The state grew everywhere in the 20th century—in very different ways, shaped by two world wars, the Russian revolution, the 1930s' depression, and decolonization. Today state involvement in economic activities ranges from 0 percent (Somalia) to 100 percent (Democratic People's Republic of Korea). Few would deny that "without an effective state, sustainable development, both economic and social, is impossible" (World Bank 1997g). But the diversity of experience makes it difficult to draw conclusions about what makes states and markets effective—and what size state is right for any set of social and economic circumstances and objectives.

Ratios of government spending to total GDP in 1996 range from less than 10 percent up to about 50 percent (table 5.1). The average for the OECD was 46 percent, having risen steadily since World War I. More than half of this goes for transfer payments and subsidies, the trappings of the modern welfare state. Investment spending by the state accounts for less than 5 percent.

Governments of different persuasions are looking for ways to freeze and eventually reduce this spending without losing votes. The market is often the most acceptable and efficient solution—with private health and unemployment insurance, private contributions to higher education costs and the care of the elderly, and even private prison services among reforms initiated in the 1990s. Industrial and agricultural subsidies are also being cut back, thus directing private investment where profitability does not depend on the profitability of handouts.

The challenge for the developing world is to provide as good an institutional framework for development as its capabilities will allow. Governments should not intervene where markets can operate more efficiently. But they do, everywhere.

State-owned enterprises, prominent in many low-income economies, rarely operate as efficiently as private firms. They also absorb a large share of the economy's resources. Their investments may be financed with government guaranteed external loans, adding to debt burdens. They are heavy users of domestic credit, often granted on preferential terms, crowding out private borrowers and giving the state-owned firms a competitive cost advantage. Their loan servicing is generally poor, and many are far in arrears on payments for goods and services purchased from other public sector entities. Many state-owned enterprises benefit from tax reductions or exemptions, distorting competition and further reducing the income to government. More often than not, they are a drain on the budget, and so constrain official allocations to more worthy social causes (table 5.8).

Containing corruption and making government more effective

Until recently a preoccupation with shrinking the size of the state led many development economists to neglect the vital task of understanding how to improve the state. One lesson from successful states is that they use market-like mechanisms to improve their efficiency.

The World Bank's *World Development Report 1997* showed that an effective state is vital for development. Using data from 94 countries over three decades, the study shows that it is not just economic policies and human capital but the quality of a country's institutions that determines economic outcomes. Institutions determine the environment in which markets operate. A weak institutional environment allows greater arbitrariness on the part of state agencies and public officials.

If laws are applied arbitrarily, or not applied at all, the market will consider them irrelevant. Similarly, if rules are changed frequently or unexpectedly, they lose credibility. The wider the discretionary controls of politicians and bureaucrats, the greater the opportunities for bribery. In these circumstances, noncompliant behavior may be the most efficient way to operate.

Governments with poor records in enforcing law and order can soon ruin even a thriving economy. If such countries attract investors, it is into areas that the state cannot afford to develop on its own. Infrastructure projects and those that exploit natural resources are usually set up under one-off, all-inclusive agreements that insulate the investor from the deficiencies of the regulatory system.

International investors can stay away from states perceived to be incompetent and corrupt. Local business communities cannot. They must operate within the system, with all its faults, or not operate at all. The credibility of the state in the eyes of local entrepreneurs has a direct bearing on economic performance.

Box 5a

A credible state promotes private sector development

A survey of 3,600 firms in 60 countries prepared for the World Bank's *World Development Report 1997* concluded that the credibility accorded by the private sector to state institutions was linked to cross-country differences in economic growth and investment. Entrepreneurs were asked about their perceptions of the stability of laws and policies—and of the institutions set up to administer them. They were also asked about crime and corruption.

The predictability of rulemaking. The fewer surprises, the better. Worst off were entrepreneurs in the Commonwealth of Independent States (CIS), where 80 percent found their business seriously hampered by unpredictable changes in rules and policies.

The continuity of institutions. Business communities in the CIS, the Middle East and North Africa, and Sub-Saharan Africa were beset by institutional upheavals stemming from political changes. Entrepreneurs in both industrial and developing countries worried about crime against persons and property. And few respondents in developing countries trusted the system of law enforcement.

Freedom from corruption. Of the 3,600 firms, 40 percent had to resort to bribery in the normal course of business—30 percent in Asia, 60 percent in the CIS. More than half the respondents knew that the bribes would not bring forth the necessary permits, but would lead to yet further bribes to other officials.

In many developing countries local business people believe the state to be both incompetent and corrupt (box 5a). They invest less and operate less efficiently than they would in a more supportive policy environment. The main reason for this underperformance is that, to survive, they must divert time and money from their businesses into negotiations with bureaucrats and unreliable institutions.

The need for better governance, everywhere

Corruption, the abuse of public power for private gain, is a problem in every country. And the way it undermines the legitimacy of government has become a central issue for discussion in the 1990s. A series of widely publicized scandals helped to put the problem at the center of international concerns. Politicians and bureaucrats were prosecuted for taking bribes in several OECD countries, in the former Soviet Union, in Asia, and in Latin America. The crimes involved illegal payments for public contracts for infrastructure, defense, manufacturing, and services projects. They also involved campaign finance excesses—and protection money for the drug trade and other organized crime payoffs.

Transparency International—an anticorruption nonprofit group—has developed a corruption perception index that draws on surveys by Gallup International, the *World Competitiveness Yearbook*, Political & Economic Risk Consultancy in Hong Kong, DRI/McGraw Hill Global Risk Service, Political Risk Services in Syracuse, New York, and data gathered from Internet sources.

Low-income countries often have weaker markets and weaker institutions. As a result they may be more corrupt. And the connection runs both ways: countries are corrupt because they are poor, and they are poor because they are corrupt. Corruption damages economic performance by depressing investment in an unpredictable policy environment. On a corruption perception index with a range of zero to 10, a 2.4-point improvement led to a 4-point increase in a country's investment rate and a real rise in per capita income (Mauro 1997).

Reducing entrenched corruption requires far-reaching policy reforms, starting with strengthening institutions and liberalizing markets. Other measures include clearly separating executive and judiciary powers, revising public pay scales, and launching tax and tariff reforms.

Since the early 1990s the World Bank has been promoting good governance in its country assistance strategies and lending. Its research programs have improved understanding of the causes and effects of corruption in developing countries. And it has established a framework for addressing corruption as part of a broader promotion of good governance practices (World Bank 1997c).

A two-part strategy aims to help countries match the state's role to its capability and improve the quality of its institutions. This requires taking stock of a state's capabilities and ranking the economic and social fundamentals that can be supplied efficiently with existing resources. States can improve their capabilities by reinvigorating their institutions. This means not only building administrative or technical capacity but also instituting rules and norms that provide officials with incentives to act in the collective interest while restraining arbitrary action and corrup-

tion. An independent judiciary, institutional checks and balances, and effective watchdogs can restrain arbitrary state action and corruption. Competitive wages for civil servants can attract more talented people and increase professionalism and integrity.

Privatization

Since the 1980s the privatization of public sector enterprises has been central in economic policy reforms—helping economies better match the state's role to its capabilities. The process was accelerated by far-reaching changes in political systems and by information technology that facilitated the globalization of private business operations. Governments of former socialist countries opened the way for greater private participation by lifting restrictions on local and foreign private investments in their economies. Developing countries elsewhere took steps to reduce the state's involvement in production and trade. Technological advances have fundamentally changed the nature of the telecommunications sector. What was once seen as a public good with a single dimension (the telephone call) is today a broad array of services (fixed, wireless, facsimile and other value-added) that can be efficiently and effectively provided by the private sector.

Some important lessons: First, the ownership change from states to markets must be seen as politically desirable. Second, it must be politically feasible—benefits to the reforming government must outweigh the foreseeable costs, including the potential loss of political support. Third, the reforms must be credible. The proposals must include adequate compensation for losers, particularly with forced layoffs and evictions. Equally, the reforms must protect investors' property rights. Enterprise reform is unlikely to succeed if these three conditions are not present (World Bank 1995b).

State enterprises have shrunk most visibly in the former socialist countries and in some middle- and high-income economies. In Sub-Saharan Africa, by contrast, reforms could have done much for macroeconomic stabilization, but the governments in power saw the risks as too great. Sell-offs met least resistance in the wake of economic crises, as in the former Soviet Union and Latin America. Although proceeds from privatization provide governments with valuable revenues at no immediate cost to taxpayers, governments (and therefore taxpayers) lose an asset that might have provided future cash flows, and governments often provide guarantees to the new owners that later cost taxpayers.

The privatization of infrastructure has proceeded worldwide at great speed since the 1980s. Today, more than 25 countries in Sub-Saharan Africa are transferring all or part of their telecommunications monopolies from the state to the private sector (table 5a). Most had looked at what was happening elsewhere and liked what they saw—faster growth, new technology, lower costs, and better services. Privatizations were most likely to succeed if they had support at the highest government levels—and from the workforce.

The state monopolies being transformed into private-led, competitive markets in Africa and Latin America show how important it is to establish lines of authority—and to set clear policies, rules, and procedures—before calling for tenders. For sales strategies, privatization's long-run benefits deserve more emphasis than cash up front. Allowing competition is the best solution. Even though the government gets less revenue from the sale of firms and licenses, it acquires growing future flows of tax revenues from the successful businesses. Phased privatizations that commit a government to sell only enough shares to give the private partner a

Table 5a

Privatization of state-owned telecommunications companies in 1997, selected countries

Country	Company name	% sold	Price paid ($ millions)	Type of sale
Australia	Telstra	33.3	[illegible]	International public offering
Côte d'Ivoire	CI-Telcom	51.0	210	Strategic equity partner
France	France Telecom	23.2	[illegible]	International public offering
Kazakhstan	Kazakhtelecom	40.0	370	International public offering
Panama	INTEL	49.0	652	Strategic equity partner
Senegal	Sonatel	[illegible]	107	International public offering
South Africa	Telkom SA	30.0	1 261	Strategic equity partner
Spain	Telefónica de España	[illegible]	[illegible]	International public offering
Sri Lanka	Sri Lanka Telecom	35.0	225	Strategic equity partner
Yugoslavia, FR (Serb./Mont.)	Telekom Srbija	49.0	[illegible]	Private sale

a. With this sale of the state's remaining stake, Telefónica de España is now 100 percent privately owned.

Source: International Telecommunication Union; World Bank.

controlling interest have also proved successful. If the partly privatized utility is making satisfactory profits, and if share prices increase, the remaining government shareholding may be sold at higher prices than the original shares, providing the government with a windfall. Of course, the downside is that share prices may fall, resulting in revenue losses for the government.

Private monopoly should not succeed public monopoly, but some infrastructure businesses, such as water distribution, may inevitably be monopolistic. Even so, privatization may still be desirable—regulated private monopoly may be better than public monopoly. Governments should ensure that there are no barriers to new market entrants; the use of limited-duration concessions is one way of limiting market power. The rules of competition must be clear, with the amount of discretion reflecting the government's capacity and credibility to regulate such matters as tariffs and service obligations. The climate for infrastructure projects can be greatly improved if the state agrees to abide by an international treaty, such as the 1997 World Trade Organization Agreement on Basic Telecommunications.

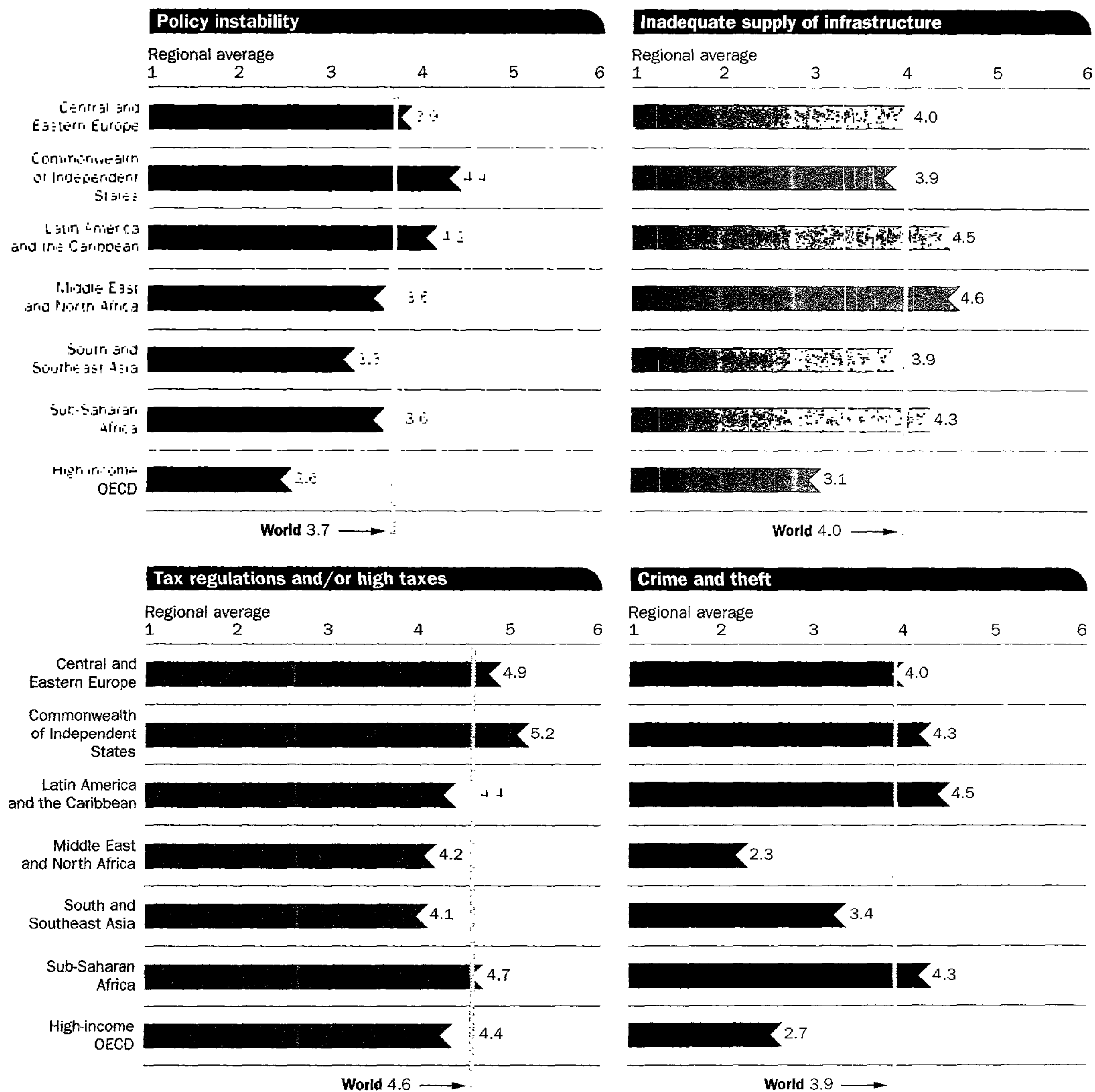
Many private infrastructure firms may need to be permanently regulated to facilitate an efficient market. As new technologies (wireless, satellite, Internet) enter the market, the agenda of regulatory agencies is likely to change. Few developing countries had fully operational regulatory systems in 1997, though several Latin American and Eastern European states were creating them. The problem is that if newly privatized utilities are poorly regulated, then the supply and quality of telecommunications, water, or energy may be as unsatisfactory as it was when provided by a state entity—and possibly worse. One unsuccessful privatization acts as a disincentive to investors. Governments that change the rules unpredictably—or fail to abide by them for one privatization—have difficulty finding buyers for the next privatization.

In telecommunications, wireless services create a competitive market where consumers have a real choice (table 5.11). The push of new technology has also improved competition in other infrastructure sectors so that regulatory requirements at the start of a privatization program run the risk of being overtaken by events unless adapted to the new technological developments. International cooperation in regulatory standards will help achieve this flexibility.

A parallel need has been created by the globalization of banking and financial services. Since the 1980s regulators have cooperated internationally to fight fraud and the laundering of proceeds from crime and corruption. Recent financial scandals and bank liquidity crises helped push governments normally protective of their authority closer to agreement on common standards and supervision systems—essential for an efficient international financial market and for the flow of investment funds. Here again, better-regulated markets—where investment decisions are not distorted by corruption—attract the greatest private capital flows.

A recent survey of local entrepreneurs in 69 countries found 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. Because investors do not consider such states credible, growth and investment suffer.

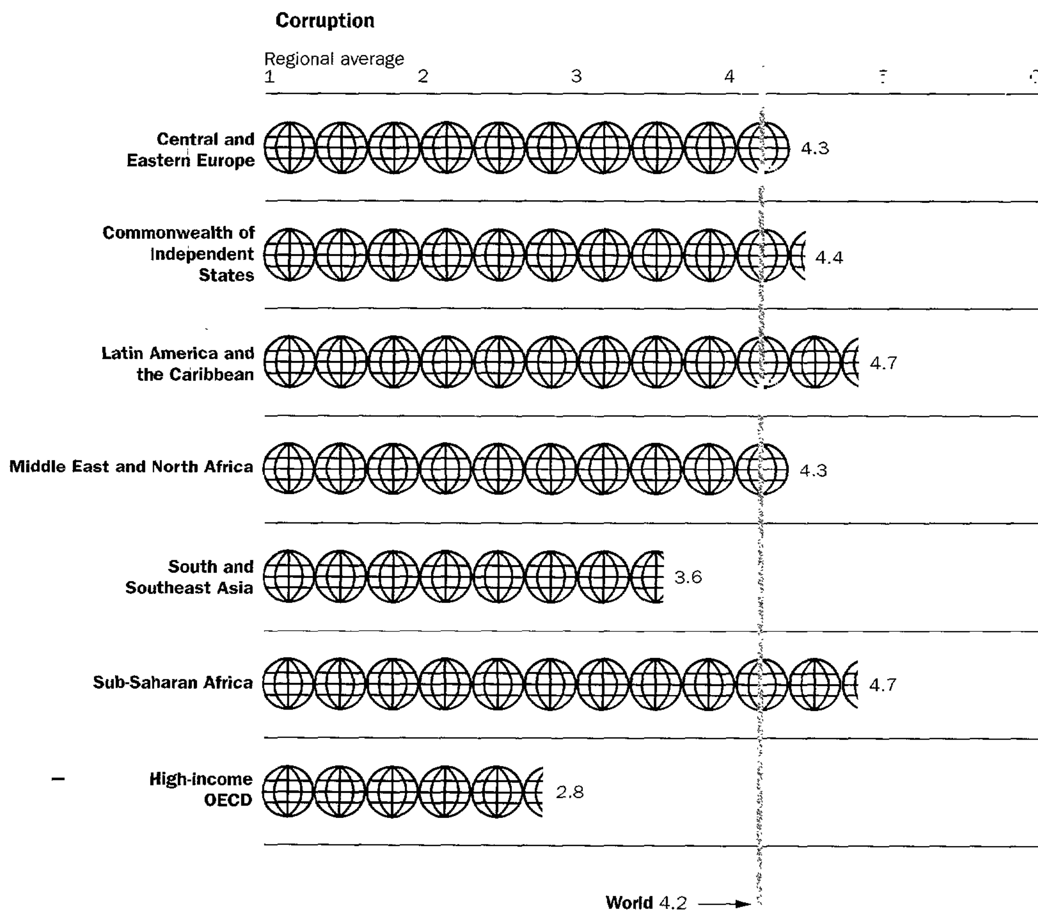
Local entrepreneurs were asked to rank each of several indicators on a scale from 1 (no problem) to 6 (extreme problem); survey results for four indicators are shown below



Countries must establish mechanisms that give state agencies the flexibility and the incentive to act for the common good—while at the same time restraining arbitrary and corrupt behavior in dealings with businesses and citizens.

Corruption severly hinders growth and development in Sub-Saharan Africa and Latin America

Local entrepreneurs were asked to rank corruption on a scale from 1 (no problem) to 6 (extreme problem); survey results are shown below



Source for both pages: World Bank, *World Development Report 1997: The State in a Changing World*, and Aymo Brunetti, Gregory Kisunko, and Beatrice Weder, "Institutional Obstacles to Doing Business," World Bank Policy Research Working Paper 1759.