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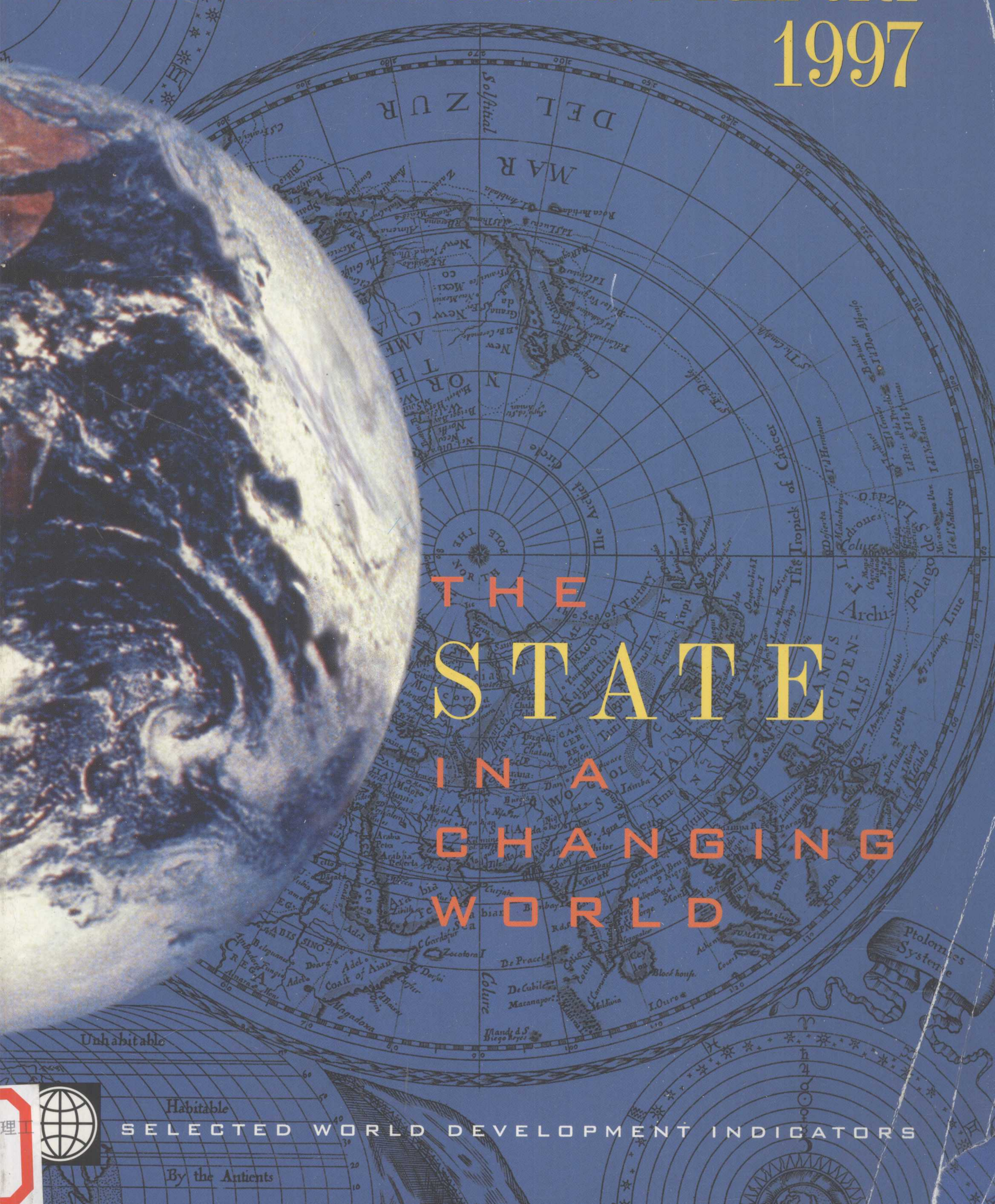

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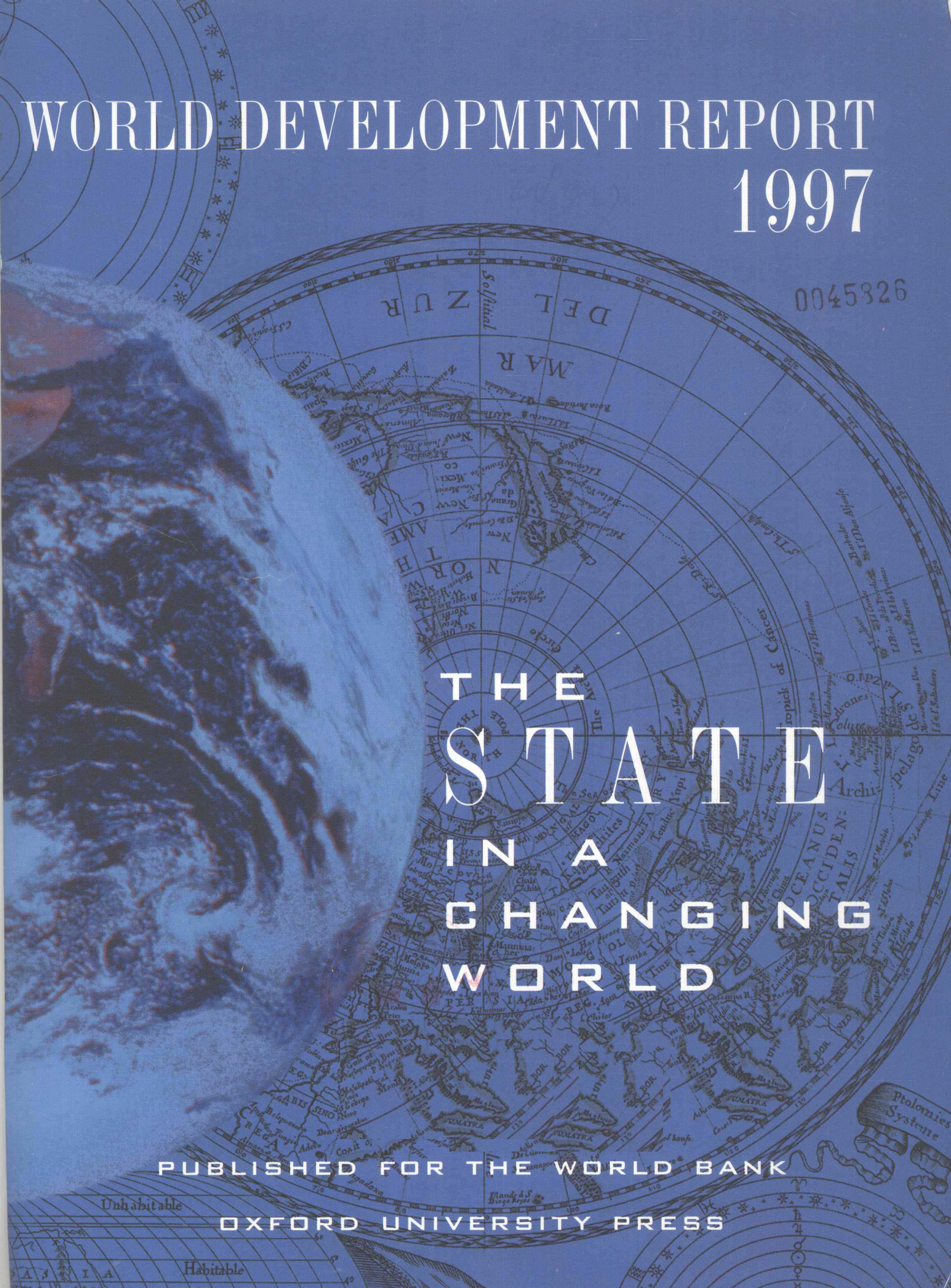
SELECTED WORLD DEVELOPMENT INDICATORS

WORLD DEVELOPMENT REPORT 1997



THE STATE IN A CHANGING WORLD

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FOREWORD

WORLD DEVELOPMENT REPORT 1997, THE TWENTIeth in this annual series, is devoted to the role and effectiveness of the state: what the state should do, how it should do it, and how it can do it better in a rapidly changing world.

These issues are high on the agenda in developing and industrial countries alike. For many, the lesson of recent years has been that the state could not deliver on its promises: transition economies have had to make a wrenching shift toward the market economy, and much of the developing world has had to face up to the failure of state-dominated development strategies. Even the mixed economies of the industrialized world, in response to the failures of government intervention, have opted for a decided shift in the mix in favor of market mechanisms. Many have felt that the logical end point of all these reforms was a minimalist state. Such a state would do no harm, but neither could it do much good.

The Report explains why this extreme view is at odds with the evidence of the world's development success stories, be it the development of today's industrial economies in the nineteenth century or the postwar growth "miracles" of East Asia. Far from supporting a minimalist approach to the state, these examples have shown that development requires an effective state, one that plays a catalytic, facilitating role, encouraging and complementing the activities of private businesses and individuals. Certainly, state-dominated development has failed. But so has stateless development—a message that comes through all too clearly in the agonies of people in collapsed states such as Liberia and Somalia. History has repeatedly shown that good government is not a luxury but a vital necessity. Without an effective state, sustainable development, both economic and social, is impossible.

History and recent experience have also taught us that development is not just about getting the right economic and technical inputs. It is also about the underlying, institutional environment: the rules and customs that determine how those inputs are used. As this Report shows, understanding the role the state plays in this environment—for example, its ability to enforce the rule of law to underpin market transactions—will be essential to making the state contribute more effectively to development.

The pathways to an effective state are many and varied. The Report makes no attempt to offer a single recipe for state reforms worldwide. It does, however, provide a framework for guiding these efforts, in the form of a two-part strategy:

- First, focus the state's activities to match its capability. Many states try to do too much with few resources and little capability. Getting governments better focused on the core public activities that are crucial to development will enhance their effectiveness.
- Second, over time, look for ways to improve the state's capability by reinvigorating public institutions. The Report puts particular emphasis on mechanisms that give public officials the incentive to do their jobs better and to be more flexible, but that also provide restraints to check arbitrary and corrupt behavior.

Drawing from examples of successful and unsuccessful states, and of state reform around the world, the Report elaborates this two-part strategy and shows how it can be implemented from a number of starting positions. Significantly, although there is an enormous diversity of settings and contexts, effective states clearly do have some common features. One is in the way government has set rules underpinning private transactions, and civil society more broadly. Another is in the way government has played by the rules itself, acting reliably and predictably and controlling corruption.

Building a more effective state to support sustainable development and the reduction of poverty will not be easy. In any situation many people will have a vested interest in keeping the state as it is, however costly the results for the well-being of the country as a whole. Overcoming their opposition will take time and political effort. But the Report shows how opportunities for reform can open, and widen, with the help of careful sequencing of reforms and mechanisms to compensate losers. Even in the worst of situations, very small steps toward a more effective state can have a large impact on economic and social welfare. As we approach the twenty-first century, the challenge for states is neither to shrink into insignificance, nor to dominate markets, but to start taking those small steps.

James D. Wolfensohn
President
The World Bank

May 30, 1997

This Report has been prepared by a team led by Ajay Chhibber and comprising Simon Commander, Alison Evans, Harald Fuhr, Cheikh Kane, Chad Leechor, Brian Levy, Sanjay Pradhan, and Beatrice Weder. Valuable contributions were made by Jean-Paul Azam, Ed Campos, Hamid Davoodi, Kathleen Newland, Kenichi Ohno, Dani Rodrik, Susan Rose-Ackerman, Astri Suhrke, and Douglas Webb. The team was assisted by Ritu Basu, Gregory Kisunko, Une Lee, Claudia Sepulveda, and Adam Michael Smith. Stephanie Flanders was the principal editor. The work was carried out under the general direction of the late Michael Bruno, Lyn Squire, and Joseph Stiglitz.

The team received useful advice from a distinguished panel of external experts comprising Masahiko Aoki, Ela Bhatt, Kwesi Botchwey, Peter Evans, Atul Kohli, Klaus König, Seymour Martin Lipset, Douglass North, Emma Rothschild, Graham Scott, and Vito Tanzi.

Many others inside and outside the World Bank provided helpful comments, wrote background papers and other contributions, and participated in consultation meetings. These contributors and participants are listed in the Bibliographical Note. The International Economics Department contributed to the data appendix and was responsible for the Selected World Development Indicators.

The production staff of the Report included Amy Brooks, Valerie Chisholm, Kathryn Kline Dahl, Joyce Gates, Stephanie Gerard, Jeffrey N. Lecksell, and Michael Treadway. Rebecca Sugui served as executive assistant to the team, and Daniel Atchison, Elizabete de Lima, Michael Geller, and Thomas Zorab as staff assistants. Maria Ameal served as administrative officer.

This Report is dedicated to the memory of Michael Bruno, Senior Vice President and Chief Economist of the World Bank from 1993 to 1996, whose life's work, including his contributions to this and past editions of *World Development Report*, immeasurably advanced our understanding of development.

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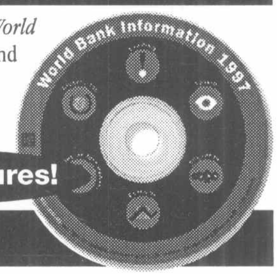

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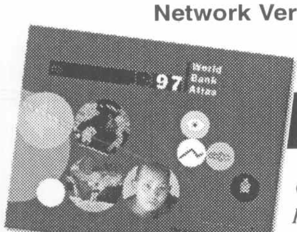

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Dollar figures are current U.S. dollars except where otherwise specified.

Billion means 1,000 million; *trillion* means 1,000 billion.

The following abbreviations are used:

CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
GDP	Gross domestic product
GNP	Gross national product
IMF	International Monetary Fund
NGO	Nongovernmental organization
OECD	Organization for Economic Cooperation and Development
PPP	Purchasing power parity

OVERVIEW

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. Many said much the same thing fifty years ago, but then they 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.

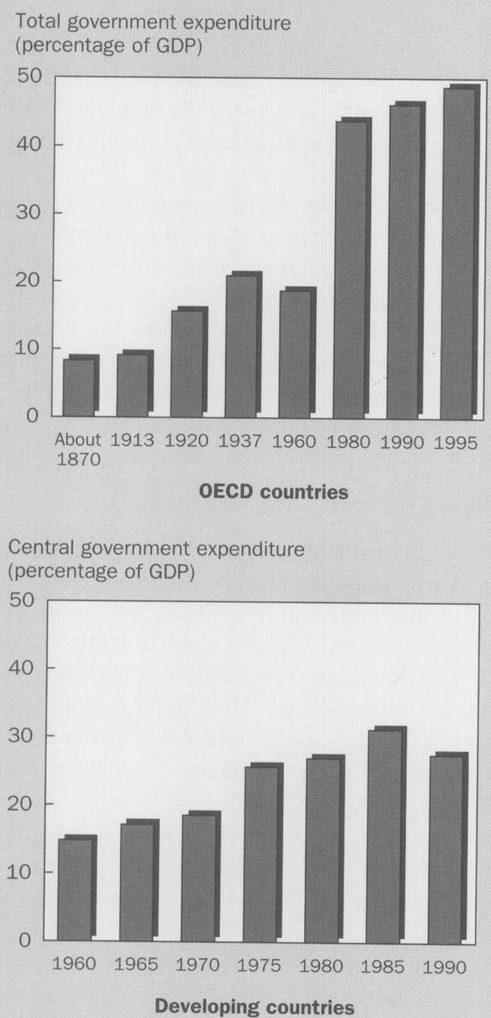
Rethinking the state—the world over

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 developing 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.

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).

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 nongovernmental 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.

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.

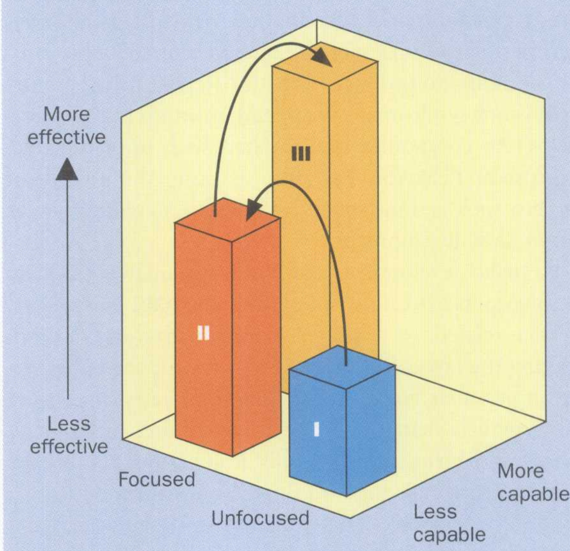
This basic message translates into a two-part strategy to make every state a more credible, effective partner in its country's development:

- *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.

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.



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 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 geographic 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

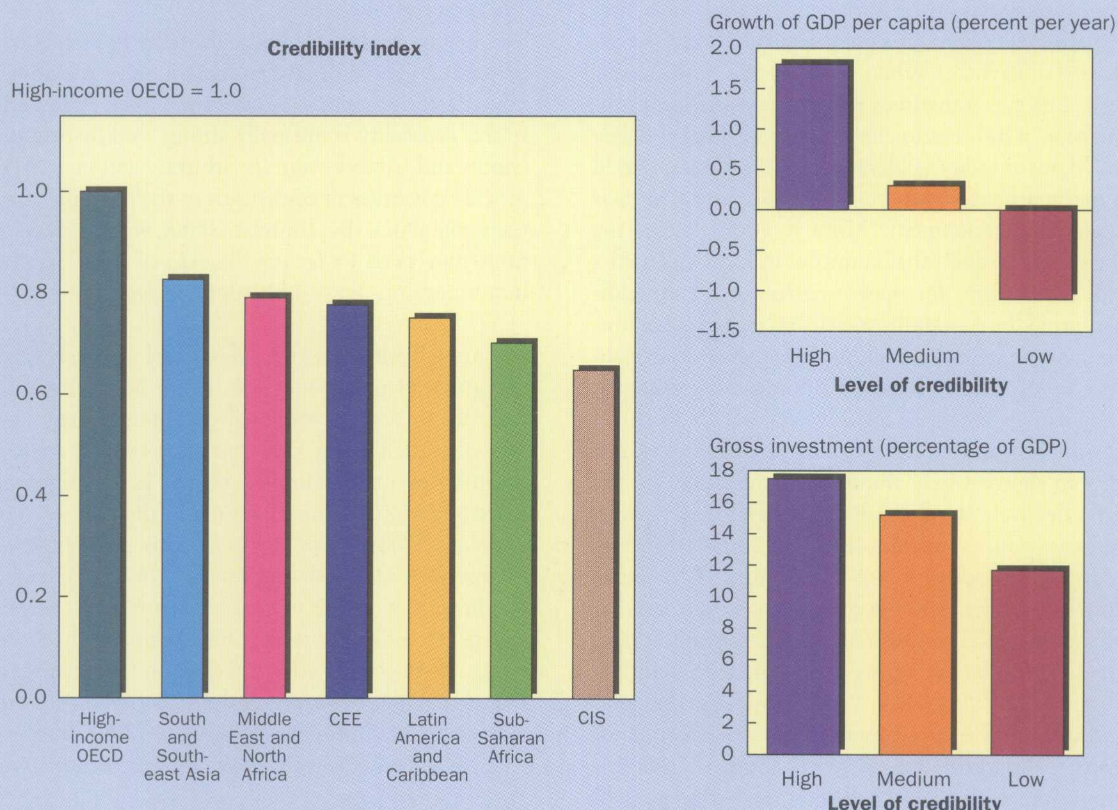
There is a growing recognition that in many countries monopoly public providers of infrastructure, social services, and other goods and services are unlikely to do a good job. At the same time, technological and organizational innovations have created new opportunities for competitive, private providers 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.