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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.

BARB:R 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:

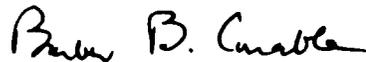
- Problems of governance are universal and are not particular to one Region, or only to the developing world. Each country is different, and a thorough understanding of the historical, social and cultural traditions of each country should underpin the Bank's response to such problems.

- 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

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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.

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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

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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.

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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;

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- 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 accommodate 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 affects 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

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

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.

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

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

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.

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.

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,

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).

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,

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

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.

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

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

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.

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

abeyance or is not respected, the answer does not necessarily need to be a new law. An

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.

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

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

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.

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 uncontested 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

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.

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....

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:

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

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.

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

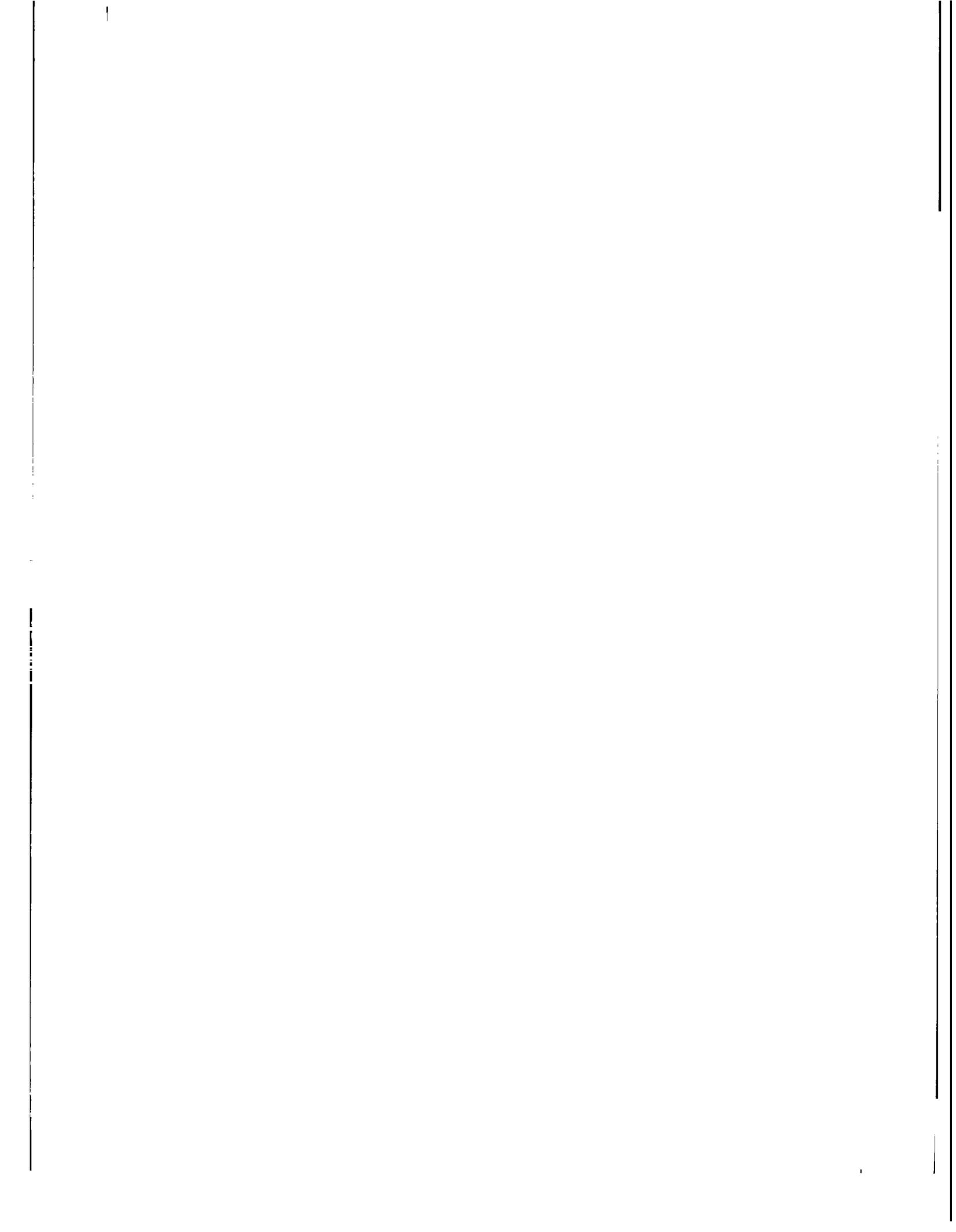
Secretarial support to the Task Force was provided by Lynette Alemar (PRDPD), Sonia Benavides (EXTIE), Maria Estrella (EXTIE), Marjorie Pavia (EXTIE) and Amelito Velasco (PRDPD).

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Vidaeus, Lars O.
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