Weber's views on how to analyze the modern state began the search for more scientific analysis. He pointed to the process of rationalization, arguing that modern states differ from primitive states in their reliance on hierarchy, in the base of the leadership's legitimacy, and in their monopoly of the use of legitimate force. But both Weber and Confucius stressed that public administration cannot be divorced from its society: "bureaucracy that actually works is part of a process of increasing secularization, organizational complexity, economic development and literacy." [Sandbrook 1985: 155].

Weber addressed the development of governance in modern states from his perspective on Western Europe. Writing nearly a century later, Gunnar Myrdal's 1968 Asian Drama: An Inquiry into the Poverty of Nations introduced the idea of "soft states" versus "hard states" in an influential addition to the modernization literature, which focused on the problems of state-building in developing countries. The "hard state" sets priorities and carries them out. Norms and practices keep bureaucrats and politicians separate. The "soft state" finds officials regularly circumventing laws and regulations. Civil

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[1]For Confucious, each "named" social role (ruler, father, son, minister, etc.) contains a description of the proper behavior for that role. If a person did not live up to that behavior, he could not claim the role. Thus a son must be filial, a father paternal, and a ruler must offer moral leadership to the nation. Social order depended on everyone fulfilling his or her social role, on the "rectification of names." The heaviest responsibility fell on the leader: if he fulfilled his duty, then the chain of rectification and social order would be in place; if not, social chaos would result.

[2]Contemporary Chinese thought continues this distinction: "a democratic government is a wang government, because it represents a free association of people, while a Fascist government is that of a pa, because it reigns through terror and physical force. [Fung, 1948, p. 75].

servants and politicians secretly collude to thwart policy implementation, and corruption riddles the system. The "hard state" is a state in control of its regulations and policies. Its civil service operates by Weberian rational bureaucratic principles: universalism, detached and routine decision-making, hierarchical supervision, and information systems that maintain continuity and predictibility. Control, capability and volition separate "soft states" from "hard states."

Later writers ammended Myrdal's work by adding analyses of the history of governance under colonial rule, and the influence of colonial institutions on the development of accountability in post-colonial states. The preconditions for "bureaucracy that actually works" are controversial. Hyden argued that effective governance develops under pressure from an entrepreneurial class, which shapes the administration of government so as to support a secure investment climate [1983]. Sandbrook echoed this point, in his discussion of preconditions for British industrialization: "security of property and life, predictability in administration, a compact and unified national market and a protected international trade" [1985, 30]. To shed some light on this question, we briefly review the development of governance in Western Europe.

B. HISTORICAL PERSPECTIVES: EVOLUTION OF GOVERNANCE IN WESTERN EUROPE

Relations between rulers and ruled differ in every country. History, custom, law, society and political economy affect the way in which the ruled in a country hold rulers to account for their performance, the relative openness of a socio-political system or an economy, and the degree of predictability in government decision-making and interaction with the public. The concept of governmental accountability in Europe developed slowly as a result of evolving relations between rulers and elite, stimulated in the past several centuries by ideas of personal freedom and government responsibility rooted in the Enlightenment. In contrast, many East Asian governments trace their own roots of accountability and predictability to the influence of Confucious and the development two thousand years ago of rational-legal bureaucracies, based on Chinese models.

In Britain, the Magna Carta signaled the first formal attempt by social elites to elicit accountability from their monarch. Early European states resembled many third world countries today. Caught between cumbersome taxation systems and their need for revenues, they borrowed heavily and operated under chronic deficits: financial crises brought Spain to bankruptcy five times between 1575 and 1647 [Eggertsson 1990: 342]. The need to raise revenues to pursue state activities (wars, in particular) brought monarchs into repeated struggles with the barons and dukes on whom they relied to extract surpluses from the peasantry.

Historically, accountability in Europe was wrested from personal rule of royalty by the pressure of domestic elites: "The admission of the right of parliament to legislate, to enquire into abuses, and to share in the guidance of national policy, was practically purchased by the money granted to Edward I and Edward II." [Stubbs 1896: 599 in North 1990: 114]. Taxation evolved from a unilateral act by the crown, to a right that involved reciprocity. Concerned by their lack of control over revenues, other European elites demanded institutions like Britain's Parliament which would eventually bring the monarch's budget out of the household and into national accounts: in France, it was the development of the Estates General; in Spain, the Cortes. The evolution was slow: only in 1782 was it possible in Britain for Parliament to clearly separate the crown's personal account from general government accounts. [Theobald 1990]. The political and economic impact of financial crisis pushed institutional changes, and these took different forms:

> The case has been made that relative economic success or failure of the countries of Europe in the past 200 or so years is related to the resolution of the financial crisis in the early nation-states. In some instances the crisis was resolved through representative government, the distribution of powers, and independent judiciary, and other institutions supportive of secure property rights. In other cases a centralist bureaucratic tradition evolved, and dissipating property rights structures became institutionalized. [Eggertsson 1990: 344-345.]

In late eighteenth century France, after the failure of the experiment of a national bank, the elite absorbed the lessons of the British "fiscal revolution" forced by Parliament: "Informed members of the public insisted on the need to subject economic policy to public discussion and to design institutions that would limit the crown's discretion over finance. The discussion of how to design such institutions led to the Revolution [of 1789]." [Root and Ingberman: 26, in Eggertsson: 348].

Elite mobilization forced accountability from leaders who had regarded tax revenues as personal property. But institutions based on the principle that the bureaucracy should serve the public rather than a narrow group of elites are only a 19th century phenomenon in Europe, as opposed to the long Asian tradition of the moral ruler who is responsible for the welfare of all his people. British public servants only began to receive salaries in 1816, and the principle of merit rather than "spoils" as the primary vehicle for recruitment and promotion in the European public services evolved only in the past hundred years. [Theobald 1990: 27; Hyden 1983: 58]. Both movements enhanced predictability and accountability in European governments.

The brief sketch above illustrates broadly how institutions supporting predictability, openness, and accountability developed in Western Europe. These institutions are likely to have developed in different ways in other parts of the world. In many cases, these institutional forms were transferred directly to developing areas during periods of colonial rule. But in the transfer as part of a system based on rule by powerful external actors, the colonial civil service was never directly accountable to those whom they ruled. Even when legislative assemblies were introduced as part of the "tutelage in parliamentary democracy" they were filled in the first instance with colonial civil servants. In the post-colonial period, these public institutions, superimposed on political and economic systems in which they had no roots, continued to lack accountability. In many cases, government bureaucracies failed to continue as impartial, autonomous institutions, but were captured by "clan pressures", politicized as "booty" [Hyden 1983: 60], and in short, reverted to the kind of patrimonial states common in early Europe. "L'état c'est moi" rings all too true in many post-colonial nations today.

Furthermore, the European colonial practices and experiences were very different if one compares, for example, Spanish conquest of South America with British rule in India, or French rule in Africa. The Spanish colonial period took place much earlier, penetrated society more deeply, and resulted in different institutional patterns. The British in India imposed an additional layer on a civilization with a preexisting system of national institutions and a centralized bureaucracy. The French, along with other colonialists, created a complex overlay of government bureaucracies and a centralized state apparatus in Africa, imposing central leadership over many groups which had developed institutions for communal, but not national, governance.

The tragedy of mismanagement and corruption can often be related to this colonial imposition of states and bureaucratic institutions, rather than their natural evolution through a process of citizen

demands for accountability and ruler adjustments [Lonsdale 1986, Hyden 1983].[3] Peter Ekeh points to the reputation for honesty among local ethnic associations in Africa, and contrasts this with corruption in local governments. Associations based on a moral economy of reciprocity, responsibility and duty contrast sharply with imposed government structures, a "profane amoral world based on instrumental relationships premised on the accumulation of rights rather than duties." [Theobald, 1990: 9].

The slow process of building relationships of accountability between states and their societies parallels that of developing standard operating procedures and other tools of rational-legal bureaucracies that lead to greater predictability. Institutional economists, in particular, stress the slowness of change: "The single most important point about institutional change, which must be grasped if we are to begin to get a handle on the subject, is that institutional change is overwhelmingly incremental." [North 1990: 89]. Effective support for the economy rests in part on state capabilities and in part on the system of incentives for those who govern. Institutions such as bureaucracy, courts, military, etc. must both be rooted in a local culture and have reached a level of complexity and efficiency which enables them to "make the action of the state effective" [Badie and Birnbaum 1983: 35]. Recent literature in political science, institutional economics and development management provides further insight into these issues.

III. THEORIES OF GOVERNANCE IN POLITICAL SCIENCE, INSTITUTIONAL ECONOMICS AND DEVELOPMENT MANAGEMENT

What does recent work in political science, development management, or institutional economics have to say about governance, specifically openness (including problems resulting in part from lack of openness e.g. corruption); predictability, and accountability (including institutional pluralism and participation)?

A common theme linking these three bodies of literature is their concern over the framework for decisionmaking in the allocation of scarce resources. Institutional economics is often historical, although an important branch addresses contemporary "principal-agent" problems. Its scope of inquiry is broad, nothing less than "the nature of political and economic institutions and how they change" [North 1989: vii]. Marrying political science and economics, institutional economics attempts to extend neoclassical price theory by tracing the evolution of the institutions--norms, rules, values and patterns of behavior--that affect the performance of economic and political systems. Neoclassical economics assumes full information and costless transactions; it ignores property rights, or assumes that they are fully defined. Institutional economics emphasizes that "when transaction costs are positive, the distribution of political power within a country and the institutional structure of its rule-making institutions are critical factors in economic development" [Eggertsson 1990: 248].

Political scientists study the processes, principles and structure of government and of political institutions: bureaucracies, political parties, popular participation, economic regulations, procedures for controlling conflict and for regulating succession [Huntington 1968: 1]. They analyze both concrete and theoretical issues of power, authority, and legitimacy in the context of the struggles over scarce resources, the distribution of assets and the allocation of production surpluses, that often shape the interaction of

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[3]With this in mind, donors should think twice about the implicit hope that externally imposed reform and reorganization of bureaucracies will somehow lead to their rationalization.

rulers and ruled.

Development management brings both schools down to earth by exploring their operational side: improving efficiency in the allocation of resources, and expanding participation in allocation decisions. Development management writing generally takes a more micro perspective, focusing on projects, programs, and policies within the context of public and private sector decision making and resource allocation. As a multidisciplinary field, development management draws on economics, management and organization theory, as well as sociology and political science [Sharma 1978; Bhaduri and Rahman 1982; Chatterjee and Gokhale 1974].[4]

In general, analysts from all three schools argue that contemporary governance problems cannot be understood outside of a political and historical context, the context which gives political "mismanagement" its underlying logic and which creates the environment in which economic activity operates:[5]

A. ACCOUNTABILITY

The literature defines accountability in several ways: political accountability, public accountability and legal accountability. [Paul 1990]:

(1). political accountability, or "the relative ability of divided peoples to organise in order to choose a ruler or government, to remind king or president of their promises, and to get rid of them if they fail or refuse to abide by their mandate." [Lonsdale 1986: 130]. This involves, *inter alia*, institutionalized methods by which citizens can review government activities, question government ministers, review public expenditure audits, and remove officials who abuse the public trust.

(2). public accountability: Includes "the spectrum of approaches, mechanisms and practices used by the stakeholders concerned with public services to ensure a desired level and type of performance. It thus covers not only the policies underlying accountability, but also the institutional system that operates in a country to motivate service providers (agents) to deliver the desired level of performance." [Paul 1990]. Public accountability involves both answering up the chain of command to superiors, and outward to the public.[6]

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[4]Much of this field has gained its strongest intellectual development through leading institutions and writers in India, notably the Indian Institute of Administration at Ahmedabad.

[5]The lessons of this review point clearly to the need to retreat beyond the recent literature to its base in the classics of political theory for insights into governance in developing countries today. "There are no very explicit modern theorists of good government (as opposed to good organisation) in contrast with the dense seventeenth or eighteenth-century Germanic tradition of *polizeiwissenschaft*." [Dunn, 1986, 173?] The freshest insights come not from recent texts on political development, but from the works of Weber, Hobbes, Hume and Hegel, De Tocqueville and the commentators on Confucius and Mencius.

[6]See also S. J. Eldersveld, V. Jagannadham, and A. P. Barnabas, The Citizen and the Administrator in a Developing Democracy (Illinois: Scott, Foresman, 1978).

(3). legal accountability: Citizens and groups can hold public agencies and civil servants legally responsible for their actions. Civil suits against the state are possible; a penal code regulates both public and private behavior, and laws are enforced through adequately funded institutions which are independent of the political system. Political corruptions occasions real risks and penalties, and individuals and groups that uncover abuses or demand accountability are legally protected.

Political scientists discuss political accountability in a context of legitimacy, power, and authority. The relationship between legitimacy and leadership is important in political scientists' conception of accountability. According to Weber, legitimacy of national leaders rests on three possible bases: constitutional legitimacy; charismatic legitimacy, and traditional legitimacy.[7] The effectiveness of governance is based in part on its level of legitimacy; greater efficiency comes from the promotion of voluntary compliance with laws and regulations rather than the reliance on coercion, threats, fear and personal loyalties.

Accountability is also, as Lonsdale puts it, "the problem of power", and the proper balance between consent and coercion. Governments that lack legitimacy often use less efficient means of control: suppression of civil liberties, coercion and sometimes violence. Their military budgets may absorb a large portion of the nation's scarce resources, and often for use against their own people. The absence of legitimacy occasions instability and eventually, may lead to violent overthrow of the government: Romania, Liberia and Somalia, for example. Rousseau's idea of a social contract between rulers and ruled describes a bargain with mutual responsibilities, but it also implies that failure of the ruler to live up to his side of the bargain removes his mandate, much as the Chinese philosopher Mencius argued. "Effective power can scarcely avoid submitting itself to some test of accountability." [Lonsdale 1986: 128]. Corruption and power frequently coexist in much of this literature. As Lord Acton reminds us: "Power tends to corrupt, and absolute power corrupts absolutely."

Authority, or the "rule of obedience" substitutes for direct control and coercion in political systems. Efficient governments establish authority as a low marginal cost method of shaping public behavior [Lindblom 1977: 22]. Often embedded in a constitution, authority provides recognition that governments have the right to require or to forbid certain behaviors, and that they have the means to ensure obedience.

Eventually, no matter whether the system is based primarily on authority or on force, the ruled hold their rulers to account. When poor economic performance reaches crisis proportions--i.e. famine--legitimacy is lost, in Africa today just as in China two thousand years ago. Prior to that, however, there are always multiple stakeholders who press governments to be accountable--to them. Julius Nyerere's stark question "must we starve our children to pay our debts?" finds a reflection in Lonsdale's observation that "(t)heir accountability to Western bankers appears to oblidge African rulers to repudiate their responsibility for the African poor" [1986, 132].

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[7]While constitutional legitimacy depends on formal law to support accountability, traditional legitimacy depends on social pressures as much as on codified rules. Richard Joseph suggests that "In addition to the establishment of ombudsmen, leadership codes, special tribunals and other well-tried but often unsuccessful initiatives, African countries have to explore customary ways of compelling accountability that enabled chiefs, village heads and councils to govern their communities while being held accountable for their actions." [Joseph, 1990, 203].

For political scientists, accountability thus has several related components: (1) the existence of constitutional or legislated protection of the public interest through a code which regulates both public and private behavior; (2) the enforcement of such laws through specific institutions which receive adequate budgetary allocations and are independent of the political system; (3) a set of social expectations reflected in an implied social contract between rulers and ruled which provides the social underpinnings of enforcement and compliance. Finally, although the meanings and practices of accountability follow changes in societies, "it is found where rulers readily delegate authority, where subordinates confidently exercise their discretion, where the abuse of power is given its proper name and is properly punished under a rule of law which stands above political faction." [Lonsdale 1986: 128, 135].

The nature of a leader's legitimacy both affects, and is affected by how she or he exercises power. Hence the existence of constitutions and formal law alone cannot explain the presence or absence of accountability. Some political scientists immersed in the African experience believe that political accountability depends "almost entirely on the ability of civil society to curb the hegemony of the state." [Chabal 1986: 13], while others argue that the Asian experience demonstrates that in order to be accountable to society at large for the country's economic performance, the "hard" state may insulate itself from particular interests in civil society, rent-seekers, special interest groups, even labor [Haggard 1990]. Latin American states experimented perhaps more than others with controlled participation and limited accountability through corporatist structures that gave specific interest groups: labor, peasants, business, etc. a formal role in government decision processes. Many of these states are now experimenting with decentralization, in the hope that this will enhance governmental accountability to society at large.

In contrast to those who assume that the problem of governance in Africa and related areas is due in part to an "all powerful state" [World Bank (LTPS) 1989: 61], Joel Migdal's analysis of "strong societies and weak states" argues that states with low accountability and legitimacy are engaged in a struggle for survival; they are weak states. Weak states have not effectively centralized and institutionalized their authority. The struggle to do so leads to the politicization of the bureaucracy and a lack of effectiveness, accountability and control. When bureaucrats and leaders attempt to consolidate the rule of law, their offices are in danger of capture by particularistic interests:

> Scholars and aid officials alike have singled out bureaucrats in the Third World for their slothfulness, lack of will, and absence of commitment to reform. These scholars have paid scant attention to the calculus of pressures these bureaucrats have faced that have made them so "lazy" or "uncommitted." Success for public policies neither waits around the corner in a "new breed" of implementor, nor will it be found in an exclusive focus on new management techniques. In fact, the politics of administration in weak states lies at the heart of problems with policy implementation." [Migdal 1988: 242].

One result of this struggle is the fear by government officials of independent economic power in societies they already see as overwhelmingly strong. Rent-seeking as the basis for wealth keeps control of financial resources ultimately with the state. Separating the state from private sector accumulation provides the basis for building a separate economic arena and ultimately, creates the constituency that enforces government accountability:

> In Africa, the state is the prime (though usually not the only) channel of accumulation, except in some extreme situations where the structures of

> accumulation have absorbed the state (Liberia under Presidents Tubman and Tolbert, Sierra Leone under Siaka Stevens, Ghana under Dr. Busia and General Acheampong, Nigeria at the end of the Gowon regime, Zaire under General Mobutu). . .Where there is a greater distance between accumulation and power, there develop autonomous indigenous business classes separate from the bureaucracy (as in Nigeria, Kenya, Senegal and Cameroon) and capable of strengthening civil society" [Bayart 1986: 115-116].

Development management addresses accountability largely from a service delivery viewpoint, generally avoiding the broader question about accountability in basic decisions regarding budgetary allocations, taxation, or whether or not to have the service in the first place. Some development management literature highlights privatization as a method to force accountability through market discipline. Samuel Paul elegantly develops this theme through his argument that government accountability can be enhanced for some services through greater competition (the ability of the public to "exit" to a private sector source) and for others through participation (ability to exert pressure, or exercise "voice"). The choice depends on the nature of the service. [Paul 1990: 4].[8] White cautions that privatization may not enhance accountability or efficiency if the service is a monopoly, is not purchased, or if oversight and regulation are not in place [1989: 148].

The development management literature stresses the potential for concrete improvements through training, motivation, and proper technology. Public accountability, in this view, depends in part on "appropriate and effective accounting systems within or outside the government, on people who are trained and motivated to manage and operate these systems and on the availability of hardware and other ancillary systems, such as working telephone links, necessary for the collection and dissemination of data and the processing of information." [Corkery 1990: 10].

1. Institutional pluralism

Institutions can refer to rules, conventions and norms, or they can refer to organizations. Institutional pluralism generally refers to a diversity of autonomous organizations outside of the government. This diversity creates a "market" of institutions in addition to the state: NGOs, business associations, unions, youth and women's groups, and other intermediate organizations. Although these organizations may not have an explicitly political role, pluralism has long represented the idea of empowerment for diverse groups of people vis a vis the government. This leads many to regard official tolerance for institutional pluralism as a vital precondition for effective power sharing and representation and for the institutionalization of accountability: "Because it raises questions about the control of power and its purposes, accountability must also be concerned with political organisation. For if power is not to some extent shared there can be no effective base from which it may be controlled, nor any protected right to discuss its purposes." [Lonsdale 1986: 128].

A plurality of institutions outside of the government may offer significant opportunities for informal representation, enabling people to "reach up" to governments. Governments at a minimum must listen to their people. Chabal notes that "[t]o heed the view of war veteran's associations, the army, students, ethnic leaders, market women, trade unions, marabouts, peasants or capitalists is one of the

[8]Paul draws, of course, on Albert Hirschman's well known book Exit, Voice and Loyalty.

requirements of effective government. . .There is, however, no causal link between the mechanisms of formal representation and the effectiveness of government." [1986: 14]. Dunn echoes this in his comment that accountability and representation are only weakly connected: "the representation of legitimate social interests is neither a necessary nor a sufficient condition for the beneficient exercise of governmental power" [1986: 162].

In contrast to Dunn's position, Vanhanen's statistical analysis of the relationship between representative governments and economic performance posits representation as an evolutionary outcome of Darwinian natural selection for market-based economies:

> (T)he emergency of private property and enterprises would create new economic interest groups and provide economic basis for their political actions. They would certainly demand representation in political decisionmaking. As a consequence of new pressures it would become rational to extend political rights of individuals and groups and to extend competition in elections. [Vanhanen 1990: 172].

Vanhanen's statistical analysis suggests, however, that in the long term, effective political participation and "popular accountability" depend more on an equal distribution of economic power resources (wealth and assets), and education than on any other variables. [1990: 191, 195].

Institutional pluralism plays a role in addition to its ability to prepare for electoral representation. We are using a definition of governance that involves not the actions of governments alone, but also their interaction with their nongovernmental partners. De Toqueville recognized that a plurality of non-governmental institutions creates a vital arena, adding options for voice, aggregating citizen demands, helping to prevent the concentration of power, and keeping governments accountable [De Toqueville 1966]. In Ghana, for example, the Bar Association mobilized support against the Rawlings government's extra-judicial procedures, helping to stem the erosion of the country's legal institutions.

From the institutional economist perspective, North argues that scope exists to affect the evolution of institutions in a positive direction: "To the degree that there are large payoffs to influencing the rules and their enforcement, it will pay to create intermediary organizations (trade associations, lobbying groups, political action committees) between economic organizations and political bodies to realize the potential gains of political change." [North 1990: 84]. Yet the promotion of pluralism has its dangers. Rational choice economist Mancur Olson argued in The Decline of Nations that pressure by economic interest groups in industrialized nations led to policy decisions that lowered economic performance, and those who study the Asian NICs argue that the autonomy of the state from social groups enabled it to conduct economic policy free from redistributive pressures.

The cases of the authoritarian but developmental NICs raises important questions about the fundamental nature of accountability and its relationship to pluralist systems based on representation and pluralism: does accountability refer more importantly to a process, or to an outcome? Most political scientists educated in the Western European tradition link accountability directly to electoral

representation, even though the literature does not support clear causality.[9] If rulers are ultimately accountable to their people for the performance of the economy, as Mencius believed, then a measure of accountability exists even in non-pluralist authoritarian states, without representation, but with honest rulers, low corruption, and equitable income distribution.[10]

2. participation

Political scientists use participation as an umbrella concept embracing several processes and behaviors generally linked to the exercise of voice to affect government decisions. Participation can occur at a variety of levels, on the national or regional level, at the local level; it can link citizens to decision making at projects and in villages. Lindblom's hierarchy of political participation demonstrates the variety of acts included in the exercise of voice. Some are clearly electoral, but others are linked to a broader vision of participation as citizen action.

In Lindblom's hierarchy, electoral participation includes regular voting in national and local elections, actively working for a party or candidates during an election, attending political meetings or rallies, giving money to a party or candidate during an election, or membership in a political club or organization. Community participation involves activity in organizations involved in community problems, working with others to try and solve some community problems, contacting a government official (state or local) about some issue or problem; and forming a group or organization to attempt to solve some community problem. [Lindblom 1977: 140].

Whether electoral or not, participation creates channels by which people influence their leaders. Claude Aké criticizes the "delinking of leaders from their followers, which, among other things, has led to a dissociation of public policy from social needs and a lack of accountability and self-corrective mechanisms for public policy." [1990: 15]. Aké argues convincingly for a definition of participation that involves not simply reacting to policies and programs, but of shaping them: "One is not just exercising a right of assenting or dissenting from outputs or options that are already predetermined by processes over which one has no control whatsoever." [1990: 16].

Participation can also mean the withholding of assent, economic boycotts, or public gatherings to voice alternative views, or demands for accountability. The respected father of passive resistance, Mohandas K. Gandhi, underlined this mode of political participation in his statement: "It is an inalienable right of people to withhold cooperation. . .If Government should betray us in a great cause. . .we cannot do otherwise than non-cooperation." [Gandhi 1957: 482].

The absence of participation affects legitimacy and may ultimately call stability into question.

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[9]Dunn argues that "(v)irtually all serious modern political theory which is in any sense directed at issues of practical reason (which aspires to guide political conduct and not solely to explain past circumstance) is concerned with the relations between representation and good government" [p. 161].

[10]Chinese philosophers suggest that the question might matter only when the performance of the dictator fails to serve the people.

One cause of the simmering rebellion in Senegal's isolated southern Casamance region is local resistance to the promulgations of a highly centralized and unresponsive state which lacked effective local channels for popular influence into policy. Botswana provides a contrast, where locally elected councils have "substantial power. . .over community development and services," and "where opposition party control of some local councils has mitigated somewhat the effect of continuing one-party dominance at the center and so enhanced commitment to the system. [Diamond, Linz and Lipset 1989: 30].

In keeping with their concern for practical applications, some development management writers argue that improving the responsiveness of organizations to local communities enhances accountability: "accountability is not achieved by formal procedures but comes out of the interaction between managers and community members." [White 1989: 160]. This interaction must be based on formal instruments of power held by community groups: "to the extent that they contribute to salaries, or influence promotions, or determine work priorities, local communities or groups can compel field staffs to be more responsive to their concerns." [Uphoff and Esman 1984: 148].

White outlines other steps to enhance project and program accountability that substitute for hierarchical control:

> mobilizing local organizations to hold managers and staff accountable; setting up procedures so that proposals by beneficiaries are part of the ongoing information system in the agency; meeting in work groups where staff have access to external professionals; instituting process documentation so that all can learn from the actual steps taken; and relying on pilot projects and experiments to test out new ideas [White 1989: 179-180].

The development management literature documents the important role participation plays in increasing the effectiveness of project and program decisions, not simply through accountability, but in increasing the appropriateness of project investments.

Can the development of community-based popular organizations constrain abuses by government agencies? Theobald argues that not enough data exist to support or refute this view, but he warns that problems exist in "attempts to base structures of accountability on local communities: needs of communities as expressed through their organizations must be reconciled with national needs and in the event of conflict the latter will prevail." [1990: 155]. Korten suggests that authoritarian national governments in the Asian NICs were tempered by multiple local rural organizations, member-controlled and offering efficient channels for local-national communication. [1990: 75]. He goes on to argue that voluntary organizations can channel public concern into political pressure on nonaccountable governments when other channels are missing. Responsible government depends in part on accountability--on checks and balances, but also on the values of those who hold power and the consciousness of those who do not [1990: 168].

B. OPENNESS

The Soviet struggles to institutionalize *glasnost* focussed international attention on openness as a governance concept. While *perestroika* referred to economic restructuring and greater reliance on the market to allocate goods, *glasnost* came to mean a relaxing of controls on information flows, on

expression and association, and on political participation. Openness, thus, has several meanings, but they all refer to relaxation of government controls on the flows of commodities, ideas, information and participation.

(1) Economic openness

Economic openness refers to competitive economies with limited restrictions, a liberal trade regime, and a variety of cross border transactions. In an open economy, goods and resources are allocated primarily by market forces. Entry into the economy is not restricted by government fiat or by other artificial barriers. Unimpeded flows of financial and economic information are fundamental to the effective working of the market, and underpin economic openness.

(2) Political openness

Political openness refers to political competitiveness, contestability, tolerance for diversity, and policy making dependent "on votes and other expressions of preference." [Dahl, 1971, 3]. Included in political openness are contestable leadership and institutionalized procedures for political "exit" (generally through fair elections). Access to information and freedom of expression are fundamental to the responsible exercise of voice; a wide range of government information is accessible through published gazettes and other public records, and confidential classifications are strictly limited.

(3) Transparency

Transparency constitutes a third dimension of openness. Governments can promote transparency even when the system is not open in the economic or political sense, although experience suggests that the high degree of governmental discretion in command economies may impede transparency. Transparent systems have clear procedures for public decision making; they publish budget information, including military expenditures, and minimize "caisses noires" and other hidden budget categories. Subsidies are clearly stipulated; appointing, promoting and dismissing personnel done according to stated, objective criteria; and procurement procedures are regularized and publicized.

Distinguishing these separate aspects of openness is necessary in order to relate "openness" to economic performance in the fifth section of this paper. Many aspects of openness can be traced to capacity problems, rather than failures of governance: Funding for compiling economic statistics may be absent; auditors may not be available; those available may not be well trained. Mechanisms that impede information flows may not signal deliberate closure, yet these can affect performance. One kind of openness may be present and others missing: closed polities but extensive foreign investment and sophisticated market information systems characterize some of the Asian NICs. While committed to a degree of economic liberalization, many of these countries were not willing to allow wide public access to sensitive financial date. Nor were they willing to embrace greater tolerance for divergent political perspectives. In short, economic openness does not readily translate into political openness. Yet even the Asian NICs (Korea, Taiwan) provide some evidence that sustaining open economies in the long term appears to require political openness: guarantees of certain political freedoms such as speech, association and the media, as spelled out in the United Nations Universal Declaration of Human Rights:

> Article 19. Everyone has the right to freedom of opinion and expression; this right includes freedom to hold opinions without interference and to seek, receive and impart information and ideas through any media and regardless of frontiers.

Article 20. Everyone has the right to freedom of peaceful assembly and association. [United Nations 1983: 1-3].

Political openness includes the institutionalization of channels of communication between citizens and officials, as opposed to personalized channels, which empower special interests and provide opportunities for corruption. Openness in this sense correlates with expanded options for specialized interest groups, mass media, and other non-governmental institutions which provide checks on public officials and enhance accountability.[11]

In another dimension of openness, Albert Hirschman's discussion of exit, voice and loyalty notes that systems which punish wavering loyalty lower the quality of information that reaches the leadership, and close themselves to important feedback that would improve accountability. [Hirschman 1970]. Closure also multiplies opportunities for corruption.

(4) **Corruption and Openness**

Theobald's thoughtful review of corruption [1990] in less developed countries summarizes and distills arguments developed in a wide range of research on corruption. Defining corruption as "the *illegal* use of public office for private gain," [1990: 15], Theobald reminds us that, as in all processes, there are costs and benefits--even to corruption. Citing Leff's argument that in less developed countries, corruption lubricates markets, increases predictability through lowering risks, offers a form of insurance, and softens quota and license distortions by creating a market for their allocation, Theobald nevertheless concludes that the costs of corruption outweigh its presumed benefits. Most damagingly, it erodes legitimacy and confidence while affording unproductive consumption.[12] Theobald's discussion of anti-corruption mechanisms illustrates a range of assumed causes:

(1) purges and campaigns (with limited outcomes);

(2) legal administrative measures and specialized, independent bodies established to investigate corruption: Theobald notes that "such bodies depend upon administrative resources which. . .are in extremely short supply. . .adequate buildings, typewriters, filing cabinets, telephones, motor vehicles, secretaries, competent investigators who are highly motivated and skilled. . .they ultimately depend on the commitment and good intentions of those who hold political power." [p. 143];

(3) depoliticization of the government (often through military coups): some military governments have been less corrupt than the civilian governments they overthrew, but the reverse has also been true. One has only to remember Bokassa in CAE, Doe in Liberia, Macias in Equatorial Guinea, Acheampong in Ghana, and Mobutu in Zaire;

(4) moral rearmament or a moral revolution: often the case in Communist revolutions, and

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[11]The information revolution created a new dimension to cross border information flows, expanding the options for "openness" beyond the press and radios, to personal computers, fax machines tape recorders, and videos.

[12]For one of the latest contributions, see M. S. Alam, "Some Economic Costs of Corruption in LDCs", Journal of Development Studies, vol. 27, October 1990, pp. 89-97.

very difficult to sustain for more than a generation without strong coercion;

(5) civil accountability: the synergistic development of the private and non-governmental sectors, a free press, citizen groups, and the growth of social expectations that the government must be accountable to the people, redefined acceptable behavior by public officials and induced pressure to lower corruption in European governments

(6) privatisation: reduction of government controls and regulations, sales of public enterprises to the private sector have potential to reduce abuses, except, perhaps, in cases such as Malawi, where political elites are at the same time private sector elites. [Theobald 1990: 140-165, passim].

Lack of openness is clearly not the only factor involved in corruption. Weber noted that regular salaries are one distinguishing characteristic of rational bureaucracies, as they provide for more effective government control over officials. In Africa in particular, chronic fiscal crises, and problems with regular payment of salaries, remove officials from that government control while also providing strong incentives to supplement income from corruption. Civil service reform may assist the process of building rationalization in bureaucracies.[13]

Using the case of Nigeria, Diamond argues that bureaucratic employment became a major avenue of wealth through political corruption, distorting entrepreneurial incentives, and putting an "economic premium on political power." A vicious circle resulted, based on a scarcity of productive economic options and exacerbated by a restrictive state which controlled the economy. Echoing Hyden, Diamond stresses that only with the development of market-based production opportunities would entrepreneurs have alternative bases of wealth; only then, might the emergence of an entrepreneurial class force the attachment of "real risks and penalties. . .to the pursuit of wealth through political corruption" [Diamond 1989: 384, 403].

High rates of social change create a climate where corruption can thrive. During change, social mores are loosened and people become available for previously unaccepted behaviors. But change may also mean that previously "acceptable" behaviors become "unacceptable." Theobald's useful review traces the gradual discontinuation of behaviors now considered corrupt in Europe, but once considered quite normal. In part, this evolution came about through the development of alternative economic bases outside of both the aristocracy and the government, as well as through the development of a rational-legal bureaucracy based on predictability.

C. PREDICTABILITY

Predictability refers to the ordering of government behavior via the "acceptance of formally established rules." [Hyden 1983: 60]. It implies standard operating procedures, institutionalized rules, non-personalized decision making, with modest levels of discretion, and regularized procedures for establishing and implementing policies. In systems with high predictability, rules and regulations are clearly promulgated and applied indiscriminantly, lines of authority are clear, and capriciousness, at a minimum. The civil service is insulated from politics rather than penetrated by it; when political leadership changes, the civil service acts as a stabilizing source of continuity.

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[13]c.f. World Bank, Public Sector Management.

Political scientists discuss predictability in terms of regularized patterns of interaction, the successful institutionalization of rules, norms, and procedures, and the related concept, stability. Huntington set the terms for the modern discussion of post-Weberian rationalization in Political Order in Changing Societies, arguing that "the most important political distinction among countries concerns not their form of government but their degree of government." [1968: 12]. Huntington argued that social and economic change bred instability, creating a "political gap" through destroying traditional institutions without creating "new bases of political association and new political institutions combining legitimacy and effectiveness." [1968: 5]. He pointed out that

> political institutions have moral as well as structural dimensions. A society with weak political institutions lacks the ability to curb the excesses of personal and parochial desires. . .Morality requires trust; trust involves predictability; and predictability requires regularized and institutionalized patterns of behavior. Without strong political institutions, society lacks the means to define and to realize its common interests. [p. 24]

The problem for political scientists, as Thomas Callaghy so aptly put it, is that while we know that development requires "strong political institutions," and governmental transformation, it is "very difficult to accelerate the shift from personalized to bureaucratic administration." Callaghy laments that "no theory exists on how such shifts occur, much less about how to accelerate them" [1989: 132]. Douglass North would answer that they occur slowly, and accelerating them could have unintended consequences.

The work of North an other institutional economists can help other social scientists think carefully about the origins of the legal and political institutions that create predictability through defining clear property rights.[14] States interact with their societies over the definition (and redefinition) of property rights and the provision of public goods: infrastructure, standard weights and measures, which lower transaction costs [Eggertsson 1990: 247]. Economic development depends critically on these state actions, and states will define property rights in different ways depending on the "distribution of political power within a country and the institutional structure of its rule-making institutions" [1990: 248]. When property rights, and the gains from investment in productive property, are assured, then price incentives will have their expected supply response. Eggertsson adds: "Without the state, its institutions, and supportive framework of property rights, high transaction costs will paralyze complex production systems, and specific investments involving long-term exchange relationships will not be forthcoming." [1990: 317].

Institutional evolution in a nation involves the development of accountability and predictability. Both are rooted in property rights, including personal rights. North goes further, to argue that while effective economic organization depends on rules: "competition, decentralized decision making, and well-specified contracts of property rights as well as bankruptcy laws," effective political organization also

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[14]Eggertsson, in a recent review of institutional economics, isolates three questions guiding his own inquiry: (1) "How do alternative sets of social rules (property rights) and economic organizations affect behavior, allocation of resources, and equilibrium outcomes? (2) Why does the form of economic organization differ from one type of economic activity to another, even within the same legal framework? (3) What is the economic logic behind the fundamental social and political rules that govern production and exchange, and how do these rules change?" [1990, pp. 4-5].

needs "bankruptcy" rules to allow easy exit. [1990: 81].

Finally, institutional economics helps explain why different policies, such as those suggested in structural reform packages, lead to such different and seemingly unpredictable results: although outwardly, the new rules may seem the same in Taiwan and in Tanzania, local enforcement, behavioral norms, organizational forms and interests, and property rights--the institutions that underpin economic responses--all differ, and changes in institutions--particularly in informal institutions--occur very slowly.

Development management writers draw on the social sciences to offer guidance to practitioners. For example, a reading of Weber's ideas on the norms of professionalism that underlie predictability in the "rational-legal state", might enrich a discussion of public management training. Based on universalistic rules and a management hierarchy, rational-legal bureaucracies create order and predictability in society. Like the Confucian "rectification of names", positions have job descriptions, those who sit in the chair are answerable for their performance to their superiors. But unlike Confucious's ideal government, the legitimacy of the rational-legal state rests not on moral leadership, but rather on its adherence to routine, its impersonal nature, and its accountability. In short, it looks rather like the Legalists' "rule of law".

IV. THE RULE OF LAW AND GOVERNANCE

> Little else is required to carry a state to the highest degree of opulence from the lowest barbarianism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.
>
> Adam Smith, 1755[15]

> A market is not just an economic mechanism; it is a legal regime.
>
> Paltiel 1989: 266

Discussions of the rule of law and governance are among the oldest existing philosophical debates. Confucian thinking stressed moral institutions as the basis of government, but the rival Legalist school argued that governments should be based on a fixed code of law [Feng 1948: 31].[16] The Legalists viewed law as an impartial instrument, developed by leaders, and necessary not so much for controlling leaders as for controlling both the people and office holders.[17] This distinction between normative and positive views of law finds reflection in Western legal theory as well.[18] Several thousands of years later, Gandhi, a lawyer, captured the attention of the world with his philosophy of nonviolence and passive resistance. His central message was that the Indian masses needed to demonstrate to the world--and to themselves--the illegitimacy of foreign rule, a rule that was fundamentally not accountable to the people.

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[15]From a paper written by Adam Smith in 1755, quoted in Edward Canan, "Editor's Introduction" to Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations (London: Methuen, 1950), p. xxxv, and cited by Bates, 1989, p. 3.

[16]Confucius, forced into exile from his position in the Chinese bureaucracy by political intrigue in 495 B.C., was China's most famous political refugee. A well-order society, he argued, depended on the fulfillment of duties and responsibilities inherent in social roles: ruler, minister, father, and son, for example. If the ruler fulfills the "way of the ruler" he would have legitimacy; for society to prosper, all must fulfill their roles.

[17]For the Chinese Legalists, even service delivery accountability rests on this positivist vision of law: once an individual is given an office, "the functions pertaining to this office have already been defined by law. . .the ruler need not, and should not, bother about the methods used to carry out his work, so long as the work itself is done and well done. If it is well done, the ruler rewards him; if not, he punishes him. . .if the ruler is strict in his rewards and punishments, incompetent people will no longer dare to take office even if it is offered to them. Thus all incompetents are eliminated." [Feng, p. 161].

[18]See John Rawls, A Theory of Justice, for example, for a discussion of normative versus positive approaches to law.

The "rule of law" may be defined as "the subordination of the behavior of state officials to rational, predictable, and publicly recognized procedures." [Paltiel 1989: 266]. Governance is intimately related to the rule of law; the rule of law underpins accountability, predictability and openness. Most systems based on a rule of law have been also constitutional systems. Constitutions acted to reduce the unilateral authority of rulers through separation of powers, to create checks and balances, to spell out property rights protected from and by the state. Exceptions do exist; Lindblom points out that in Cuba, "Revolutionary Justice is based not on legal precepts but on moral conviction." [1977: 129].

The rule of law is an essential precondition for predictability. Impartial administration of justice, freedom of citizens from arbitrary personal interference, and effective procedures of due process are necessary for predictability. Law "provides continuity and essential predictability that are critical to reducing uncertainty among contracting parties." [North 1990: 95]. Some institutional economists argue that instititutionalizing the rule of law may necessitate certain kinds of government structures: "In modern nations, [credible commitments by the state to stable property rights] seem to require an effective separation of powers." [Eggertsson 1990: 348].

The next section discusses three aspects of the rule of law: the content of formal codes, regulations, and laws; the process of their formulation, promulgation and enforcement; and the separation of judicial functions from other government functions. The rule of law thus encompasses both content (the nature of the laws themselves) and process.

A. CONTENT

What obligations does the law require? What rights does it protect? The development of the content of law establishes the legal standards against which both public and private sector actions are measured. It regulates the market system through establishing "exclusive property rights", "the sanctity of contract" and "common standards" all of which underpin market exchanges [Cerny 1990: 206].

1. Property rights.

Property rights are rarely defined by economists yet their importance is never doubted. The definition problem is serious, however, as one's "property" includes one's labor. Property rights are fundamental in the rule of law underpinning market systems and command economies. The structure and enforcement of ownership rights determines economic incentives, and their stability and predictability. As economies develop, legal institutions and property rights evolve to support transactions that increase in complexity and impersonality. Mercantilist economies, with highly liquid investments, differ from industrial and post-industrial economies, which require secure property rights and "political and judicial organizations that effectively and impartially enforce contracts across space and time." [North 1990: 121].

China provides a particularly compelling example of the connection between an independent rule of law, a well functioning market system, and governance. In China, both the content of laws and their enforcement are weak. Before December 1978, "laws--administrative, criminal, civil, or commercial--were largely nonexistent." [Paltiel 1989: 260]. The post-Mao introduction of new laws failed to establish predictability in enforcement, nor to draw clear distinctions between ad hoc administrative decrees and formal legislation. Party control substituted for the rule of law: Hua Guofeng admitted in 1980 that "there are no systematic and practicable administrative rules which define limits

of power and responsibilities and lay down administrative procedure." [Hua, in Paltiel 1989: 261].

Paltiel argues that in China, where law and property rights are weak, Chinese entrepreneurs seek to enhance security and reduce their risks through finding governmental patrons to protect their business activities. This clientalism, he suggests, becomes "the functional substitute for property rights." [1989: 257]. Weak property rights exacerbate a situation of personalized bureaucratic relations: "the heavy hand of the Party's disciplinary methods undermines contract, law, and property, thereby reducing calculabilty and adding an element of political risk to every business transaction." [1989: 267]. Ultimately, the strengthening of clientalism "subverts the impersonal operation of predictable rational-legal norms within the state. Instead of the abstractions of hierarchy and market, human relations become the essential matrix of economic behavior." [1989: 272]. Entrepreneurs spend their energies seeking special exemptions and bargaining with bureaucrats, rather than upgrading productivity and efficiency.

2. Political/Human rights.

The rule of law is essential to protect the rights of citizens in their efforts to force accountability from governments. In Latin America, "crucial individual and collective rights were made effective before the convocation of competitive elections, the organization of effective interest representation, and the submission of executive authority to popular accountabilty." [O'Donnell and Schmitter 1986].

Yet the relation of political rights to governance is not necessarily direct. Dunn argues that "The presence or absence of effectively guaranteed civil and political liberties does not in itself ensure the prevalence of good or bad government. . .the most important contribution of government to popular welfare in time of peace is furnished by the conduct of economic policy. . ." [Dunn 1986: 169].

Historically, in the long term, political rights and personal or human rights appear to be necessary to underpin market systems. Free movement of goods, freedom to establish businesses, security from arbitrary expropriations--property rights--are all related to the protection of personal liberties. Property, as ti is the fruit of one's labor, is an aspect of human rights. Barzan, in fact, argues that "the distinction sometimes made between property rights and human rights is spurious. Human rights are simply part of people's property rights. Human rights may be difficult to protect or exchange, but so are rights to many other assets." [1989: 2].[19]

B. PROCESS

Process involves effective communication of the content of the laws. It involves predictable methods for changing the content of the laws, so that ad hoc decrees do not continually change the legal and regulatory environment, rendering both people and their property insecure. And it involves the effective enforcement of law via adequate budgets, salaries, staff, and workable institutions. Governments may enact and promulgate laws, which are never enforced. Larry Diamond provides the

[19]The rights of women to own property are restricted in some countries, particularly where women are considered to be their father's or husband's property. The implications of Barzan's argument is especially provocative in those instances.

example of the 1979 Nigerian constitution, replete with provisions for a code of conduct and specific enforcement mechanisms:

> The code required every public officer to declare all his assets at regular intervals to the Code of Conduct Bureau, which was empowered to monitor compliance and refer charges to the Code of Conduct Tribunal. The latter, a quasi-judicial body, had the authority to impose serious penalties on offenders, including vacation of office, seizure of assets, and disqualification from public office for ten years. But neither of these bodies ever worked as intended, because the National Assenbly, upon which the constitution made their activation and supervision dependent, buried the enabling legislation. Without this legislation, the bureau was unable to hire any permanent officers, or to investigate suspicions and complaints...Crucial regulatory functions, upon which the legitimacy of the Second Republic heavily depended, were left open to manipulation, sabotage, and abuse by the politicians. [1989: 384-385].

The Nigerian example suggests that the judiciary should have independent control over its budget. Others suggest that internal safeguards are insufficient to ensure the rule of law; systems need non-governmental watchdogs. Korten argues that "The judiciary is a passive instrument. It can act only on those cases that are brought before it--either criminal suits brought by government or civil suits brought by citizens. Public interest legal organizations from the voluntary sector are essential to the protective role of the judiciary." [Korten 1990: 187]. Others might answer that courts can play a more active role, through writ of certiorari, they can pull cases from elsewhere in the system up to review.

C. INDEPENDENCE OF THE JUDICIARY

Historically, many European political scientists and jurists have argued for the central importance of an independent judiciary in ensuring the rule of law. In some systems a separation of powers is related to judicial independence, but not in all. Wilsford argues that the

> French judicial system is characterized by executive control at all levels. . .the executive seeks to consolidate its influence on judicial decision making by promoting those that agree with it politically and moving those that disagree to less desirable posts. . .Lack of judicial independence was institutionalized in the 1958 constitution. Article 64 makes the president the sole guarantor of judicial independence. . .There is no independent, sovereign agency that protects [these rights] for the citizen <u>from</u> the State. [Wilsford 1989: 147, 144].

This discussion would be incomplete without a warning on the problem of unequally distributed property rights [Lindblom 1977; North 1990]. Governments play a significant role in determining both the structure of laws and their enforcement. Depending on the motivation of government actors, the institutional base of property rights may be politically derived and dependent on clientalist or patrimonial ties. Thus, the rule of law may operate smoothly and still suppress broad-based growth. As Perrow warns, in a related vein, "Beware of efficiency arguments that do not ask: efficiency for whom, and at what cost to others?" [Perrow 1986: 278].

V. DOES GOVERNANCE MATTER? GOVERNANCE AND ECONOMIC PERFORMANCE

> Development models are not simple packages of policies; they are configurations of political, institutional, and historical events.
>
> Haggard and Cheng, in Deyo, p. 128

Empirical work on the relationship between governance and economic performance reveals a mixed record. There appears to be, however, evidence that (1) the impact of government on economic performance is more substantial than some economic theory acknowledges, and (2) failure to meet minimal performance levels can cause both publics and investors to withdraw confidence.[20]

The possibility that political interventions are determinant in the "black box" within which economic policies are made now enjoys a growing concensus. Governance may be the independent variable determining "who gets what, when, and how." [Lasswell]. Sandbrook's prescription for effective governance in Africa highlights the responsibility borne by the state in creating the conditions under which markets and entrepreneurs can effectively function:

> First and most fundamental, the general socio-political and legal framework must be conducive to market relationships. An environment of security of property and predictability is basic to encourage investment; in turn, this requires political stability and a minimum degree of social harmony. Otherwise, capitalists cannot calculate that an investment today will bear fruit tomorrow. A legal code that protects the prerogatives of the owners and is officially respected (and hence calculable) is another element. . .Also vital is the protection of the institution of private property through such steps as: limiting the claims of employees, abolishing traditional land tenure, safeguarding the sanctity of contracts, and guaranteeing full compensation in the event of nationalization. [Sandbrook 1985: 33-34].

Yet empirical research relating specific aspects of governance to economic performance is quite scarce. Most of the political science literature reverses the dependent and independent variables, examining the impact of economic conditions on the development of democratic institutions. Those who do address the issue of government and economic performance tend to examine regime-types (authoritarian, patrimonial, democratic, etc.) rather than the narrower elements we are concerned with here (accountability, openness, predictability). Their conclusions support the practical view that in its earlier stages, economic growth is correlated with adherence to known policies: good fiscal management,

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[20]The Chinese political philosopher Mencius argued more than two thousand years ago that governments based on "wang" must take the lead in building the economic base for supporting their people. The ultimate symbol of the failure of governments to protect the people came from famine, and in the minds of the Chinese, famine signalled the withdrawl of the mandate from the ruler, and the end of a dynasty.

skillful use of government instruments to manage the market, competitive enterprise systems that reward performance, broad-based education, and support for the rule of law. These policies show up in both authoritarian and democratic regimes.

A. ACCOUNTABILITY AND GROWTH

Lonsdale summed up the uncertainty surrounding accountability when he noted wryly that "Accountability is thus the measure of responsibility. . .Whether it also guarantees social justice and economic development is an altogether thornier question" [Lonsdale 1986: 128]. And Dunn concluded that "The synthesis of political accountability with economic prosperity is a contingent and permanently reversible historical achievement. It is not an institutionally guaranteed causal property of any form of regime." [1986: 173].

The Asian NICs (Korea, Taiwan, Singapore) provide a useful foil for this discussion. Although for the most part nondemocratic, these governments draw much of their legitimacy from deeply held social norms, based on their responsibility for the performance of the national economy. The powerful capacity of these governments to select and implement their chosen policies, together with the integrity of the government bureaucracy explains much of their economic success, which in turn enhances legitimacy. They are accountable to their people for economic performance.

The skill of the NIC governments is so evident that some observers, comparing Africa to the NICs, argue that poor governance in Africa is partly a function of comparatively limited skills and capacities in economic management and policy design. Yet skill levels are also a function of political decisions. Governments decide where to allocate scarce resources: to education, or to parastatal subsidies, for example. They create the conditions under which skills can be effectively used. In addition, many of the developing world's most skilled citizens are in political exile. Faced with political repression, norms of corruption and rent-seeking, and patronage politics, many talented individuals wait outside their countries for improvements which will enable them to return and effectively serve the public interest.

1. Participation and institutional pluralism and growth.

Is participation related to economic performance? Stephan Haggard argues that low formal participation: limits on party representation, interest group formation, and labor organization allowed political space for these governments to move rapidly in devising, adjusting, and implementing growth-oriented policies without significant societal pressures. Each of the Asian NICs he examined was marked by

> political systems in which the economic policymaking process was relatively insulated from direct political pressures and compromises. In all cases, legislatures are historically weak or nonexistant and other channels of politically access and representation tightly controlled. [Haggard 1990: 262].

Others note, however, that grassroots participation may have blunted the lack of openness at the top. In Taiwan, for example, a network of local farmers organizations allowed people to influence many of the decisions affecting them [Korten 1990].

Other evidence suggests a correlation between participation and broad based growth. Morris and Adelman's extensive study of nineteenth century development examined 35 institutional and economic variables for 23 countries, comparing paths of development from 1850-1914. Their conclusion found "no universally recommended paths of economic growth," although empowerment and participation figured strongly in the second of their two generalizable findings: "Progressive agriculture is necessary (but not sufficient) to sustained industrialization; increased political power to nonelite groups is essential (but not sufficient) to government policies that spread growth widely." [1989: 1428].[21] On the other hand, L. G. Reynold's analysis of economic growth from 1850 to 1950 in forty Third World countries suggested that "the single most important explanatory variable is political organization and the administration of government." [Reynolds, cited in Adamolekun, 1990: 91].

Huntington and Nelson introduce some complications into these findings in their argument that effective land reform, one of the key components to later economic equality, is best introduced under "noncompetitive and nondemocratic governments," i.e. those with low participation:

> If participation has expanded to the point where medium sized landowners play an active role in politics, land reform becomes difficult or impossible. Parliaments are the enemy of land reform, and a modest body of political participants is likely to have the interest and the means to obstruct the approval and implementation of such reforms. What is needed for reform in these circumstances is the limitation of participation and the centralization of power in an autocratic ruler. [1976: 76].

2. Legitimacy and Growth.

Finally, legitimacy and growth are also related. Research by Diamond, Linz and Lipset remind us that "Regimes that begin with low legitimacy also find it difficult to perform effectively, and regimes that lack effectiveness, especially in economic growth, find it difficult to build legitimacy." [1989: 10]. Legitimacy, while not spelled out as a governance variable in the terms of reference for this review, clearly affects economic performance, if only through the greater cost and lower efficiency of government control through coercion and violence rather than through consent.

B. OPENNESS AND GROWTH

With the possible exception of Japan with its contestable political system and respect for civil liberties, the Asian NICs achieved their remarkable economic performance with carefully circumscribed economic openness, and very little political openness. The NICs are distinguished by strong commitment to education, an "emphasis on and nurturing of a rigorously educated elite." [Johnson: 152]. In addition, they created a politically instulated bureaucratic elite, with planning concentrated in semi-autonomous

[21]Interestingly, for Mencius, the economic basis of kingly (wang) government rested on equal land distribution [Fung, p. 75]. Unequal distribution led to unequal growth, which might eventually lead to peasant uprisings that could bring down a dynasty.

institutes and councils.[22] And in the early stages, they generally manifested neither political openness, nor conventional separation of powers. The KMT in Taiwan was run until recently on strict Leninist lines. As for Korea:

> Amid Kennedy administration pressure to go civilian and respect human rights, the ROK promulgated a new constitution in 1963. Harvard scholar Rupert Emerson journeyed to Seoul and advised Koreans, in classic American fashion, to disperse power through a strong legislature, a two-party system, and various checks and balances. Five years later Samuel Huntington published a book that cited the ROK for precisely the opposite: he applauded the regime for its accumulation of central power and its stability amid rapid economic and social change. Huntington's concern for order transcended liberal categories: the problem was not to hold elections but to create organizations. [Cumings in Deyo 1987: 72].

In other senses, such as transparency, openness is often relevant to growth, or at least its absence opens a system to abuse, without counterbalancing controls. As Haggard argues in the case of Marcos' Philippines:

> [The] high level of executive discretion combined to weaken auditing, oversight and planning. Institutional checks on spending were effectively removed. . .The government could destroy firms through prejudicial policies, discretionary 'taxation', extortion, and the redefinition of property rights. The result was increasing uncertainty, loss of confidence, a decline in productive investment, capital flight, and finally, open political opposition. [1990: 218].

Yet high levels of discretion are not always correlated with poor growth. Haggard and Cheng remind us that in Taiwan, the "Investment Commission retains wide discretion, negotiating all investments on a case-by-case basis" [Haggard and Cheng 1987: 116]. Perhaps the difference lies in the autonomy of the Investment Commission, and its position outside of the executive, while in the case of the Philippines, it is the executive itself that is autonomous.

(1) Corruption and Growth.

In less developed economies, Leff argued, corruption provides economic benefits; in effect, it increases predictability through lowering risks, offering a form of insurance, and softening the distortions of quotas and licenses by creating a de facto market for their allocation.[23] Most analysts

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[22]The Economic Planning Board, and the Korean Development Institute in Korea; the Council on International Economic Cooperation and Development, in Taiwan.

[23]In the lengthy period before both external and internal pressures push the development of rational bureaucracies Weberian ideal-type universalistic norms, Leff suggests that corruption can "lubricate administrative rigidities" cutting through restrictive business regulations and eliminating red tape. [in Theobald, p. 112] As Theobald concludes, corruption "assists capital formation; it fosters entrepreneurial abilities; allows business interests to penetrate the bureaucracy and, lastly, permits the logic of the market

agree however, that corruption is on the whole, a negative weight on development, wasting national resources, undermining stability and administrative capacity, and postponing the evolution of bureaucracies based on universalistic criteria. [Theobald 1990]. But perhaps the most serious consequence of corruption is that it erodes the confidence of citizens in government--it undermines legitimacy. As that happens, governments encounter even greater problems acquiring strength to enact policies and to implement them.

Corruption obviously affects the ability of the state to husband and allocate scarce resources, but there is some evidence to show that problems of corruption eventually recede as alternative avenues to wealth occupy the attention of entrepreneurs, and affective and kinship ties are replaced by more impersonal relationships. The Rhee regime in post-WW II South Korea was notable for its "visible corruption", for example [Haggard and Cheng 1987: 116].

C. PREDICTABILITY AND GROWTH

Economic policies always encounter uncertainties. These uncertainties are greatly worsened, however, when there is great capriciousness or instability surrounding either the way policies are made or by whom they are made. Predictability is essential for long-term capital investment. Market-based economies depend on legal regimes composed of property rights and the sanctity of contracts. A legal system and government administration in harmony with the market enhance predictability, calculability and efficiency [Lindblom 1977; Polyani 1944]. This relationship reduces transaction costs, and makes possible the interactive economic management needed for economic performance.

A major vehicle for this predictability is well-defined and protected property rights. Institutional economics argues that economies need incentives to operate close to the technical production frontier; incentives depend on the structure of property rights, which is determined primarily by the state. Secure property rights enhance stability and predictability:

> The structural frontier of an economy will depend on the following factors: (1) the degree to which decision makers bear the full social costs and benefits of their actions; (2) The degree to which present and future ownership rights are clearly defined and secure and the extent to which disputes over ownership and contractual performance can be settled in an orderly manner and at a low cost. Secure property rights encourage investors to increase the economy's stocks of productive capital; (3) The degree to which the structure of property rights contributes to the lowering of both the cost of measuring valuable margins of assets and commodities and the cost of transferring from one owner to another the ownership rights over resources; (4) The degree to which the state directly assigns ownership rights to assets to the uses of highest value in situations where high transaction costs prevent voluntary exchange. [Eggertsson 1990: 326-327].

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to insinuate itself into transactions from which public controls attempt to exclude it" [Theobald, p. 116].

Predictability counts. When property rights are incomplete, easily abrogated, or unstable, economies suffer. Acts of the predatory state alter investment in profoundly costly ways, affecting choice of technology and inputs, production processes, discount rates, and time profiles [Eggertsson 1990: 341]. The nature of investment, and sometimes its very presence or absence, depend on investors' reading of the likelihood of appropriation through decree or through suddenly adjusted "taxation":

> [S]ome political systems create incentives that place the structural production frontier close to the technical production frontier; other political systems do not. Usually, a political change is required to move the structural production frontier closer to the technical frontier, and therefore, a benefit-cost evaluation of economic reforms must include both the costs of political change and the costs of maintaining (enforcing) each system. [Eggertsson 1990: 319-320]

North and Thomas state their view quite simply: "Economic growth will occur if property rights make it worthwhile to undertake socially productive activity." [North and Thomas 1973: 173, 8]. The specification, protection and enforcement of property rights (including property rights over one's own person) is a task for governments. Although many believe that to link questions of torture, and other human rights abuses, to economic performance is to debase them (if no correlation can be found, then can we disregard egregious examples of their abuse because it does not affect GNP?), a basis exists for their inclusion in discussions of the rule of law and the development of stable property rights that will support long term growth with equity. Work to date on women in development--a human rights issue--supports this relationship. Distorted labor markets (in which distortions arise through discrimination) impact adversely upon growth.

Predictability is about stability, both stability of regulations and law, and political stability, although Mackie cautions that "It is not easy, however, to determine what combination of [political] factors is favorable to growth. One cannot even conclude that political stability alone is a sufficient condition, although something like it may be a necessary condition." [Mackie 1987: 283]. Finally, some specific examples exist in the literature of the economic cost of a highly discretionary bureaucracy. In the Philippines, for example, the corporate tax code was "riddled with special exemptions. The system thus depended heavily on regressive indirect taxes and trade taxes that reinforced the bias against exports" [Haggard 1990: 248].

In the final analysis, it should be clear that research attempting to correlate economic performance to governance variables must necessarily use a relatively short time frame. The recent economic performance of Chile, Taiwan and South Korea took place with very low levels of political openness, and their market economic systems seemed to work in the absence of pluralistic political systems. In the past few years, however, all three countries have made significant transitions toward more open, competitive and participatory political systems, suggesting that sustaining as opposed to establishing market based growth may require the development of political representation.

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TOWARDS IMPROVING GOVERNANCE

Bank experience in policy reform and adjustment has brought to the fore consequential questions about the quality "governance" in many borrowing countries.[1] The malfeasance of governments -- capriciousness which signals that neither the rule of law nor economic performance are worthwhile goals -- impoverishes citizens, undermines economic performance, and erodes prospects for future productivity. As a result governance itself has become an issue for development institutions.

The Bank has long addressed some aspects of governance through public sector reform, institutional development and capacity building work, and by encouraging greater local and NGO participation in development processes. The overriding criteria for Bank action has been that the problems addressed are both operationally important and tractable to some form of Bank intervention. Even when work in these areas deepened knowledgeability about governmental problems, there was a reluctance to be more candid about the adverse impact of poorly

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1. This draft issues paper --substantially changed from earlier drafts -- was in progress when word was received that the PC would prefer that there be one discussion paper and no issues paper. Nevertheless, with the thought that our discussions might be helped by more specific and operational focus, I am circulating this short paper. It grows out of the PC note (authored by Geoffrey Lamb), Sarwar's paper, and comments on Sarwar's paper received from Gobind Nankani and Mary Shirley (and some comments on one summary from Paul Isenman.) Obviously it is also influenced by Francisco Sagasti's paper, I. Shihata's paper, and the accountability paper by Sam Paul.

performing governments upon economic development. The Long Term Perspective Study on Africa, however, signalled the change. As the LTPS concluded:

"Underlying the litany of Africa's development problems is a crisis of governance... Because countervailing power has been lacking, state officials in many countries have served their own interests without fear of being called to account....The leadership assumes broad discretionary authority and loses its legitimacy. Information is controlled and voluntary associations are coopted or disbanded. This environment cannot readily support a dynamic economy. At worst, the state becomes coercive and arbitrary. These trends can, however, be resisted....Dedicated leadership can produce a different outcome. It requires a systematic effort to build a pluralistic institutional structure, a determination to respect the rule of law, and vigorous protection of the freedom of the press and human rights."

This message was reinforced in the forewords to the report by Mr. Conable:

"Private sector initiative and market mechanisms are important, but they must go hand in hand with good governance - a public service that is efficient, a judicial system that is reliable, and an administration that is accountable to its public."

For the international community interest in this issue has been spurred on by the historic changes underway in Eastern Europe. As these, in turn, follow on the democratization processes which have

occurred in Latin America, and in East Asia (Korea and the Philippines) it is increasingly apparent that the time is at hand to re-examine the role of the Bank in improving governance in borrowing countries.

The past decade has witnessed significant changes as well in the role of government - changes in expectations about that which it should do in relationship to, for example, the environment - and changes in the demands for that which they should not do in relationship to the private sector. It is not just that the role of government is being reduced; it is also simultaneously being changed. The precise manner of that shift in role and function varies not only by country, but by sector. Governments are assuming a different, less direct, and yet fundamentally important new role in relationship to markets, the private sector, and the factors of production in every productive sector. This new role will be as facilitator, enabler - providing the frameworks conducive to growth. While privatization, for example, of public enterprises will continue, there will be new roles to take in anti-trust regulation, consumer protection, and public finance and new policy instruments needed in fiscal, regulatory, and monetary policy.

Purpose and Scope

The purpose of this paper is to position the Bank for a more effective role in the 1990s in improving the performance of governance as it impacts upon economic development. This calls for exploring the possibility of extending the scope of the Bank's work in this area beyond its present primary focus on public sector reform, institutional development, and increasing beneficiary participation, while staying

well within the Bank's mandate.

Governance has three distinguishable parts:

1. nature and form of the political regime (democratic, dictatorial, single party, multi/party);
2. processes by which power and authority are exercised (in particular in regard directly or indirectly to economic decision making)
3. capacities to design, formulate, and implement policies and programs (including administrative capacities in the private as well as public sector).

The first part is not legally within the Bank's purview, proscribed as it is by the Articles of Agreement. Further, there is little empirical evidence that particular forms of government result in better economic development. The third part, as noted, has for some time been the subject of Bank attention. This paper addresses the second part -- and within that part, focuses directly on openness, accountability, and predictability. In each instance it looks at how that issue affects economic performance, what institutions are involved, and what could be done by the Bank.

This second part -- the processes by which power is exercised -- directly impacts a country's economic development. If power is used to serve the interests of a narrow elite, if public resources are misappropriated for private benefit, if the public's confidence in the legal system is eroded, if there is no confidence in the government's capacity to deal rationally with economic issues, the behavior of

economic actors is adversely affected. Or, if security expenditures are used to maintain internal control rather than any real external threat and "law" is the whim of personal power, investment opportunities suffer along with human rights.

The area to be explored, therefore, covers the interaction of political power and authority with the management of the economic development process and covers the main processes by which power and authority is exercised either directly in the economic sphere or with significant consequences for the development prospects of countries. For the purposes of this paper, it is proposed to focus specifically on three tractable parts of governance: increasing information and openness in the conduct of public business, strengthening institutional accountability and pluralism, and providing a predictable framework for economic activity.

Definitions

Webster's unabridged dictionary defines governance as the "exercise of authority, control, management, power of government." Governance can also mean "rule, sway, regime, direction, command."

Fowler's Dictionary of Modern English Usage (1965) says of the word: "governance has now the dignity of archaism, its work being done, except in rhetorical and solemn contexts, by government and control"

Certain words are described in Fowler's dictionary as archaism's and such reference, where nothing more is said, is intended to "give warning that the word is dangerous, except in the hands of an experienced writer who can trust his sense of congruity." The

appropriateness of this warning becomes clear when one sees how this word is being used both inside and outside the Bank.

In defining what falls within the Bank's mandate, we can draw on Mr. Shihata's paper "Issues of Governance in Borrowing Countries" (November 9, 1990) in which he provides judgement on what falls within, and without, the Bank's mandate as specified in the Articles of Agreement.

The three relevant provisions in the Articles of Agreement (Annex 1), Mr. Shihata points out, cover all decisions by the Bank, not just lending. He concludes that the following injunctions apply:

(i) "The Bank should not be influenced by the political character of the member." Its membership of a political block, political ideology, or the nature and form of its government should be "of no relevance to the Bank."

(ii) The Bank should not interfere in the domestic or foreign partisan politics of any member state.

(iii) The Bank should not allow political factors to influence its decisions. Two exceptions are noted here. First, when such political factors have a significant economic impact (as when the degree of political instability or extent of civil war directly affects "the development prospects of the country including its prospective creditworthiness.") Second, the Bank must give "due regard for decisions of the

Security Council under Articles 41 and 42 of the UN Charter" (which cover binding measures taken by the Council to maintain international peace and security).

In regard to the traditional Bank practice of ignoring a governments performance on human rights, Mr. Shihata adds that violations may reach such proportions as to become a Bank concern either due to their significant direct economic effects, or as violations of international obligations relevant to the Bank such as those mandated by binding UN Security Council regulations. One aspect of the joint PRE-Leg collaboration will address the question whether people who lack property have economic rights. International ligation on property rights (including intellectual property rights) has grown with the increase in international investment and trade. What legal rights have those who have no property? While there are various international covenants, they have but limited legal standing and hence the question needs careful research.[2]

ISSUES

Increasing Information and Openness

Traditionally the Bank has been concerned with the publication of accounts, auditing, and greater budgetary transparency. Following experience with structural adjustment the Bank has endeavored to

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2. See, for example, the "International Covenant on Economic, Social and Cultural Rights" in A Compilation of International Instruments, United Nations, (ST/HR/1/REV.3) 1988.

encourage governments to go public with the reform programs and to build ownership of reforms so that they might have greater sustainability. All of these steps are integral to generating greater openness in governance.[3]

The Bank's concern for open economies has its counterpart in open polities -- and for the same reasons. Just as closed economies harbor distortions, and provide opportunities for rent seeking, so do closed polities. Competitiveness in public discourse catches mistaken assumptions, clarifies choices, and may surface unintended consequences for economic policy choices. Further, an absence of discourse invites corruption as those who perceive their only source of influence is through bribery.

Increasing access to information is fundamental for competitiveness to occur, and efficiencies to become possible. Increasing access to information is closely related to accountability --to which we will turn next --and in this area the bank and others has been helped along by the advances made in telecommunications and the spread of the computer, fax machine, and electronic mail. Previously closed polities have not been able to close their borders to these technological changes. More people are in communication across national boundaries, learning about events and developments within their countries from external sources than ever before. Even national models forecasting economic events can be second guessed by highly skilled and

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[3]. For a detailed discussion of the related issues see Joan Nelson, Economic Crisis and Policy Choice (Princeton Univ Press, 1990) - a book that grew out of a larger long term study that included, inter alia, attention to the political economy of adjustment and its management.

able private citizens. Much of this change is already underway, yet it also provides opportunities for international institutions to further the advance of knowledge and support increased levels of technology transfer to increase openness in economic and financial information.

The Bank's more traditional concern with financial accounts, auditing, and procurement systems is another area warranting more attention. Sometimes, unfortunately, in these more traditional areas progress has been uneven; sometimes the pressure to lend overcomes the pressures to enforce audit requirements. In many countries, government accounts have not been audited in years. Sometimes the record for parastatals is worse, with successive bank loans to parastatals without requisite audits performed. Sometimes these problems occur because there are incapacities in the offices of auditor generals, and a reluctance to sub-contract work to private auditors. Private auditing firms are short of trained accountants. Training facilities at local universities are underfunded and poorly staffed; training curriculum is limited to less useful auditing of inputs rather than attention to outputs. The scope for Bank supported innovation, spread of best practice, and institutional development is significant.

Further, there is much that the Bank can do to help borrowers improve the quality of, and access to, financial and economic information in order to enhance the public policy debate. Economic and financial data series can be assembled systematically and regularly published. Processes for public procurement can be regularized and made publicly available. There remains a real need for capacity development within many borrowing countries for the collection and dissemination of

public documents, library systems, and data reference collections.

Institutional Accountability and Pluralism

Traditional polities in many different parts of the world and with widely different socio/legal traditions often have some form or another of holding accountable rulers and chiefs, though the precise form varied across epochs and cultures. Sometimes modern governments poorly recombine traditional values and hence may be even less formally accountable than their less modern predecessors. When scale and size increase, and modern governments delink too rapidly from deeply held local indigenous values, they are apt to be both less legitimate and less accountable.

Improving accountability at the national or local government level means, for the purposes of this paper, encouraging governments to be answerable to publics for the quality --or lack thereof -- of their economic performance.[4] Sometimes citizens and indigenous institutions lack the information to voice the questions that lead to accountability; other times they lack the opportunity, or forum; frequently they lack the security of knowing they will not be punished. Hence information, forum, and legal safeguards -- all three are important to securing accountability.

Most specifically accountability requires having in place

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[4]. Frequently in this paper local governments can be considered as part of the discussion, although in general they lag behind the national governments in resources, capacities, and power. Further, the issue of decentralization is closely related to the issues discussed. For an operationally useful guide to decentralization in economic policy reform and sector investment see Jerry Silverman, Public Sector Decentralization, Africa Region, Division Study paper No 1, Nov 1990 (red cover)

financial accounting and auditing, regular reporting on the performance of economic and social activities undertaken by government, including the performance of public enterprises, and ready citizen access to relevant information, (disclosure rules, publication). Further, the process for making decisions should be widely understood. These factors should become the ordinary entitlements of citizens.

Accountability takes, as Sam Paul has reminded us, many forms.[5] There is parliamentary accountability -- the classic form -- in which civil servants report to ministers who in turn report to parliament and are subject to legislative reviews. There are public account committees, or, in other instances, congressional oversight committees -- where their staffing influences their capacity as much as their legal mandate. (There is also professional accountability where professional norms influence behavior, most notably in medicine, law, engineering.) And there is legal accountability in the right of citizens to sue the state for redress under certain circumstances, and to sue corporations or private sector entities for malfunctioning goods and services. unfortunately this kind of accountability is not readily affordable by most, and hence is less useful for our purposes.

There is also accountability that comes through the force of public opinion, through the activities of pressure groups, media coverage, nongovernmental organizations, research institutions, and social communications. These institutions and the institutional pluralism that they bring about can bring public official to account for

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5. See Sam Paul, "Accountability in Public Services, Exit, Voice and Capture" (August, 1990, CECPS)

their choices. Here the relationship with the changed nature of international communication comes to the fore for satellite TV broadcasting is breaking the monopoly of state controlled media in many states. Yet even more locally, the electronic networks among NGOs is empowering those groups to ask questions and bring public scrutiny to bear in many new ways.[6]

The Bank has already made significant contributions to institutional pluralism in its work with NGOs, its more general work on institutional development, and its commitment to expand beneficiary participation. Greater strengthening of accountability may mean moving into previously unoccupied areas. Here the new programs of LAC in strengthening new democracies in Chile and Argentina by strengthening the parliamentary oversight functions in economic policy making are especially noteworthy.

Providing A Predictable Environment for Economic Activity

Historically governments have had authority to establish legal systems and ensure their implementation. Unfortunately, however, too few developing country governments have made substantial progress in this area. Too often judicial systems may even be used for harassment, rather than the encouragement of production. Capricious policy changes are then underscored with arbitrariness in the administration of justice as that system is politicized. That combination creates powerful

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6. See Sheldon Annis article on Mexico City in Lewis et al, Strengthening the Poor:What Have We Learned? (ODC, 1988)

disincentives for commercial, financial, and economic activities.

This situation has led to the need for more explicit Bank support for the development of secure and enforceable legal frameworks and judicial systems. At minimum there should be more provision for enforceable contracts and protection of property rights. Such a predictable environment is conducive, if not central, to the expansion of entrepreneurial behavior, investment, or other productive enterprises.

Creating a predictable environment is a challenging collection of tasks rooted in the causes of instability. Yet some parts of the task can be done, as countries as widely different as Botswana, Malaysia, and Cost Rica illustrate. Each of these countries have developed an impartial administration of justice characterized by effective legal and court systems and found them instability-inducing, providing the climate needed not only for reduced social tensions, but enhanced opportunities for private sector development.

As the Bank has programs with universities, or more generally is active in capacity building, much more can be done to expand possibilities for predictability. Certain kinds of degree programs -- MBAs, MPAs -- and some kinds of graduate education -- law and journalism --might be encouraged. Independent research institutions and professional associations could be encouraged --e.g. regional associations of economists. In policy dialogue with country leaders, opportunities should be developed to point to the role that independent research, consulting, and policy analysis institutions can assume.

LAMB

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 14, 1990

TO: Task Force on Governance

FROM: Geoffrey Lamb, PRDPD

EXTENSION: 3-2544

SUBJECT: President Council's Note on Governance

Here is the note on our work circulated to the PC for their discussion next Monday. We will be able to discuss the PC reactions next Tuesday morning. (Dec. 18, 9:30 a.m., Rm. S13-005)

Attachments

CBryant:ltv

NOTE ON WORK IN PROGRESS ON GOVERNANCE

Purpose

1. This note summarizes PRE-led work in progress on governance, and is intended to inform PC members of issues being addressed and proposed outputs. The paper from LEG delimits broad areas for Bank action on governance. Within this framework, the cross-complex work program described in this note will define major operational issues of governance and explore possible Bank responses. An issues paper is being produced for early senior management consideration, followed by a fuller paper for PC and Board review within this fiscal year. A schedule is set out at the end of this note.

Key Areas of Work

2. The Bank is increasingly encountering "governance" problems in its everyday operations -- most obviously in Africa, where the Region has pioneered work on governance, but in fact across all regions. The Bank has tried for a long time to address some aspects of governance through public sector reform and institutional development efforts, and by encouraging greater local and NGO participation in development processes. But there are some important areas, discussed in the LEG paper, where we have not so far done very much. This gray area involves the economic impact of the exercise of governmental power and authority. How should we come to grips with this operationally, beyond what we are already doing in public sector management and economic policy reform?

3. In determining the potential role of the Bank in each of these areas, the overriding criteria should be that Bank action should not involve overt political choices (e.g. in favor of multi-party democracy, etc.), and that the problems addressed --e.g. state enterprise accountability, participation in poverty programs, reduction of government corruption -- should be both operationally important and tractable to some form of Bank intervention. The emphasis will be on identification of good practice appropriate to specific situations, rather than on breaking new ground. Three lines of work are being explored:

- Increasing information and openness in the conduct of public business. Traditional Bank concerns include publication of accounts, auditing, and greater budgetary transparency. More broadly, the Bank has been trying to encourage governments to "go public" with their reform programs -- and associated undertakings to the international community -- to build ownership of reforms and increase their staying power. Even in established activities such as the scrutiny of public expenditure, more systematic concern for openness may ultimately involve the Bank more directly in hitherto closed issues, for example military expenditure.

- Strengthening institutional accountability and pluralism. What role should the Bank play in dealing with accountability more broadly than the traditional concern with public accounting and auditing, hard budget constraints for state enterprises, etc? Striking the right balance between accountability and autonomy of state

enterprises is an example on the borderline between such public sector management concerns and governance. At a broader level LAC, for example, is helping parliaments in Argentina and Chile to strengthen oversight of economic policy and management. Better accountability is also a critical way to get at the problem of corruption -- which for many people is the crux of bad governance. Rooting out corruption additionally requires reducing pervasive and arbitrary controls which enhance government power, provide opportunities for rent-seeking, and inhibit the development of plural and independent social and economic institutions.

- Providing a predictable framework for economic activity, as the LEG paper indicates, is a key requirement of good governance. There could be more explicit Bank support for development of secure and openly enforceable legal frameworks and administration of justice (especially relating to property rights and contracts). Within that overall system of law and due process, it is also important to improve the quality and predictability of government behavior -- to reduce capricious policy changes, and to eliminate arbitrariness and harassment in government conduct, particularly towards the private sector.

4. Another major area is participation. Here the Bank has done a lot in recent years, especially with respect to community and NGO participation in projects. But there are wider issues. One is inclusion of potentially excluded communities and groups (women, poor people, etc.) in decision-making. Another is strengthening participation, capacity and accountability at lower levels of government (e.g. working with local NGOs and improving local government), especially given the key role they play in poverty programs, safety nets and the management of infrastructure investments. This is an area the Bank is only beginning to deal with on any scale -- the new urban policy paper, for example, moves strongly in this direction.

Organization of the Work Program

5. PRE has primary responsibility for producing the proposed Board discussion paper. The paper will be prepared in close collaboration with Operations and Legal, which are represented on the task force responsible for organizing the work and consulting Bankwide. The task force will be guided by a steering group of Directors.

Schedule

Note on work in progress	to PC	December 17
Issues paper	to PC	February 26
Discussion paper	to PC	April 15
Board seminar		to be decided

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