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WORLD DEVELOPMENT REPORT 1997

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WORLD DEVELOPMENT REPORT 1997

SUMMARY

THE STATE IN A CHANGING WORLD

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AROUND THE GLOBE, THE STATE IS IN THE SPOTLIGHT. Far-reaching developments in the global economy have us revisiting basic questions about government: what its role should be, what it can and cannot do, and how best to do it.

The last fifty years have shown clearly both the benefits and the limitations of state action, especially in the promotion of development. Governments have helped to deliver substantial improvements in education and health and reductions in social inequality. But government actions have also led to some very poor outcomes. And even where governments have done a good job in the past, many worry that they will not be able to adapt to the demands of a globalizing world economy.

The new worries and questions about the state's role are many and various, but four recent developments have given them particular impetus:

- The collapse of command-and-control economies in the former Soviet Union and Central and Eastern Europe
- The fiscal crisis of the welfare state in most of the established industrial countries
- The important role of the state in the "miracle" economies of East Asia
- The collapse of states and the explosion in humanitarian emergencies in several parts of the world.

This Report shows that the determining factor behind these contrasting developments is the effectiveness of the state. An effective state is vital for the provision of the goods and services—and the rules and institutions—that allow markets to flourish and people to lead healthier, happier lives. Without it, sustainable development, both economic and social, is impossible. As we said much the same thing fifty years ago, but then it tended to mean that development had to be state provided. The message

of experience since then is rather different: that the state is central to economic and social development, not as a direct provider of growth but as a partner, catalyst, and facilitator.

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

Rethinking the state—the world over

The world is changing, and with it our ideas about the state's role in economic and social development. Today's intense focus on the state's role is reminiscent of an earlier era, when the world was emerging from the ravages of World War II, and much of the developing world was just gaining its independence. Then development seemed a more easily surmountable—and largely technical—challenge. Good advisers and technical experts would formulate good policies, which good governments would then implement for the good of society. State-led intervention emphasized market failures and accorded the state a central role in correcting them. But the institutional assumptions implicit in this world view were, as we all realize today, too simplistic. Flexibility to implement the policies devised by technocrats was accorded pride of place. Accountability through checks and balances was regarded as an encumbrance.

In a few countries things have indeed worked out more or less as the technocrats expected. But in many countries outcomes were very different. Governments embarked on fanciful schemes. Private investors, lacking confidence in

public policies or in the steadfastness of leaders, held back. Powerful rulers acted arbitrarily. Corruption became endemic. Development faltered, and poverty endured.

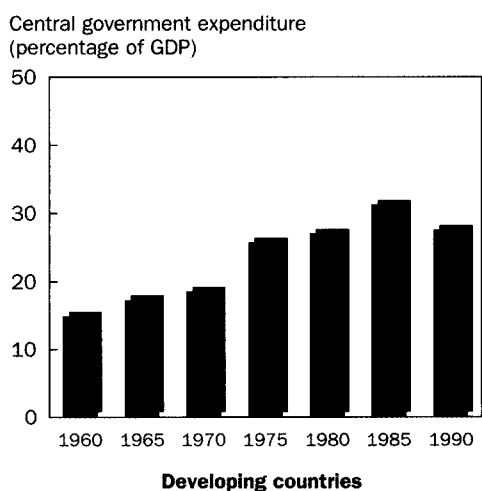
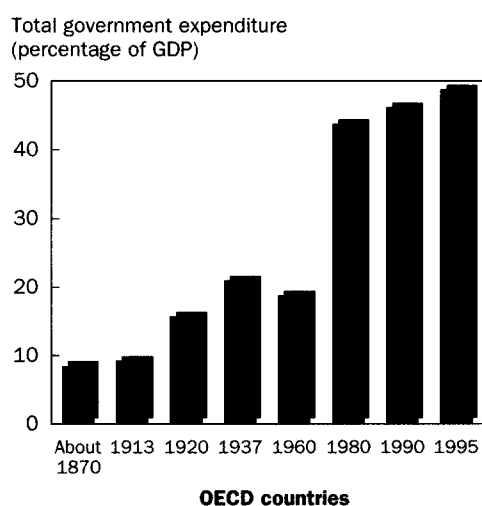
Over the last century the size and scope of government have expanded enormously, particularly in the industrial countries (Figure 1). The pre-World War II expansion was driven by, among other factors, the need to address the heavy toll on economic and social systems brought on by the Great Depression. The postwar confidence in government bred demands for it to do more. Industrial economies expanded the welfare state, and much of the de-

veloping world embraced state-dominated development strategies. The result was a tremendous expansion in the size and reach of government worldwide. State spending now constitutes almost half of total income in the established industrial countries, and around a quarter in developing countries. But this very increase in the state's influence has also shifted the emphasis from the quantitative to the qualitative, from the sheer size of the state and the scope of its interventions to its effectiveness in meeting people's needs.

As in the 1940s, today's renewed focus on the state's role has been inspired by dramatic events in the global economy, which have fundamentally changed the environment in which states operate. The global integration of economies and the spread of democracy have narrowed the scope for arbitrary and capricious behavior. Taxes, investment rules, and economic policies must be ever more responsive to the parameters of a globalized world economy. Technological change has opened new opportunities for unbundling services and allowing a larger role for markets. These changes have meant new and different roles for government—no longer as sole provider but as facilitator and regulator. States have come under pressure even where governments have previously seemed to perform well. Many industrial countries find themselves grappling with a welfare state that has grown unwieldy, and having to make difficult choices about the services and benefits that people should expect government to provide. Markets—domestic and global—and citizens vexed by state weaknesses have come to insist, often through grassroots and other non-governmental organizations, on transparency in the conduct of government, and on other changes to strengthen the ability of the state to meet its assigned objectives.

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

Figure 1 The state has grown everywhere



Note: Data for the OECD countries are for central and local government, including social security expenditures. See the Technical Note for details. Source: Tanzi and Schuknecht 1995; OECD, various years; IMF, various years (b).

A two-part strategy

How can we cut through the maze of questions and pressures now facing the world's states? No one-size-fits-all

recipe for an effective state is suggested here. The range of differences among states is too enormous, as are their starting points. Rather this Report provides a broad framework for addressing the issue of the state's effectiveness worldwide. It points to a number of ways to narrow the growing gap between the demands on states and their capability to meet those demands. Getting societies to accept a redefinition of the state's responsibilities will be one part of the solution. This will include strategic selection of the collective actions that states will try to promote, coupled with greater efforts to take the burden off the state, by involving citizens and communities in the delivery of core collective goods.

But reducing or diluting the state's role cannot be the end of the reform story. Even with more selectivity and greater reliance on the citizenry and on private firms, meeting a broad range of collective needs more effectively will still mean making the state's central institutions work better. For human welfare to be advanced, the state's capability—*defined as the ability to undertake and promote collective actions efficiently*—must be increased.

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

- *Matching the state's role to its capability* is the first element in this strategy. Where state capability is weak, how the state intervenes—and where—should be carefully assessed. Many states try to do too much with few resources and little capability, and often do more harm than good. A sharper focus on the fundamentals would improve effectiveness (Box 1). But here it is a matter not just of choosing what to do and what not to do—but of how to do it as well.
- But capability is not destiny. Therefore the second element of the strategy is to *raise state capability by reinvigorating public institutions*. This means designing effective rules and restraints, to check arbitrary state actions and combat entrenched corruption. It means subjecting state institutions to greater competition, to increase their efficiency. It means increasing the performance of state institutions, improving pay and incentives. And it means making the state more responsive to people's needs, bringing government closer to the people through broader participation and decentralization. Thus, the Report not only directs attention to refocusing the state's role, but also shows how countries might begin a process of rebuilding the state's capability.

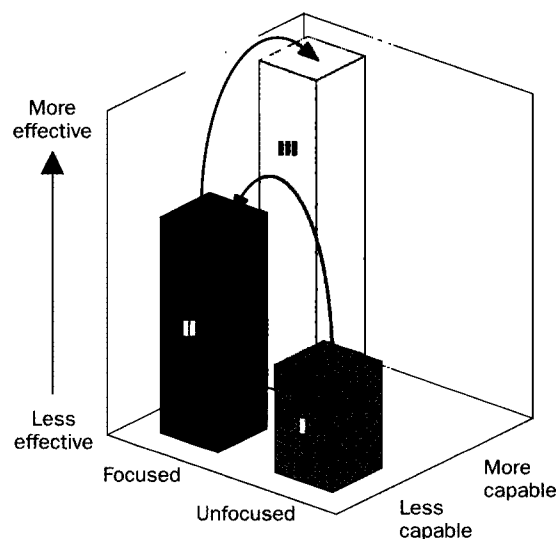
Matching role to capability

Matching role to capability is not a simple message of dismantling the state. In some areas much greater focus is badly needed to improve effectiveness: choosing what to

Box 1 The pathway to a more effective state

A more capable state can be a more effective state, but effectiveness and capability are not the same thing. *Capability*, as applied to states, is the ability to undertake and promote collective actions efficiently—such as law and order, public health, and basic infrastructure; *effectiveness* is a result of using that capability to meet society's demand for those goods. A state may be capable but not very effective if its capability is not used in society's interest.

The path to a more effective state, although not linear, is likely to be a two-stage process. First, the state must focus what capability it has on those tasks that it can and should undertake. As it does this, it can then focus on building additional capability. As the figure illustrates, countries in Zone I pursue a broad range of activities in an unfocused manner despite little state capability, and their efforts prove ineffective. But countries cannot move to Zone III overnight—building capability takes time. The pathway to greater effectiveness leads, first, to focusing on fundamental tasks and leveraging the state's limited capability through partnerships with the business community and civil society (Zone II). Countries then can move gradually to Zone III by strengthening their capability over time.



do and what not to do is critical. But this also involves choosing how to do things—how to deliver basic services, provide infrastructure, regulate the economy—and not just whether to do them at all. The choices here are

many and must be tailored to the circumstances of each country.

The first job of states: Getting the fundamentals right

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

- Establishing a foundation of law
- Maintaining a nondistortionary policy environment, including macroeconomic stability
- Investing in basic social services and infrastructure
- Protecting the vulnerable
- Protecting the environment.

Although the importance of these fundamentals has long been widely accepted, some new insights are emerging as to the appropriate mix of market and government activities in achieving them. Most important, we now see that markets and governments are complementary: the state is essential for putting in place the appropriate institutional foundations for markets. And government's credibility—the predictability of its rules and policies and the consistency with which they are applied—can be as important for attracting private investment as the content of those rules and policies.

A survey, specially commissioned for this Report, of domestic entrepreneurs (formal and informal) in sixty-nine countries confirms what was already known anecdotally: that many countries lack the basic institutional foundations for market development (Box 2). High levels of crime and personal violence and an unpredictable judiciary combine to produce what this Report defines as the “lawlessness syndrome.” Weak and arbitrary state institutions often compound the problem with unpredictable, inconsistent behavior. Far from assisting the growth of markets, such actions squander the state's credibility and hurt market development.

To make development stable and sustainable, the state has to keep its eye on the social fundamentals. Lawlessness is often related to a sense of marginalization: indeed, breaking the law can seem the only way for the marginalized to get their voices heard. Public policies can ensure that growth is shared and that it contributes to reducing poverty and inequality, but only if governments put the social fundamentals high on their list of priorities.

Too often, policies and programs divert resources and services from the people who need them most. The political clout of the more affluent in society sometimes leads governments to spend many times more on rich and middle-class students in universities than on basic education for the majority and scholarships for the less well off. In many regions poverty and inequality are often biased against ethnic minorities or women, or disfavored geo-

graphic areas. Marginalized from public discussion and excluded from the broader economy and society, such groups are fertile ground for violence and instability, as many parts of the world are increasingly learning.

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

Government regulation is not the only answer to pollution. An expanding toolkit of innovative and flexible incentives is now available to get polluters to clean up their act. Although there is no substitute for meaningful regulatory frameworks and information about the environment, these new tools, which rely on persuasion, social pressure, and market forces to help push for improved environmental performance, can often succeed where regulation cannot. Countries are using some of these tools, with promising results, in four areas:

- Harnessing the power of public opinion
- Making regulation more flexible
- Applying self-regulatory mechanisms
- Choosing effective market-based instruments.

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

There is a growing recognition that in many countries monopoly public providers of infrastructure, social services, and other goods and services are unlikely to do a good job. At the same time, technological and organizational innovations have created new opportunities for competitive, private providers in activities hitherto confined to the public sector. To take advantage of these new opportunities—and better allocate scarce public capability—governments are beginning to separate the financing of infrastructure and services from its delivery, and to unbundle the competitive segments of utility markets from the monopoly segments. Reformers are also moving to separate programs of social insurance, designed to address the problems of health and employment insecurity for all, from programs of social assistance, intended to help only the poorest in society.

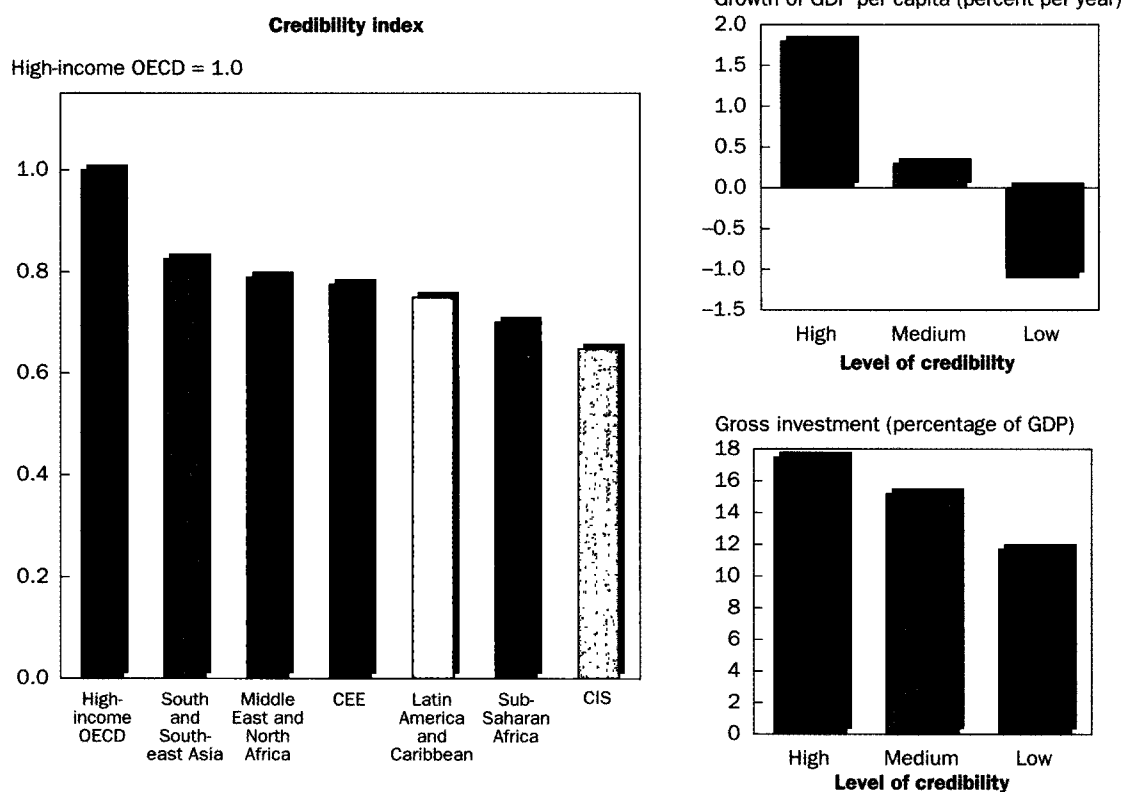
COPING WITH HOUSEHOLD INSECURITY. It is now well established that the state can help households cope with certain risks to their economic security: it can insure against destitution in old age through pensions, against devastating illness through health insurance, and against job loss through unemployment insurance. But the idea that the state alone must carry this burden is changing. Even in

Box 2 Credibility, investment, and growth

A survey of local entrepreneurs in sixty-nine countries shows that many states are performing their core functions poorly: they are failing to ensure law and order, protect property, and apply rules and policies predictably. Investors do not consider such states credible, and growth and investment suffer as a consequence.

Firms were asked to rank each of several indicators on a scale from one (extreme problem) to six (no problem). Averaging the answers, as the left panel does for each world region, yields an overall indicator of the

reliability of the institutional framework (normalized here to the high-income OECD countries) as perceived by private entrepreneurs—we call it credibility. The other two panels show that, once differences in income and education and policy distortions have been controlled for, there is a strong correlation between countries' credibility rating and their record of growth and investment. The credibility ratings are based on investors' perceptions. But it is these perceptions that determine investment behavior.



Note: The credibility index (left panel) is a summary indicator that combines the measures in Figure 2.3. Each bar in the two right panels is the average for a group of countries. The graphs are based on regressions for the period 1984–93 of GDP growth (thirty-two countries) and investment (thirty-three countries) on the index, controlling for income, education, and policy distortion. South and Southeast Asia and Middle East and North Africa are each represented by only three economies. Source: World Bank staff calculations using data from the private sector survey conducted for this Report and Brunetti, Kisunko, and Weder, background papers.

many industrial countries the welfare state is being reformed. Emerging economies from Brazil to China will be unable to afford even pared-down versions of the European system, especially with their rapidly aging populations.

Innovative solutions that involve businesses, labor, households, and community groups are needed to achieve greater security at lower cost. This is especially important for those developing countries not yet locked into costly solutions.

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

INDUSTRIAL POLICY. When markets are underdeveloped, the state can sometimes reduce coordination problems and gaps in information and encourage market development. Many of today's oldest industrial economies used various mechanisms to spur the growth of markets in their early stages of development. More recently, Japan, the Republic of Korea, and other countries in East Asia used a variety of mechanisms for market enhancement, in addition to securing the economic, social, and institutional fundamentals. Sometimes these interventions were quite elaborate: the highly strategic use of subsidies, for example. Other times they were less intrusive, taking the form of export promotion and special infrastructure incentives. But the ability to choose wisely among these interventions and use them effectively is critical; ill-considered trade, credit, and industrial policies can and have cost countries dearly. Many developing countries pursued ill-thought-out activist industrial policies, with poor results. Countries that have pursued an activist industrial policy successfully could not have done so without strong institutional capability.

MANAGING PRIVATIZATION. Carefully designed regulations and other active government initiatives can enhance the growth of markets. But in many countries this can take time, as private initiative is held hostage to a legacy of antagonistic state-market relations. And poorly performing state enterprises are often a big drain on the state's finances. Privatization provides an obvious solution. In general it is easier to sell off state assets once a supportive environment for private sector development is in place. Economies such as China, Korea, and Taiwan (China) have therefore opted not to give top priority to privatization, but to allow the private sector to develop around the state sector. This option, however, may not be available where the fiscal burden is very high, and where the presence of poorly performing state enterprises impedes much-needed overall restructuring of the economy.

Experience has shown that the way privatization is managed is terribly important to the end result. The key factors are transparency of process, winning the acquiescence of employees, generating broad-based ownership, and instituting the appropriate regulatory reform. Where privatization has been managed carefully, it is already showing positive results: in Chile, for example, and the Czech Republic. Its importance in the strategy to foster markets may vary, but for many developing countries seeking to scale back an overextended state, privatization must be kept on the front burner. A carefully managed privatization process brings very positive economic and fiscal benefits.

Knowing the state's limits

The key to predictable and consistent implementation of policy is a good fit between the state's institutional capabilities and its actions. In well-developed states, administrative capability is normally strong, and institutionalized checks and balances restrain arbitrary action, even as they provide government organizations the flexibility to pursue their mandates. By contrast, states with weaker institutions may need to err on the side of less flexibility and more restraint. This can be done in two ways:

- Through self-restricting rules, which precisely specify the content of policy and lock it into mechanisms that are costly to reverse. Regional common-currency arrangements, such as the CFA currency zone in francophone Africa or quasi currency boards as in Argentina, are examples of such mechanisms in the field of monetary policy. "Take-or-pay" contracts with independent power producers serve a similar function in utilities regulation.
- Through working in partnership with firms and citizens. In industrial policy, for example, states can foster private-to-private collaboration. In financial regulation they can give bankers an incentive to operate prudently. And in environmental regulation they can use the spread of information to encourage "bottom-up" citizen initiatives.

Countries in transition face a special challenge: not only are roles changing as a result of the adoption of market-based systems; so are capabilities. Some transition countries retain inherent capabilities in the form of qualified people and usable equipment, but they are not organized to perform in their new roles. Sometimes islands of excellence are found in countries where overall effectiveness has suffered. The task of improving effectiveness here is in some ways easier and in some ways more difficult: easier because capability does not start from a low base, more difficult because rebuilding capability means chang-

ing attitudes. Reform is not a matter of simply assigning people new responsibilities.

Reinvigorating state institutions

Acknowledging the state's existing, possibly meager capabilities does not mean accepting them for all time. The second key task of state reform is to reinvigorate the state's institutional capability, *by providing incentives for public officials to perform better while keeping arbitrary action in check.*

Countries struggle to build the institutions for an effective public sector. One reason the task is so difficult is political. Strong interests may develop, for example, to maintain an inequitable and inefficient status quo, whereas those who lose out from this arrangement may be unable to exert effective pressure for change.

But the problem of continued ineffectiveness, or of corruption, is not entirely political. Often politicians and other public officials have strong incentives and a sincere interest in improving public sector performance. But managing a public bureaucracy is a complex business that does not lend itself to clear, unambiguous solutions. In fact, building institutions for an effective public sector requires addressing a host of underlying behavioral factors

that distort incentives and ultimately lead to poor outcomes. Three basic incentive mechanisms can be used, in a variety of settings, to combat these deeper problems and improve capability (Figure 2):

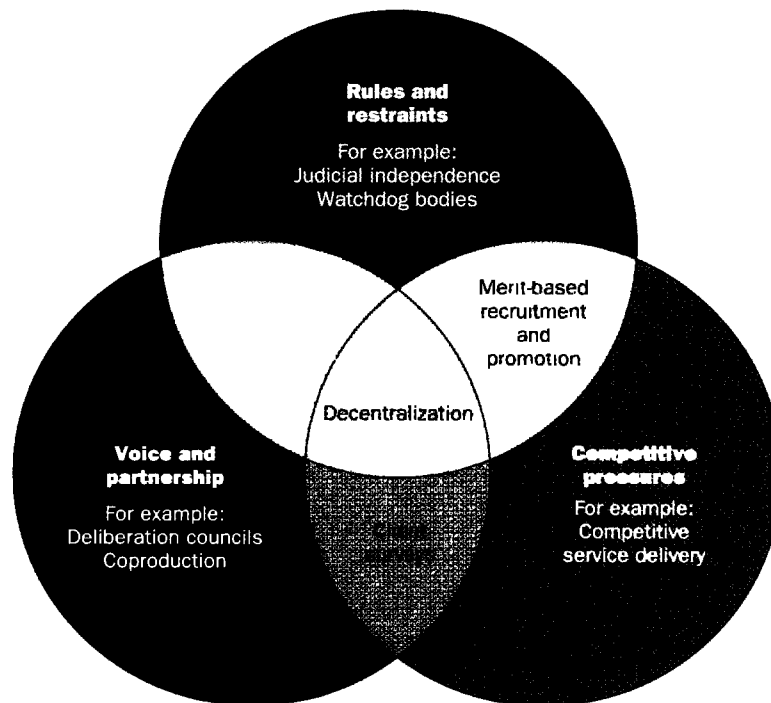
- Effective rules and restraints
- Greater competitive pressure
- Increased citizen voice and partnership.

Effective rules and restraints

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

In many developing countries legislative and judicial oversight of the executive is weak. The setting of goals and the links to the policies needed to achieve them are sometimes diffuse, legislatures suffer from limited information

Figure 2 A range of mechanisms can enhance state capability

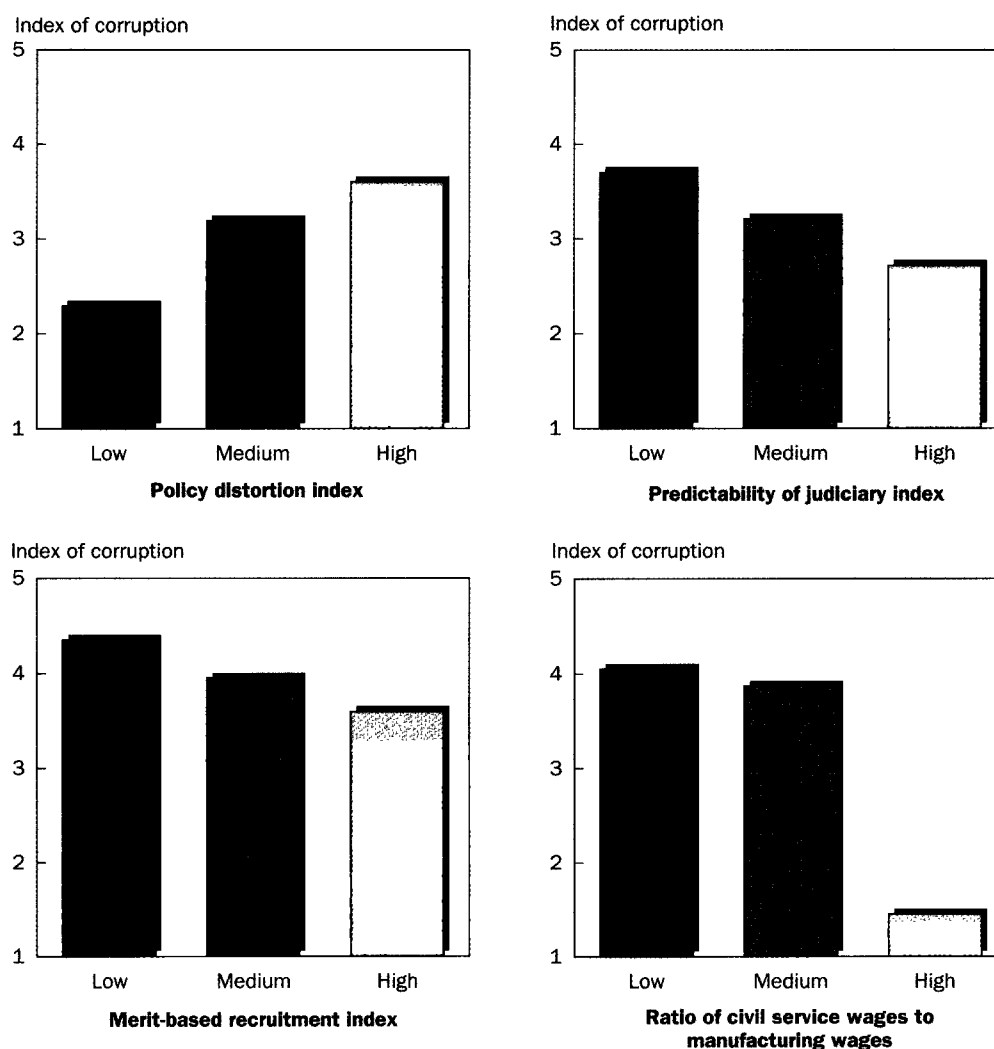


and capability, and judicial independence is compromised. An independent judiciary is vital to ensure that the legislative and executive authorities remain fully accountable under the law, and to interpret and enforce the terms of a constitution. Writing laws is the easy part; they need to be enforced if a country is to enjoy the benefits of a credible rule of law. These institutions of restraint take time to establish themselves, but international commitment mechanisms such as international adjudication, or

guarantees from international agencies, can serve as a short-term substitute.

A major thrust of any effective strategy to reinvigorate the public sector will be to reduce the opportunities for corruption by cutting back on discretionary authority. Policies that lower controls on foreign trade, remove entry barriers for private industry, and privatize state firms in a way that ensures competition—all of these will fight corruption (Figure 3). Such reforms should not be half-

Figure 3 Factors associated with corruption



Note: Each index score is the average for a group of countries. See the Technical Note for details and definitions of the indexes. Higher values of the corruption index mean more corruption, and similarly for the other variables. The top left panel is based on a simple correlation for thirty-nine industrial and developing countries during 1984–93 (for the policy distortion index) and 1996 (for the corruption index). The top right panel is based on a regression using data from fifty-nine industrial and developing countries during 1996. The bottom left panel is based on a regression using data for thirty-five developing countries during 1970–90. The bottom right panel is based on a simple correlation for twenty industrial and developing countries in the late 1980s to the early 1990s; wage data are means. Source: World Bank staff calculations.

hearted: reforms that open opportunities for private entry into closed sectors of the economy, but leave that entry to the discretion of public officials rather than establish open and competitive processes, also create enormous scope for corruption. Formal checks and balances can also help reduce official corruption, but they are seldom enough. Reforming the civil service, restraining political patronage, and improving civil service pay have also been shown to reduce corruption by giving public officials more incentive to play by the rules.

Where corruption is deeply entrenched, more dramatic efforts will be needed to uproot it. These efforts should be focused on better monitoring of official action—both by formal institutions and by individual citizens—and punishment of wrongdoing in the courts. In Hong Kong (China, as of July 1, 1997), an independent commission against corruption is one successful example of such an approach. Likewise, recent reforms in Uganda have incorporated several elements of the anticorruption strategy outlined here, with some encouraging results. The same mechanisms could be applied around the globe: corruption, despite claims to the contrary, is not culture specific. Reducing it will require a multipronged approach, which must include the private sector and civil society more broadly. The briber has as much responsibility as the bribed; effective penalties on domestic and international business must be part of the solution.

Subjecting the state to more competition

Governments can improve their capability and effectiveness by introducing much greater competition in a variety of areas: in hiring and promotion, in policymaking, and in the way services are delivered.

BOOSTING COMPETITION WITHIN THE CIVIL SERVICE. Whether making policy, delivering services, or administering contracts, a capable, motivated staff is the lifeblood of an effective state. Civil servants can be motivated to perform effectively through a combination of mechanisms to encourage internal competition:

- A recruitment system based on merit, not favoritism
- A merit-based internal promotion system
- Adequate compensation.

Starting in the nineteenth century, all of today's established industrial countries used these principles to build modern professional bureaucracies. More recently these principles have been applied in many countries in East Asia, which have transformed weak, corrupt, patronage-based bureaucracies into reasonably well functioning systems. But many developing countries do not even need to look overseas or to history for role models: they exist at home. Central banks, for example, often continue to work

effectively and retain their competence even when all other institutions have declined. These agencies work well for all the reasons listed above. They are less subject to political interference. They have limited but clear objectives. They are given adequate resources and training. And their staff are usually better paid than their counterparts in other parts of government.

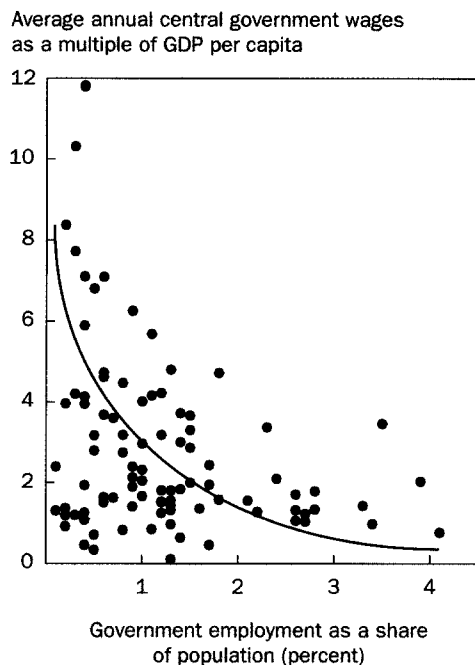
Cross-country evidence reveals that bureaucracies with more competitive, merit-based recruitment and promotion practices and better pay are more capable. In several countries (Kenya, the Philippines) political appointments run quite deep, whereas countries such as Korea have benefited from reliance on highly competitive recruitment and a promotion system that explicitly rewards merit. Ongoing reforms in the Philippines are examining these issues in an effort to improve bureaucratic capability. By and large, countries in which broader checks and balances are weak need to rely more heavily on more transparent and competitive systems. The experience of certain high-performing East Asian economies also shows that meritocracy and long-term career rewards help build an esprit de corps, or a shared commitment to collective goals. This reduces the transactions costs of enforcing internal constraints and builds internal partnerships and loyalty.

In many countries civil servants' wages have eroded as a result of expanding public employment at lower skill levels and fiscal constraints on the total wage bill (Figure 4). The result has been a significant compression of the salary structure and highly uncompetitive pay for senior officials, making it difficult to recruit and retain capable staff. Some countries, such as Uganda, are undertaking far-reaching reforms to reduce overstaffing dramatically, increase average pay, and decompress the salary structure. But in many countries these problems have yet to be addressed.

MORE COMPETITION IN THE PROVISION OF PUBLIC GOODS AND SERVICES. In many developing countries services are delivered badly or not at all. Politicians often intervene in the day-to-day operations of public agencies, and managers have limited flexibility. There is limited accountability for results. And in many countries the public sector has assumed a monopoly in delivery, eliminating pressures for better performance.

Building an effective public sector in these circumstances will mean opening up core government institutions, to improve incentives in areas that the public sector has long monopolized. Dozens of countries throughout the Americas, Europe, and Asia have capitalized on changes in technology and introduced competition in telecommunications and electric power generation. This has resulted in lower unit costs and a rapid expansion of service. Competition is also being enhanced by contracting out services through competitive bids and auctions.

Figure 4 Higher government employment often means lower government wages



Note: Data are for ninety-six industrial and developing countries during various years in the early 1990s. See the Technical Note. Source: Schiavo-Campo, de Tommaso, and Mukherjee, background paper.

This is a significant trend in industrial countries (the United Kingdom, Victoria State in Australia), but such mechanisms are also being used to improve efficiency in developing countries (for example, that of road maintenance in Brazil). Faced with weak administrative capacity, some countries (Bolivia, Uganda) are also contracting out the delivery of social services to nongovernmental organizations.

There is a growing trend to set up focused, performance-based public agencies with more clarity of purpose and greater managerial accountability for outputs or outcomes. New Zealand provides the most dramatic example among the high-income countries. It broke up its conglomerate ministries into focused business units, headed by chief executives on fixed-term, output-based contracts with the authority to hire and fire and to bargain collectively. Singapore has long followed a broadly similar approach with its performance-based statutory boards. Other developing countries are following suit, with Jamaica, for example, establishing executive agencies along the lines of the British model.

But countries with inadequate controls and weak capacity need to proceed with caution. For these countries, giv-

ing public managers more flexibility will merely increase arbitrariness and corruption with no commensurate improvement in performance. And writing and enforcing contracts, particularly for complex outputs, require specialized skills that are scarce in many developing countries. These countries need first to strengthen rule-based compliance and financial accountability (as Argentina and Bolivia have done) within the public sector, provide greater clarity of purpose and task, and introduce performance measurement (as in Colombia, Mexico, and Uganda). As output measurement and ex post controls on inputs are strengthened, agencies can be provided more flexibility in exchange for their greater accountability for results.

Bringing the state closer to people

Governments are more effective when they listen to businesses and citizens and work in partnership with them in deciding and implementing policy. Where governments lack mechanisms to listen, they are not responsive to people's interests, especially those of minorities and the poor, who usually strain to get their voices heard in the corridors of power. And even the best-intentioned government is unlikely to meet collective needs efficiently if it does not know what many of those needs are.

GIVING PEOPLE A VOICE. Partnership involves bringing the voice of the poor and of marginalized groups into the very center of the policymaking process. In many countries, voice is distributed as unequally as income. Greater information and transparency are vital for informed public debate and for increasing popular trust and confidence in the state—whether in discussing expenditure priorities, designing social assistance programs, or managing forests and other resources. Client surveys (in India, Nicaragua, and Tanzania) and citizen charters (in Malaysia) are providing new options for making voices heard.

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

BROADENING PARTICIPATION. Evidence is mounting that government programs work better when they seek the participation of potential users, and when they tap the

community's reservoir of social capital rather than work against it. The benefits show up in smoother implementation, greater sustainability, and better feedback to government agencies. Higher returns from water-borne sanitation systems in Recife, Brazil; housing schemes for the poor in Port Elizabeth, South Africa; forest management efforts in Gujarat State, India; and health care in Khartoum, Sudan, are all testament to the power of partnership—the participation of local people. This is in contrast with top-down approaches, which often fail.

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

DEVOLVING POWER, CAREFULLY. The typical developing country has a more centralized government than the typical industrial country. But with some significant exceptions, the past thirty years have seen a small shift in public spending power in developing countries from the national to lower levels. The industrial economies have seen an opposite trend, with spending power moving to the center. Neither of these observations, of course, takes into account the decentralization implicit in recent market reforms, which have clearly reduced the direct power and resources of central government in a broad range of countries.

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

- *Rising inequality.* The gap between regions can widen—an issue of considerable concern in China, Russia, and Brazil. Labor mobility provides a partial solution, but it is seldom easy, especially in ethnically diverse countries where migrants are not always welcome.
- *Macroeconomic instability.* Governments can lose control of macroeconomic policy if local and regional fiscal indiscipline leads to frequent bailouts from the center, as occurred in Brazil.
- *Risk of local capture.* A serious danger is that of local governments falling under the sway of special interests, leading to misuse of resources and of the coercive power of the state.

These dangers show, once again, how central government will always play a vital role in sustaining develop-

ment. The challenge is to find the right division of labor between the center and the other tiers of government.

Strategic options for reform

Building a more responsive state requires working on mechanisms that increase openness and transparency, increase incentives for participation in public affairs, and where appropriate, lessen the distance between government and the citizens and communities it is intended to serve. This yields four broad imperatives for policymakers:

- Where appropriate, ensure broad-based public discussion of key policy directions and priorities. At a minimum this includes making available information in the public interest and establishing consultative mechanisms—such as deliberation councils and citizen committees—to gather the views and make known the preferences of affected groups.
- Encourage, where feasible, the direct participation of users and other beneficiaries in the design, implementation, and monitoring of local public goods and services.
- Where decentralization is considered desirable, adopt a carefully staged and/or sectoral approach in priority areas. Introduce strong monitoring mechanisms and make sure sound intergovernmental rules are in place to restrain arbitrary action at the central and the local level.
- At the local level, focus on mechanisms—and horizontal incentives in government's relations with the rest of the community—that build accountability and competition.

Of course, a strategy of more openness and greater decentralization has its dangers. The more numerous the opportunities for participation, the greater the demands that will be made on the state. This can increase the risk of capture by vocal interest groups, or of gridlock. Bringing government closer to some people must not result in taking it even further away from others. Equally, without clear-cut rules to impose restraints on different tiers of government, and incentives to encourage local accountability, the crisis of governance that afflicts many centralized governments will simply be passed down to lower levels. But there are some safe ways to start the ball rolling, including the use of communication and consensus building to render reform intelligible to citizens and firms and enhance its chances of success.

Beyond national borders: Facilitating global collective action

Globalization is a threat to weak or capriciously governed states. But it also opens the way for effective, disciplined states to foster development and economic well-being, and it sharpens the need for effective international cooperation in pursuit of global collective action.

Embracing external competition

The state still defines the policies and rules for those within its jurisdiction, but global events and international agreements are increasingly affecting its choices. People are now more mobile, more educated, and better informed about conditions elsewhere. And involvement in the global economy tightens constraints on arbitrary state action, reduces the state's ability to tax capital, and brings much closer financial market scrutiny of monetary and fiscal policies.

"Globalization" is not yet truly global—it has yet to touch a large chunk of the world economy. Roughly half of the developing world's people have been left out of the much-discussed rise in the volume of international trade and capital flows since the early 1980s. Governments' hesitance to open up to the world economy is partly understandable. Joining the global economy, like devolving power from the center, carries risks as well as opportunities. For example, it can make countries more vulnerable to external price shocks or to large, destabilizing shifts in capital flows. This makes the state's role all the more critical, both in handling such shocks and in helping people and firms grasp the opportunities of the global marketplace. But the difficulties should not be exaggerated, particularly when laid against the risks of being left out of the globalization process altogether.

The cost of not opening up will be a widening gap in living standards between those countries that have integrated and those that remain outside. For lagging countries the route to higher incomes will lie in pursuing sound domestic policies and building the capability of the state. Integration gives powerful support to such policies—and increases the benefits from them—but it cannot substitute for them. In that sense, globalization begins at home. But multilateral institutions such as the World Trade Organization have an important role to play in providing countries with the incentive to make the leap.

Promoting global collective action

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

- *Managing regional crises.* The threat of nuclear war between the superpowers has given way to a mushrooming of smaller conflicts, entailing costly problems of refugee relief and rehabilitation. No solid international framework exists for managing these conflicts or helping avoid them. A more integrated assessment of

how state policies (and international assistance) help manage nascent conflict is needed in designing economic and social policy.

- *Promoting global economic stability.* Concern has been growing about the potentially destabilizing effects of large and rapid flows of portfolio capital, particularly when a crisis in one country can spill over into other markets. A variety of international mechanisms have been suggested to guard against such problems, and the International Monetary Fund has recently created a new facility to help members cope with sudden financial crises. But prudent and responsive economic policies at home will be countries' best protection. Growing international labor mobility is also raising a host of issues requiring international collective action.
- *Protecting the environment.* Urgent global environmental issues include climate change, loss of biodiversity, and protection of international waters. International collective action can help through better coordination, greater public awareness, more effective technological transfer, and better national and local practices. Progress has been slow, however, raising the worry that it will take a major environmental catastrophe to goad countries into concerted action.
- *Fostering basic research and the production of knowledge.* Now being revitalized to meet renewed challenges in food production, the Consultative Group on International Agricultural Research has shown how technology can be developed and disseminated through international collective action. Similar consultative mechanisms need to be developed to tackle other pressing research problems in the domains of environmental protection and health.
- *Making international development assistance more effective.* To become more effective, foreign aid needs to be tied more closely to the policies of the recipient countries. A high priority for aid agencies is to systematically channel resources to poor countries with good policies and a strong commitment to institutional reinvigoration.

Removing obstacles to state reform

The history of state reform in today's established industrial countries offers hope—and gives pause—to today's developing countries. Until the last century many of the problems that now appear to have reduced the effectiveness of the state in the developing world were in plain evidence in Europe, North America, and Japan. But the problems were addressed, and modern states with professional systems emerged. This gives us hope. But it also gives us pause, because institutional strengthening takes time. The reforms of the Meiji restoration, which launched Japan onto the path of development, took al-

most twenty-five years to take root. A more capable state can be built, but the process will be slow and will require immense political commitment. It is urgent to act now.

Over the past fifteen years many governments have responded to internal and external pressure by launching far-reaching reforms to improve their performance. Typically, changes in macroeconomic policy—dealing with exchange rates, fiscal policy, and trade policy—have come fastest. These reforms have political implications but do not require the overhaul of institutions. They can be undertaken quickly, often through decree, by a small group of competent technocrats. All it takes is the political decision to make the change.

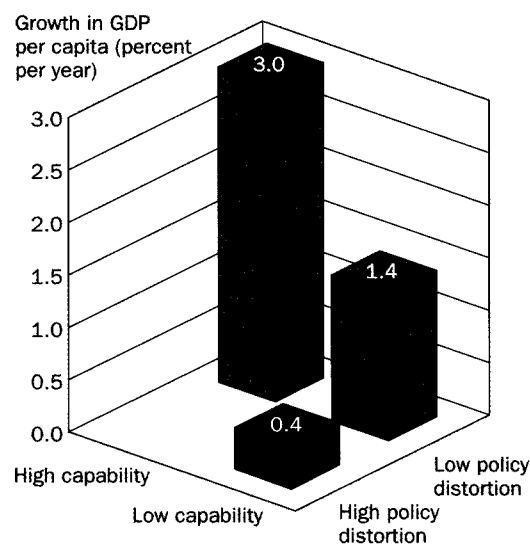
But other state reforms, dealing with regulation, social services, finance, infrastructure, and public works, cannot be accomplished so rapidly because they involve changing institutional structures established for different purposes, to fit different rules of the game. This kind of institutional reform involves wrenching changes in the way government agencies think and act, and often a complete overhaul of long-established systems of patronage and corruption. But such change is absolutely essential if the capability of the state is ever to improve. The two together—good policies and more capable state institutions to implement them—produce much faster economic development (Figure 5).

Comprehensive reform along these lines will take a great deal of time and effort in many developing countries, and the agenda varies considerably from region to region (Box 3). Reform will also encounter considerable political opposition. But reformers can make a good start by strengthening central agencies for strategic policy formulation, introducing more transparency and competition, hiving off activities and agencies with easily specified outputs, seeking more feedback from users about the delivery of services, and working with labor unions on programs that will enable workers to seek security in change rather than seek security against change.

When do reforms occur?

Deep distributional conflicts and constraints embedded in state institutions are at the heart of the explanation for so many countries' failure to reform. But they are not immutable. Ultimately, change comes when the incentives to throw out the old policies and old institutional arrangements become stronger than the incentives to keep them. An economic crisis or an external threat, or the arrival of a new government with fewer vested interests in the old system, may provide the impetus for reform. But reform can be delayed if those in power stick with outdated policies because it is in their (or their allies') interest to do so. And the delay can sometimes be painfully long, as in Haiti under the Duvaliers, or Zaire today.

Figure 5 Countries with good economic policies and stronger institutional capability grow faster



Note: Each growth rate is the average for a group of countries. Results are based on a regression using panel data from ninety-four industrial and developing countries for the period 1964–93, controlling for education, income, and other variables. See the Technical Note for details. Source: Commander, Davoodi, and Lee, background paper.

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

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

Box 3 The regional agenda

The key features and challenges of improving the effectiveness of the state in the various developing regions are summarized below. These are of necessity broad generalizations, and each region includes several countries whose experiences are very different.

- Many countries in *Sub-Saharan Africa* are suffering from a crisis of statehood—a crisis of capability. An urgent priority is to rebuild state effectiveness through an overhaul of public institutions, reassertion of the rule of law, and credible checks on abuse of state power. Where the links between the state, the private sector, and civil society are fragile and underdeveloped, improving the delivery of public and collective services will require closer partnerships with the private sector and civil society.
- The capability of the state in most *East Asian* countries cannot be considered a problem. But states' ability to change in response to the new challenges facing the region will play a critical role in their continued economic success.
- The main issue in *South Asia* is overregulation, both a cause and an effect of bloated public employment and the surest route to corruption. Regulatory simplification and public enterprise reform, and the resulting contraction of the role of the state, will be complex and politically difficult.
- The job of reorienting the state toward the task of “steering, not rowing” is far from complete in *Central and Eastern Europe*. But most countries have made progress and are on the way to improving capability and accountability.
- Low state capability in many countries of the *Commonwealth of Independent States* is a serious and mounting obstacle to further progress in most areas of economic and social policy. Reorientation of the state is still at an early stage, and a host of severe problems have emerged from a general lack of accountability and transparency.
- In *Latin America*, decentralization of power and of spending, coupled with democratization, has dramatically transformed the local political landscape, in what some have called a “quiet revolution.” A new model of government is emerging in the region. But greater emphasis is also needed on reform of the legal system, the civil service, and social policies.
- In the *Middle East and North Africa*, unemployment is by far the greatest economic and social problem and makes government downsizing especially difficult. Because the political and social difficulties of reform are considerable, although not insurmountable, a promising approach might be to begin decentralizing selected services, and focus on reforming state enterprises, while preparing the ground for wider-ranging reforms.

far that the winners far outnumber the losers. Then reform can produce immediate economic and political gains.

How can reforms be sustained?

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

Reforming the state requires cooperation from all groups in society. Compensation of groups adversely af-

ected by reform (which may not always be the poorest in society) can help secure their support. Although compensation may be costly in the short run, it will pay off in the long run. Deep-seated differences and mutual suspicions among groups can also delay reform. There are no quick fixes for removing age-old enmities, but social pacts, such as Spain's Moncloa Pacts and Benin's National Economic Conference, can help.

International agencies can encourage and help sustain reform in four ways. First, they can provide important technical advice on what to do and what not to do. This assistance is often invaluable, especially for smaller states that lack the resources to handle all the technical issues internally. But it must be complemented by local expertise, to adapt reforms to local conditions and institutions. The World Trade Organization plays a major role in trade reform, the World Health Organization on health issues, and the International Labour Organisation on labor legislation and employment policy. Second, international agencies can provide a wealth of cross-country

experience on a wide range of issues. Often staffed by people from all over the world, they can bring in experts from different backgrounds. Third, the financial assistance these agencies provide can help countries endure the early, painful period of reform until the benefits kick in. Fourth, they can provide a mechanism for countries to make external commitments, making it more difficult to back-track on reforms. If the history of development assistance teaches anything, however, it is that external support can achieve little where the domestic will to reform is lacking.

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

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

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

Instances of state collapse are both extreme and unique, but they are growing. As the Report elaborates, no simple generalizations about their causes or effects can be made, nor, for that matter, are there any easy solutions to their reconstruction; each case brings its own challenges for countries, their neighbors, and the international system. The consequences, however, are almost uniformly borne by ordinary people, illustrating once again how fundamental an effective, responsive state is to the long-term health and wealth of society.

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

A tour of the world's economies in 1997 would turn up countless examples of these virtuous circles in action. But it would provide equally plentiful evidence of the reverse: countries and regions caught in vicious cycles of poverty and underdevelopment set in train by the chronic ineffectiveness of the state. Such cycles can all too easily lead to social violence, crime, corruption, and instability, all of which undermine the state's capacity to support development—or even to function at all. The crucial challenge facing states is to take those steps, both small and large, toward better government that set economies on the upward path, using the two-part framework suggested in this Report. Reform of state institutions is long, difficult, and politically sensitive. But if we now have a better sense of the size of the reform challenge, we are also much more aware of the costs of leaving things as they are.

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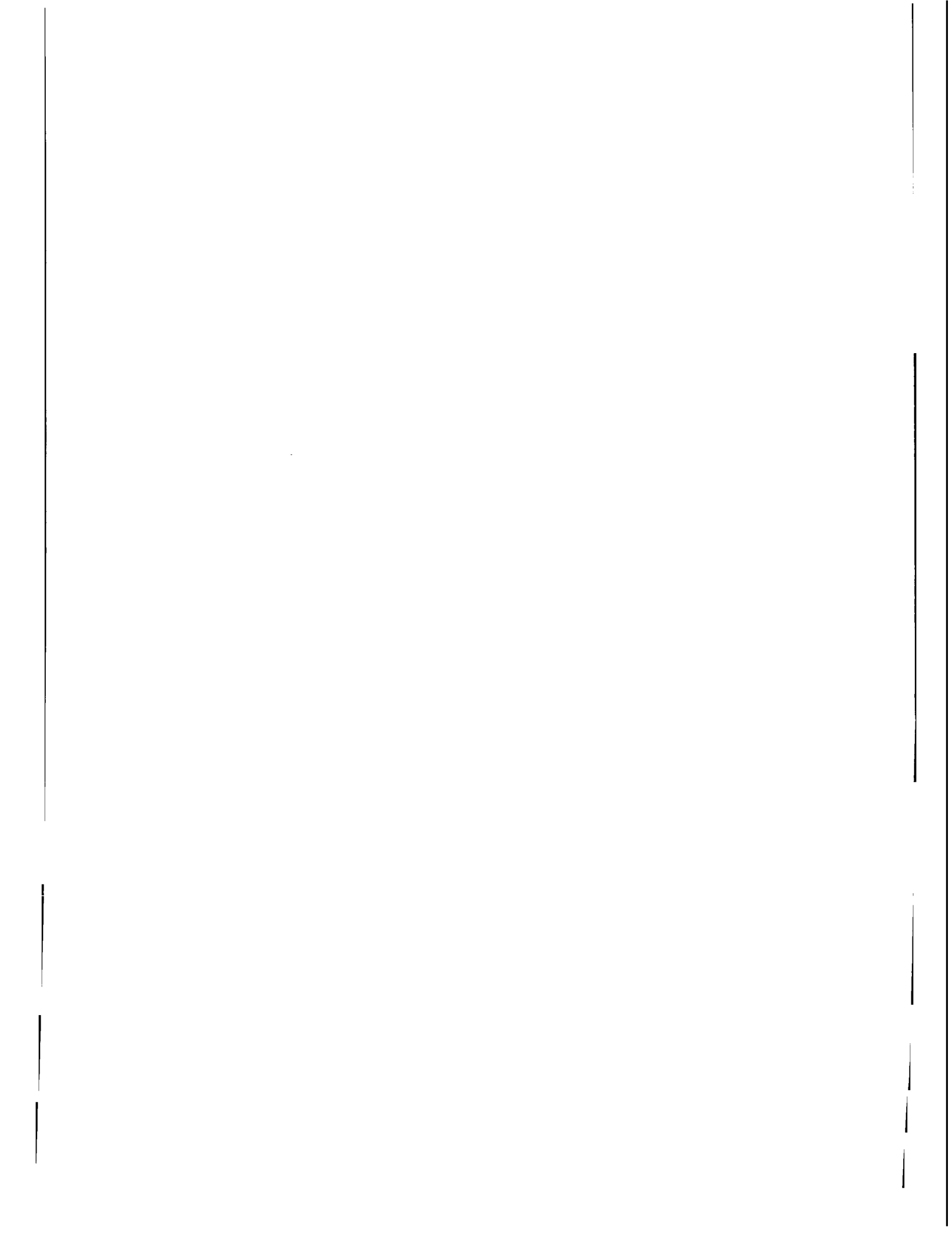
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