

Case Studies and Recommendations



ountries around the world have been initiating reforms aimed at integrating their economies into the global marketplace and devolving central power to local governments. This report has presented a series of policy prescriptions for globalizing and localizing economies, and the five case studies included in this chapter describe how some of those recommendations can be put into practice. The examples differ, both because the type and extent of the reforms each country needs vary widely and because each set of reforms has been implemented in a vastly different economic and policy environment. Context is particularly important here, since the feasibility of reform depends on the political conditions in a country. Successful reform requires careful sequencing and the willingness to exploit sometimes fleeting opportunities.

The five cases discussed here—in the Arab Republic of Egypt, Hungary, Brazil, Pakistan, and Tanzania—represent a regional sampling of fairly typical policy situations (box 8.1). Each case study describes the policy setting, the recommended reform strategy, and the success of new policies thus far. In Brazil, Egypt,

and Hungary, some of the reforms are already under way though more remains to be done. Pakistan and Tanzania are at an earlier stage in the reform process.

Making the most of trade liberalization: Egypt

The number of regional trading arrangements has surged since 1990, and many countries are now members of large free trade areas or customs unions such as the European Union (EU) and Mercado Común del Sur (MERCOSUR). Should countries that are not members of a regional trading arrangement seek preferential access to their neighbors' markets? How does this option compare with unilateral or multilateral liberalization? This examination of Egypt's trade policy options illustrates the trade-offs many developing countries face in choosing whether to join a regional trade group (box 8.2). And it demonstrates the importance of some of the recommendations in chapters 2 and 3.

Since the mid-1970s, Egypt has been steadily liberalizing its trade policies, which has contributed to economic growth. But the benefits from liberalized trade have been stymied by domestic

Box 8.1

Five case studies

Making the most of trade liberalization: Egypt. This case applies chapter 2's proposals for trade reform, showing how international trade agreements can be used to demonstrate commitment to freer trade. It also illustrates some of the disadvantages of regional (as opposed to global) trade agreements and the kinds of domestic reforms the Egyptian government will have to implement to take advantage of the opportunities offered by global trade.

Reforming weak banking systems: Hungary. This case study deals with the financial sector reforms discussed in chapter 3. It demonstrates clearly that regulators need to take prompt action when a bank violates specific guidelines or procedures, as the report has argued. Taking steps to reduce this so-called "regulatory forbearance" is the next major challenge facing Hungarian policymakers.

Macromanaging under fiscal decentralization: Brazil. Building on the themes of decentralization and democratic subnational governance discussed in chapter 5, this case study illustrates the need for carefully sequenced decentralization. It also identifies the changes Brazil will need to make in order for its newly centralized structure to function effectively, including establishing electoral rules, creating regulations to manage relations between national and subnational governments, and drafting rules for subnational borrowing.

Improving urban living conditions: Karachi. The Karachi case study draws on chapter 7 to show how community groups and informal developers can complement the efforts of the public sector to provide essential services.

Cultivating rural-urban synergies: Tanzania. The final case study focuses on reforming foreign trade (chapter 2) and establishing policies that deal with urbanization and growth (chapter 6). It demonstrates how one country can use international trade and urban-rural economic linkages to stimulate growth in both the urban and rural sectors.

constraints, including an inefficient service sector, a slow-moving government bureaucracy, and overcrowded ports and transportation facilities. For some time, Egyptian industrial goods have had duty-free access to European markets, but Egypt is now considering signing an expanded preferential trading arrangement with the EU.¹ Such an agreement may reassure investors of Egypt's commitment to liberal trade policies, but—as explained in box 2.1—it would also mean that the pattern of Egypt's imports and exports will be shaped less by market forces and more by the differences in tariff treatment between Europe and Egypt's other trading partners.

Initial reforms

Economic growth in Egypt accelerated between 1975 and 1985 following the adoption of open-door policies.

It was fueled by sizable increases in foreign assistance, remittances from Egyptians working abroad, and foreign direct investment.² This growth spurt ended in 1986, largely because of a regional economic slowdown caused by declining oil prices. The level of aggregate demand in the economy then fell further in the early 1990s because of government spending cuts, an increase in real interest rates, and a drop in exports to the former Soviet Union and Eastern Europe. Per capita growth of real national output slowed from an average of 2.5–3.0 percent a year in 1989–91 to 0.4 percent in 1992 and 1993.

The Egyptian government responded with an impressive program of economic reform. Fiscal tightening reduced marginal tax rates and the government's budget deficit.³ Monetary reforms included decontrolling interest rates, devaluing and unifying exchange rates, reducing the growth of the money supply, and liberalizing the capital account. A 1991 law established a legal basis for privatization, and by September 1998, 113 of the initial 314 public enterprises originally targeted had been at least partially privatized. In the same year, the Parliament ratified a law authorizing the privatization of banks.

Foreign investors were quick to react. In 1995 they put \$400 million in foreign direct investment into Egypt, followed by \$800 million in 1996 and around \$1.2 billion in 1997. Half the foreign direct investment is in manufacturing and 30 percent in banking. Tariff revenues as a share of total imports fell from 25 percent in 1985 to 17 percent by 1997, reflecting the country's increased openness to trade. As a result of these flows and trade reforms, real gross domestic product (GDP) grew by 5.1 percent in 1996 and by 5.9 percent in 1997.

Red tape and inefficient services constrain exports

Despite its reforms, Egypt has yet to take full advantage of the potential of trade liberalization. The country has many advantages to exploit in producing manufactured exports, including a convenient location and wages that are one-tenth those in Israel or Tunisia. Given these positive factors and its duty-free access to European markets, the country was expected to increase its manufactured exports rapidly.⁴ Manufactured exports (in 1992 prices) did increase, but slowly, rising from \$1.4 billion in 1988 to an estimated \$2.4 billion in 1996—still only about 17 percent of total goods and services export revenues.

Box 8.2 The Arab Republic of Egypt at a glance

	Egypt, Arab Rep.	Middle East and North Africa	Lower- middle- income countries		
<i>Poverty and social indicators</i> ^a					
GNP per capita (U.S. dollars) ^b	1,180	2,060	1,230		
Poverty (percentage of population below \$1 per day)	7.6		
Urban population (percentage of total population)	45	57	42		
Life expectancy at birth (years)	66	67	69		
<i>Key economic ratios</i>					
	1976	1986	1996	1997	
Gross domestic investment/GDP	28.4	23.7	16.6	17.7	
Exports of goods and services/GDP	22.3	15.7	20.2	20.2	
Gross domestic savings/GDP	16.7	13.8	10.8	13.0	
	1976–86	1987–97	1996	1997	1998–2002
Average annual GDP growth	7.1	4.0	5.0	5.5	5.2

Year	Exports	Imports
1991	4,500	10,000
1992	4,500	9,500
1993	4,500	10,500
1994	3,500	10,500
1995	5,000	12,500
1996	4,500	13,500
1997	5,000	14,000

..Not available.
a. Data shown are from the latest available year within the range 1991–97. *GNP per capita* figures are from 1997.
b. Calculated using World Bank *Atlas* method.
Source: World Bank, *World Development Indicators*, 1999.

One reason for this sluggish growth is the inefficiency of services, which raises the price of inputs and transactions costs to exporting firms and undermines their competitiveness.⁵ For example, the four main Egyptian ports (Damietta, Port Said, Dekheila, and Alexandria) are essentially state monopolies, and their service charges are three times those of their closest competitors. Container freight rates to Egyptian ports are generally 15 to 20 percent higher than rates to other Mediterranean ports, and air freight rates to and from northern Egyptian cities are twice those to cities in Israel.

In addition, all trade transactions are subject to an onerous bureaucratic burden. A 10 percent sales tax is applied to all commodities, including inputs to goods produced for export, making it harder for firms to sell abroad at competitive prices. A process does exist for refunding import tariffs on inputs to goods for export, but it involves four forms, a letter, a permit, and two separate committee reviews. Imports also face delays, as all goods must go through multiple clearance, licensing, and inspection procedures that impose a cost estimated as equal to an extra 15 percent tariff. Each Egyptian customs official clears an average of \$600,000

worth of imports a year; in Singapore the average is \$666 million a year.⁶

The government has begun to reduce bureaucratic delays and charges and lower transportation costs.⁷ But further reform remains essential. For example, the customs system could be improved in a number of ways, including the following: bringing in international inspection firms; accepting valuations of imports based on invoices, rather than having the customs service value items; focusing tests of imported goods on safety, which is a legitimate concern, not on quality, which can be better judged by the ultimate buyer; and accepting international standards of certification.

Local transportation networks also have to be strengthened. Private competition should be introduced in port handling, a move that has reduced shipping charges by as much as 50 percent in Mexico and Chile. The build-operate-transfer contract offered to the private sector for the expansion of the Cairo inland port of Athr al-Nabi and the construction of two new specialized ports are encouraging steps in this direction. New projects are on the drawing board to improve road transportation, including an upgrade of the Mediter-

anean coastal road as part of the North African coastal road (which will eventually link with Europe's road network via the Gibraltar crossing). A 113-kilometer Greater Cairo Ring Road is also under construction, but there is still much room for improvement, as the high incidence of traffic fatalities indicates—44 deaths per 100,000 kilometers driven.

Nontrade constraints on foreign direct investment will also have to be eased. At the moment, entry into a market requires government approval. Moreover, restrictive labor laws make exit expensive, which discourages firms from entering markets in the first place. Surveys of firms suggest that about 30 percent of managers' time is devoted to coping with regulatory demands. Removing these regulatory impediments, especially those that discriminate against foreign investors, is crucial if a country is to increase investment rates, as chapters 3 and 6 emphasize.

Further trade reform

In Egypt dissatisfaction with export performance has led to renewed interest in trade reform. But entry into some form of preferential agreement with the EU requires careful assessment. As noted earlier, Egyptian exporters have had duty-free access to EU markets for industrial goods since the 1970s. Egypt is currently negotiating a European-Mediterranean Agreement with the EU that would seek to liberalize trade in other ways. However, there are different types of preferential agreements with the EU, not all of which would benefit Egypt.

A first option is for Egypt and the EU to eliminate their tariffs on imports of goods from one another. Such an agreement could lead Egyptian importers to shift their purchases away from the most efficient foreign supplier to EU firms whose cost of supplying the Egyptian market is artificially lowered because they pay no tariffs. Indeed, one analysis suggests that such an agreement could actually reduce Egyptian welfare by the equivalent of 0.2 percent of GDP. In contrast, full unilateral elimination by Egypt of such tariff barriers would benefit Egypt.⁸ A preferential liberalization that is confined to tariffs on goods offers little to developing countries, especially when compared with unilateral elimination of tariffs on goods trade.

However, a preferential trade agreement that includes liberalization in goods, harmonization of standards, and greater access to service markets can offer substantial benefits to developing countries such as Egypt. As services are used extensively as inputs in the export sector,

measures taken to enhance competition in the service sector, such as permitting foreign direct investment, can improve the productivity of many industries further down the stream of production. Furthermore, to the extent that such an agreement reduces regulatory barriers to Egyptian exports (because those exports now comply with EU health, safety, and product standards), the benefits could be as much as 1.8 percent of Egyptian GDP.⁹ Even further gains will accrue to Egypt if enhanced foreign investment enables its firms to fuse into the global production networks of European firms.

Only a comprehensive trade reform agenda that tackles red tape and brings down barriers to trade and investments in goods and services will benefit Egypt. A broad preferential trade agreement with the EU would enable Egypt to harmonize its domestic regulations with those of its major trading partner. But such an agreement is no substitute for Egypt's full participation in the forthcoming Millennium Round of World Trade Organization (WTO) negotiations, which holds out the promise of multilateral reform in services and agriculture.

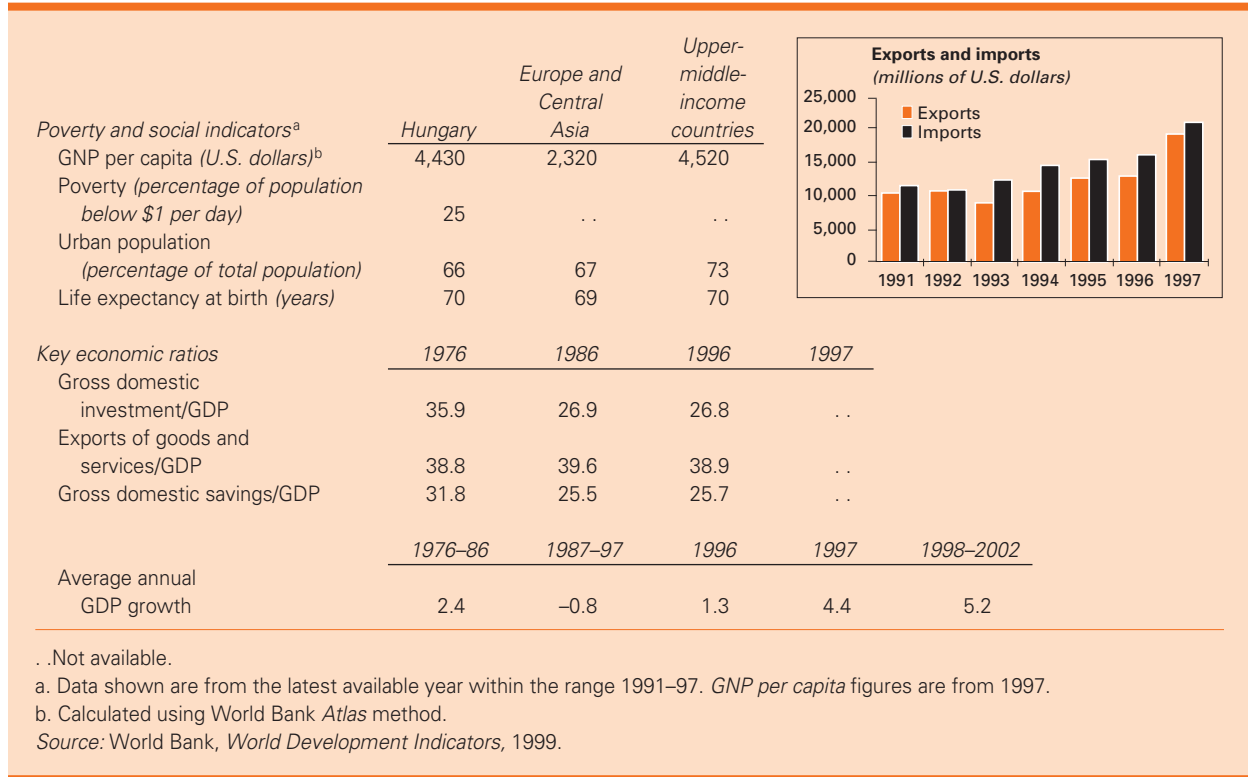
Reforming weak banking systems: Hungary

The many banking crises in developing countries over the last several decades—with their deleterious consequences for poverty reduction, social stability, and growth—illustrate the importance of a sound regulatory framework for banks. The need becomes all the greater as capital flows move freely across national borders and as the number and complexity of financial instruments available to banks expand. Making progress toward a strong independent bank regulatory regime, as described in chapter 3, should be a primary concern for policymakers in developing countries. Hungary's progress points to several lessons of wider applicability—and to the challenges facing countries that have inherited state-run banking systems with substantial bad debts (box 8.3).

In the last 10 years Hungary has dramatically transformed its banking sector. Once dominated by insolvent government-owned institutions, the sector now has many privately owned banks and is oriented toward serving a market economy. Hungary made this transformation as part of a radical restructuring of the economy aimed at replacing socialist principles with a private market system.

Hungary's experience illustrates three recommendations from chapter 3. First, it demonstrates the need to strengthen bank supervision and to insulate it from gov-

Box 8.3 Hungary at a glance



ernment interference. The inability of Hungarian banking supervisors to take early action against banks with deteriorating loan portfolios worsened the country's banking difficulties. Second, Hungary's experience supports the case for complementing regulatory reforms with private sector monitoring of banks. Hungary strengthened its monitoring capabilities by reforming the public deposit insurance scheme, improving corporate governance of banks, and mandating the issue of subordinated debt. Third, Hungary's experience demonstrates that foreign participation in national banking systems need not wait until domestic banks have been strengthened. A recent analysis has suggested that foreign participation in transition economies' banking systems has tended to improve their performance.¹⁰

Initial reforms

When the Berlin Wall fell in 1989, Hungary was slightly more advanced in banking reform than its East European neighbors. But the government still faced many of the same problems as they did. Most of the banking sector was in public hands, and its assets were dominated by directed loans to state enterprises.¹¹ As a

result of the breakup of the Council of Mutual Economic Assistance (COMECON) and the collapse of the Soviet Union, Hungarian firms lost 60 percent of their export market. Many enterprises were unable to adjust to the competitive pressure of a liberalized import regime, which pitted them against both domestic and foreign firms. As a result, enterprise arrears to banks skyrocketed, endangering the banking system.

Hungary's early attempts at bank reform were tentative.¹² The government began by creating a two-tier structure in 1987, shifting the corporate banking business of the National Bank of Hungary to three newly formed commercial banks. The number of banks (excluding deposit associations and innovation funds) expanded from 8 in 1986 to 30 in 1990 as a result of new entry and the conversion of small, specialized financial institutions into commercial banks. The market share of the four largest commercial banks fell from 58 to 48 percent between 1987 and 1990. But large institutions continued to dominate the banking sector. Together with the government-owned national savings bank, the five largest banks accounted for 82 percent of total assets in 1990.

In 1991 the government introduced a new regulatory framework based on market-oriented principles.¹³ The 1991 banking act introduced prudential concepts, Bank for International Settlements (BIS) regulations on provisioning, and limits on exposure. The accounting act introduced international accounting standards. The new bankruptcy code prohibited banks from simply rolling over unpaid loans at maturity and forced them to provision fully for their losses.

While these reforms were enacted, they were not always enforced. Nor did they address the immediate problem of bank insolvency. Government-owned banks were burdened by nonperforming loans, including many inherited from the former regime and some more recent loans to state-owned enterprises. Under the terms of two workout programs in 1991–92, the government took over about \$1 billion, or 90 percent, of the banks' nonperforming debt.

Unfortunately, this debt relief was provided unconditionally. Banks receiving funds were not forced to modernize, the same managers remained in place, and regulations were not enforced. As a result, bank managers continued to believe that the government was ready to provide unconditional relief to any bank in trouble. Not surprisingly, poor lending practices continued.

In 1994 the government decided to go one step further and privatize the banks. To make the banks salable, it had to inject about 9 percent of GDP into the banking system. Banks were recapitalized to meet BIS standards by the end of 1995. In each troubled bank, loans were separated so that a core bank with a solid portfolio could be readied for privatization. Unlike the bailouts of 1991 and 1992, this plan stipulated that banks receiving state funds modernize their systems of control and operation, replenish the funds they held in liquid form against the risk of loan defaults, and adopt best practices in loan appraisal, risk assessment, and asset clarification. In some cases senior bank managers were replaced.

When privatization started in 1994, foreign banks purchased many Hungarian banks. Between 1994 and 1998 foreign ownership in Hungary's banking sector increased from 15 to 60 percent, while direct state ownership of the sector fell from 67 to 20 percent. Privatization appeared to have the desired effect on bank performance. MKB, the first large bank to be privatized, saw its income triple, the number of branches double, and its staff shrink from 1,800 to 1,240. Returns on bank assets increased from 0.5 to 1.0 percent in

1994–98, and doubtful loans as a proportion of assets dropped from 20 to 3 percent in 1993–97. Margins on loans also began to fall with increased competition—from 7 to 5 percent in 1998.

But Hungary's banking system faces continuing challenges. For example, problems remain in enforcing regulations on domestically owned banks. Two such banks failed in 1998. One was the second biggest in Hungary; it appears that its management was largely unconstrained by a dispersed local ownership, believed that it was too big for government to allow it to fail, and so lent recklessly. Regulators were slow to act, despite a bank run in February 1997. Rather than force prompt corrective action, the government provided cash infusions and suspended capital requirements. Only in June 1998 was the management replaced and in-depth restructuring begun.

Future reforms

This episode, in which it took more than a year after a bank run to restructure a bank, originated in part in legal impediments on the power of the supervisory authorities. The Basle Accords core principles suggest that banking supervisors should have the legal authority to issue and enforce the regulations necessary to maintain the soundness of the banking system. But in Hungary the Ministry of Finance—rather than banking supervisors—had exclusive power to issue regulations. Moreover, the supervisory authority appeared constrained in its ability to take appropriate disciplinary actions. Because under current law disciplinary measures can only be taken on the basis of audited accounts, Hungary's bank supervisors could not respond quickly to regulatory infractions.

Strengthening the hand of banking supervisors will help the stability of the banking system, but traditional bank regulation may be insufficient by itself to forestall excessive risk-taking by banks. As discussed in chapter 3, countries should consider how to complement government regulation by stimulating private sector monitoring of banks, through such steps as improving the corporate governance of banks and mandating the issue of subordinated debt.¹⁴

If Hungary can take further steps to reduce regulatory forbearance and build a greater role for private sector monitoring of banks, then the country will be well on its way to cultivating a first-class banking system. At a fundamental level, Hungary has looked outward to find solutions to its banking problems. It has recog-

nized the value of adopting and enforcing international banking standards, while increasingly resisting bank bailouts to politically connected insiders.

The Hungarian experience offers pointers for other transition countries, especially in Eastern Europe. Given the central role that banks play in transforming both domestic and international flows of savings into growth-enhancing investments, the payoff to a sound banking system will reach far beyond minimizing the risk and costs of banking crises.

Macromanagement under fiscal decentralization: Brazil

In the early decades of the 21st century, demands for greater local political autonomy will mold the political structures of developing countries. Policymakers will have to manage the process of reallocating rights and obligations to different tiers of government. Brazil's experience with decentralization, which resulted in a series of intergovernmental fiscal crises, highlights the difficulty of managing the politics of fiscal decentralization in a period of democratic and economic transition. It also confirms three of chapter 5's policy recommenda-

tions: first, that the decentralization of revenues match the decentralization of expenditures; second, that central governments maintain a hard budget constraint in their dealings with subnational governments; and third, that constitutional mandates, particularly electoral rules, be in place so that the first two measures can be enforced (box 8.4).

Formal decentralization

In 1988 Brazil's first postmilitary constitution sought to decentralize political power. Power at the federal level is now divided among the executive, legislative, and judicial branches. The president, who heads the executive branch, is elected by direct popular vote for a four-year term. Congress has two houses—the Chamber of Deputies, in which each state receives a certain number of seats according to its population, and the Senate, in which each state has three senators.

In principle, the constitution gives the president considerable powers over the legislature. The president has the exclusive right to initiate legislation in some policy areas, including those that create jobs or increase salaries in many parts of the public sector. The presi-

Box 8.4 Brazil at a glance

	Brazil	Latin America and the Caribbean	Upper-middle-income countries			
<i>Poverty and social indicators^a</i>						
GNP per capita (U.S. dollars) ^b	4,720	3,880	4,520			
Poverty (percentage of population below \$1 per day)	17			
Urban population (percentage of total population)	80	74	73			
Life expectancy at birth (years)	67	70	70			
<i>Key economic ratios</i>						
	1976	1986	1996	1997		
Gross domestic investment/GDP	23.1	19.1	20.7	22.8		
Exports of goods and services/GDP	7.0	8.8	7.1	6.2		
Gross domestic savings/GDP	20.7	21.6	18.6	20.6		
	1976–86	1987–97	1996	1997	1998–2002	
Average annual GDP growth	2.9	1.9	2.8	3.2	3.5	

Year	Exports	Imports
1991	28,000	18,000
1992	32,000	22,000
1993	35,000	25,000
1994	40,000	30,000
1995	45,000	35,000
1996	48,000	38,000
1997	52,000	42,000

.. Not available.
a. Data shown are from the latest available year within the range 1991–97. GNP per capita figures are from 1997.
b. Calculated using World Bank Atlas method.
Source: World Bank, *World Development Indicators*, 1999.

dent alone prepares the annual budget and must seek congressional approval for it. The Congress is restricted in the kinds of amendments it can propose to the budget, and it cannot initiate programs or projects not included in the president's budget.¹⁵

In practice the president's power is circumscribed by the difficulty of marshaling support in a political system with so many parties (15 are represented in the Congress) and weak party discipline at the national level. The electoral system, and particularly proportional representation, are partly responsible for this multiplicity of parties. Candidates for the Chamber of Deputies run at large in each state rather than facing off in single-seat districts, so small parties must scour an entire state to obtain enough votes to win a seat or two. Strong state loyalties lead politicians to form alliances in support of projects that will benefit their own state, regardless of their party. Sitting state governors command the loyalty of federal deputies, since the governor's support is more useful in their campaigns than the president's. Because of their influence over deputies and senators in their party, state governors can thwart or propel presidential designs.¹⁶

The constitution sets up a three-tier governmental structure consisting of the federal government, 26 states (plus a federal district with the status of a state), and about 5,500 municipalities. States elect their governors directly and have unicameral legislatures, with the members elected at large by proportional representation. This structure is repeated at the municipal level, with mayors elected directly and municipal councillors elected at large. The constitution gives subnational governments broad but vaguely defined powers and creates no real boundary between them. It grants states "all powers not otherwise prohibited to them by the constitution" and municipalities "the power to provide services of local interest." Since the constitution makes the municipal authorities the third tier of government, states have no power over the actions of the municipalities within their jurisdictions.

Although the constitution is vague about the division of responsibilities among levels of government, it divides up revenues very explicitly. It assigns specific tax bases to each level of government and creates a system of tax sharing that substantially redistributes revenue among both the levels of government and the regions.¹⁷ The tax-sharing system has two major components. The first consists of fixed shares of the federal government's two principal taxes—the income tax and the industrial products tax—which are distributed according

to a set formula to states and municipal governments. The second involves the state value added tax (VAT), which state governments must share with the municipalities in their jurisdictions. Consequently, the municipal share of net tax revenues after transfers increased by roughly 40 percent in six years, rising from 12 percent in 1987 to 17 percent in 1992.¹⁸

Although the 1988 constitution emphasizes decentralization, it does strengthen the central government's control in one essential area: personnel. It defines the rights of public sector employees at all three levels of government and provides employees with job and salary security. Governments cannot dismiss redundant civil servants or reduce nominal salaries. The constitution also gives public employees generous pension rights, which have been a factor in subsequent fiscal crises, since labor costs are a significant share of subnational expenditures.¹⁹ These controls exemplify the problem of overregulating subnational governments described in chapter 5.

State borrowing and the debt crisis

Decentralization in Brazil has resulted in a prolonged macroeconomic crisis sparked by the growing indebtedness of the states.²⁰ While the new constitution gives the national Senate the power to deny all subnational proposals for borrowing, the Senate has rarely done so. As a result, states and municipalities continue to borrow from a wide variety of sources. They have issued bonds on the domestic market and have borrowed from domestic private commercial banks and various federal intermediaries, including the federal housing and savings bank and the federal development bank. All but two of the 26 states own commercial banks from which they have occasionally borrowed. More frequently, they have forced these banks to lend to favored clients. States have also borrowed abroad, both from multilateral agencies (which demand federal guarantees) and from private lenders (which do not).

The debt crisis unfolded in three acts. The opening act was a legacy of the international debt crisis of the 1980s, when states—along with the federal government—ceased servicing their debt to foreign creditors. Once the government and creditors at the national level had reached an agreement, the federal government tried to induce the states to resume servicing their debt. In 1989 the federal government agreed to transform the accumulated arrears and remaining principal into a single debt to the federal treasury, rescheduling \$19 billion on these terms.²¹

The second act, which began in the late 1980s, involved the states' debts to federal financial institutions. It was resolved by rescheduling roughly \$28 billion in loans and transferring them to the federal treasury. But the federal government wrote an escape clause into the agreement. If the ratio of states' debt-servicing costs to their revenues rises above a threshold fixed by the Senate, the excess can be deferred and capitalized into the outstanding stock of debt. By rescheduling the principal and placing a ceiling on debt-servicing costs, these agreements considerably reduced the states' immediate burden. But the escape clause also made it seem that the federal government was prepared to provide debt relief to any state that required it.

The third act began in the early 1990s and revolved around defaults on state domestic bonds. Four large states do the most financing through bonds: São Paulo, Rio de Janeiro, Minas Gerais, and Rio Grande do Sul. Traditionally, the states' commercial banks underwrite these bonds, which are ultimately sold to private banks and investors. They generally have a five-year maturity date, with interest due then. Ironically, the bond crisis was precipitated by the considerable success of the government's stabilization plan, the Plano Real. The plan dramatically reduced inflation, so states could no longer count on inflation to reduce real salaries and pensions over time.²² As a result, state governments soon found themselves with payrolls equal to 80 or 90 percent of their revenues.

As state finances became more precarious, private banks began increasing their interest rates and shortening the length of time they would hold bonds. Ultimately, private banks declined to hold state debt at any price. The states found themselves unable either to pay or to reschedule their debts and sought relief from the federal government, which authorized them to exchange their bonds for more readily marketable federal bonds. But with the interest rate on federal bonds hovering at 25–30 percent in real terms, the stock of bond debt exploded by \$12 billion in 1995 and by another \$10.7 billion in 1996. At the end of 1996 the stock of state (and municipal) bond debt stood at \$52 billion. The heavy interest obligations on this growing stock of debt, combined with the states' inability to reduce personnel costs or raise revenues, has resulted in growing state and municipal deficits. From a surplus of 0.7 percent of GDP in 1992, the operational balance of state and municipal governments fell to a deficit of 2.3 percent of GDP in 1997—52 percent higher than the federal government deficit.

Negotiations to resolve the debt situation began in mid-1995 with three parties: the federal Congress, the president and his economic team, and the states. But not until December 1997 did the first major debtor state, São Paulo, sign a binding agreement with the federal government. The other major debtor states followed over the next nine months. In general, the agreements followed the pattern of the two previous debt agreements. Debt was rescheduled rather than written off, and a debt service ceiling was imposed above which costs could be capitalized into the stock of debt. The main innovation of the new debt agreements is a large interest rate subsidy. Rather than requiring subnational governments to pay the existing interest rate on federal bonds, the federal government agreed to impose a fixed real interest rate of 6 percent.

With each debt workout, the federal government has tried to tighten the regulations on state borrowing. States benefiting from debt rescheduling are required to permit the federal government to deduct debt service from intergovernmental transfers. New federal lending to states currently in default is prohibited. The constitution has been amended to prohibit the issue of new state bonds until 2000, and the central bank does not allow private banks to increase their holdings of state debt. These federal regulations have not been enough to forestall the most recent act of the debt crisis that started in 1999, since most of the recent growth in debt stems not from new borrowing but from the capitalization of interest on existing debt.

The macroeconomic effects of the rescheduling agreements have been limited. Although the agreements lowered the interest rates the states pay, the federal government continued to be the states' creditor and to pay the actual cost of borrowing funds. The interest rate paid by the public sector as a whole has not declined. The terms of the agreements, moreover, have not been enough to forestall the capitalization of interest on debt owed to the federal government. State debt has continued to grow, so the agreements have not reduced the aggregate interest costs paid by the public sector. They have merely shifted more of the interest costs to the federal treasury.

What can be done?

Some aspects of the solution to this financial and intergovernmental crisis are not hard to identify. Initially, the federal government must address the underlying source of the debt crisis by finding a way to control personnel costs, which consume 80–90 percent of current

revenues. Reducing these costs will require eliminating the controls on state personnel policies mandated in the 1988 constitution, so that states can dismiss redundant staff, negotiate salary reductions, adopt stricter criteria for retirement, and reduce pension benefits.

The government must also act to eliminate the expectation of federal bailouts. The first bailout signaled states and their lenders that the federal government was ready to step in to rescue debt-ridden local governments. While some lenders may actually have believed their borrowers were creditworthy, they also believed that the federal government would make good on state obligations if the stability of the financial system were threatened or a breakdown of services in a major state loomed. This implicit federal guarantee permitted states to continue to borrow well past the point at which they had the means to service their debts.

The current federal regulations to limit subnational borrowing are clearly not sufficient to counteract this expectation. But the states cannot borrow unless someone is willing to lend to them. If private lenders are convinced that the federal government will not bail out defaulting states, the lenders themselves will act as a source of restraint.²³ Convincing lenders that no federal bailout will be forthcoming requires more than a statement of intent, particularly given Brazil's recent history of bailouts. The federal government needs to demonstrate its commitment by allowing a state government to default and leaving the lender and the state to work out a settlement. Once private lenders are persuaded that financing subnational governments carries real risks, they are likely to restrain their lending despite the supplications of state governors. Establishing a constitutional restraint on the federal government's ability to lend to the states will enhance the credibility of this policy.²⁴

Softening federal mandates on subnational personnel policies and hardening the budget constraint on subnational borrowing will help to forestall future debt crises. But ultimately, sustainable reform requires changing the political circumstances that gave rise to these policies. The distribution of power between the president and the legislature needs to be reexamined, along with the electoral rules that result in such a high degree of party fragmentation and lack of discipline. Several measures discussed in chapter 5 are especially relevant to the Brazilian case. To make it harder for interest groups from the states to conspire against the whole, the office of the president must be strengthened, perhaps by requiring a supermajority to override a presidential veto.

Since the height of the debt crisis, Brazil has taken several positive steps. In 1998 the Congress approved a constitutional amendment that would allow states to dismiss staff (provided their personnel spending exceeded a certain percentage of state revenues). In 1999 the government responded to one state's much-publicized default on rescheduled debt by exercising its new authority to deduct the overdue debt service from federal-to-state transfers. Later in the year the Congress opened debate on a proposal to change the electoral rules for the lower house, replacing the current system of proportional representation with one in which half the seats would be filled from single-seat electoral districts. The first two of these actions will go a long way toward providing states with the means and incentive to respond to fiscal pressures without resorting to default. The third, if it functions as its advocates anticipate, may reduce party fragmentation and strengthen the government's ability to resist appeals for bailouts.

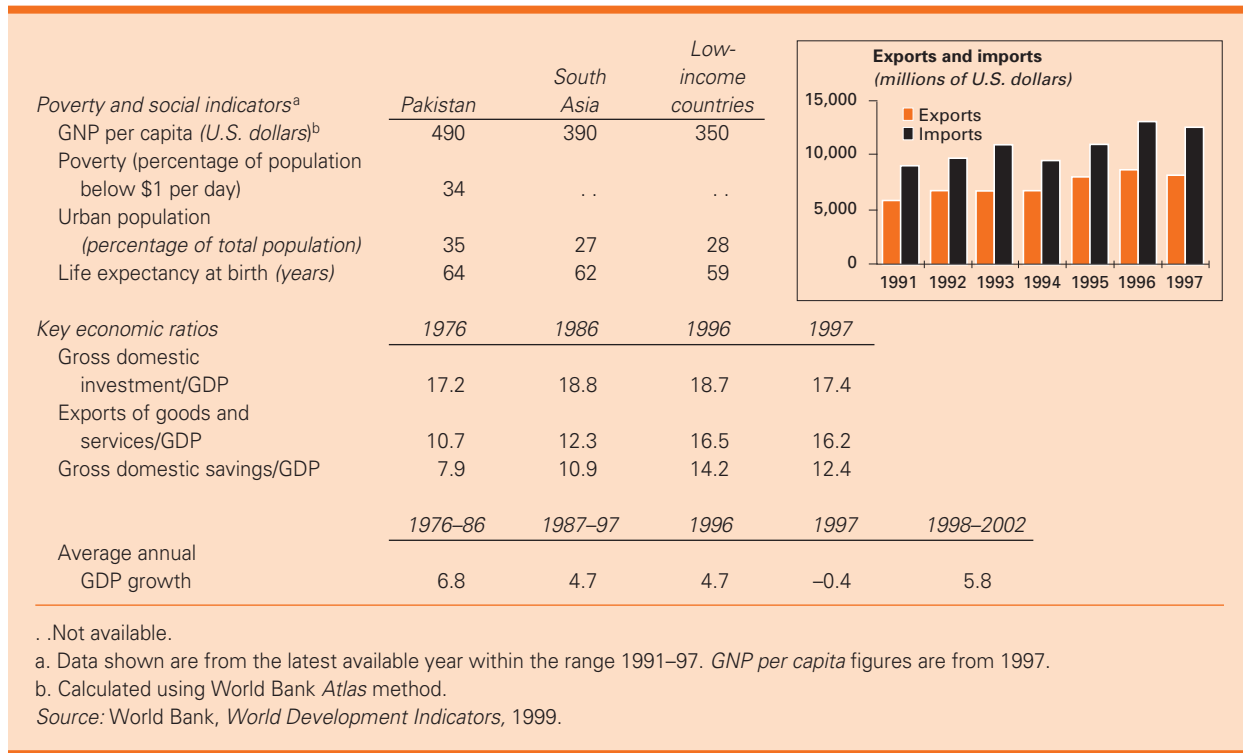
Improving urban living conditions: Karachi

The explosive growth of urban populations in developing countries will challenge the capacity of society to improve urban living conditions. This case study suggests how the recommendations of chapter 7 concerning the provision of municipal services can be translated into action in Karachi, Pakistan's major metropolis.²⁵ Karachi is representative of many large cities in developing countries where the public sector has had difficulty coping with rapid urban growth. It shares many characteristics with Bombay, Istanbul, Jakarta, and Lagos, though the reasons for the difficulties in providing services differ from city to city. As chapter 7 recommends, in Karachi the public sector needs to tap the knowledge and dynamism of the rest of society through partnerships with private enterprise, community groups, and nongovernmental organizations (NGOs). With their support, the public sector can focus on those services only it can provide, including land titling, appropriate building and development regulation, and trunk infrastructure for water, sewerage, and roads.

Karachi today

Karachi's 11 million people account for around 8 percent of Pakistan's total population and a quarter of its urban population (box 8.5). The city grew rapidly after the massive migration that followed the partition of British India in 1947, putting severe stress on the housing market.²⁶ The public sector, which owned most of

Box 8.5 Pakistan at a glance



the land in and around Karachi, reserved for itself the dominant role in land development. Regulations on land development drove up the cost of new housing by mandating large plot sizes, making generous allocations for rights-of-way, setting high on-site infrastructure standards, and mandating costly building materials. This excessive regulation priced most households out of the market. Delays in extending trunk infrastructure—roads, piped water, and sewerage—limited the supply of land with access to those services and raised still further the prices of plots that already had them. These constraints on the supply of housing interacted with constraints on demand, especially the inability of low- and middle-income households to obtain mortgage financing. The result has been an informal, unplanned, and unregulated system of housing development.

From 1970 to 1985 the informal sector managed an estimated 33 percent of all residential land conversion and development in the metropolitan region and met more than 50 percent of the city's housing needs. Although Karachi needs an estimated 80,000 housing units each year, between 1987 and 1992 an average of only 26,700 building permits were issued yearly. The informal sector created about 28,000 units each year in

unplanned settlements termed *katchi abadis*, in which half the city's people now live. The population of *katchi abadis* has grown at an annual rate of 9 percent, nearly twice the city's overall population growth rate of 4.8 percent. Densification of existing housing in inner-city areas and illegal construction in the suburbs have met the rest of the housing gap.

A supporting industry has emerged in connection with *katchi abadis*. Unregulated land developers obtain land—often in collusion with government development authorities—and divide it into plots that are sold to individual households. Such middlemen illegally acquire at least 1,000 acres of state land every year in Karachi and use it for informal housing. Water distribution is controlled by the so-called “water mafia,” which takes water from various water hydrants and distributes it by truck. Even high-income areas regularly have water delivered by tankers. A 1,200-gallon tank sells for Rs. 200 (\$3.40), and the price per unit increases for water sold in smaller quantities to households unable to afford the money or storage space for larger amounts. Over time, low-income neighborhoods acquire trunk water connections by lobbying their representatives on the municipal council or by collecting

money and bribing public officials. Alternatively, the supply can be arranged by the land developers, who create illegal connections to the public piped network. Communities often collect money and lay internal water supply networks at their own cost.

Katchi abadis also arrange their own wastewater disposal. A survey of 136 katchi abadis in Karachi comprising 79,426 houses and 8,479 lanes shows that these communities have laid sewer lines in 82 percent of the lanes at an estimated investment of Rs. 200 million (\$3.4 million). In Orangi township, 88,211 houses in 5,856 lanes have built their latrines, lane sewers, and over 400 collector sewers with an investment of Rs. 74 million (\$1.5 million). At public sector rates, this construction might well have cost nearly 10 times as much.

A massive informal sector is far from the optimal approach to housing shortages. Because households obtain their land through irregular channels, they do not own their primary asset and cannot use it as collateral to finance housing construction. The insecurity of their property rights undermines what should be a natural incentive to invest in property and infrastructure. Economies of scale do not exist for the delivery of essential services because services are provided piecemeal (and sometimes illegally). Facilities are often of questionable quality because the informal sector does not have the necessary technical capacity. And the illegal dumping of wastes and inadequate treatment of sewage lead to increasingly dangerous health conditions. Sewage remains a particular problem in the informal settlements, which often discharge it into open natural drains. Community-built sewerage systems are seldom integrated into official sewerage system plans. If they were, the costs would be dramatically reduced, the projects would be completed in a fraction of the time it takes to complete them now, and the poor, not the contractors, would be the beneficiaries.

Governments have so far been indifferent, if not hostile, to the katchi abadis even though they house half the city's population. The rationale is that katchi abadis are a transitory phenomenon. Formal plans and projects ignore the existing investment in these communities on the assumption that the government will ultimately provide high-quality standard solutions. Community-based organizations and NGOs have pressed for a change in policy, but official responsibility for housing is fragmented among overlapping city, provincial, and federal agencies, making concrete action difficult.²⁷

The path to reform

What institutional changes and arrangements would yield the most favorable outcomes, given Karachi's condition today? As a key first step, the government needs to recognize that what exists on the ground is not a temporary situation, but a reality. The katchi abadis represent the starting point for thinking about Karachi's future. These vast community investments in housing and infrastructure are part of the city's future, and wiping them out in order to start again from scratch is simply not feasible. Thus, any housing plan the government puts forward must take the informal communities into account.

The government must also nurture—and ultimately institutionalize—positive interactions among government agencies, interest groups (formal and informal), and communities. Currently, there is little trust among the various actors in the housing drama, especially between the government and organizations representing low-income households. These groups have the most accurate knowledge of housing conditions and are well positioned to articulate residents' needs. Working with them will help ensure that housing priorities are met, but the groups need access to good information if they are to function effectively. An additional method of reestablishing trust is to rationalize the overlapping responsibilities of municipal, provincial, and federal agencies in order to strengthen accountability at each level.

Overregulation of the housing market has resulted in Karachi's current unworkable system of housing provision. This system needs to be replaced by one that incorporates legitimate private construction firms into the market for low-income residents. Standards for subdividing and building, for example, should be made more realistic. While housing must meet public health and safety requirements, it need not be so elaborate that it unnecessarily raises the price of housing out of the reach of low-income people.

The public sector, for its part, should confine its role in the formal system of housing production to areas in which it has a comparative advantage. The first of these areas is property rights. The government should pursue title adjudication and improve the administration of property registration systems. The second area is trunk infrastructure. Karachi needs new water and sewer lines and trunk roads that will connect the tertiary networks already existing in the katchi abadis to existing public infrastructure. The third area is housing credit. The

government can improve housing prospects for low-income residents by allowing them to apply for credit collectively. Community groups able to make an acceptable down payment on land can be an important source of infrastructure development. Once they have acquired title to the land, they can use this asset as collateral for infrastructure loans.

These three measures can reduce the cost of new and tenured housing with access to essential services. But the government must also address the current problems of the *katchi abadis*, possibly by adopting the model of development offered by the Orangi Pilot Project described in chapter 7.²⁸ This model reduces the cost of internal development to about 10 percent of conventional planning costs and makes maintenance and operation feasible. It is socially acceptable and can be upgraded over time. The city can design future infrastructure that incorporates community-built facilities into the overall network. It can also provide technical advice to the informal contractors, perhaps through certification processes to upgrade their skills.

For water supply, the government could consider formalizing the *de facto* privatization that has already occurred. Rather than attempting to extend its water networks into informal settlements, the Karachi water authority might be better off considering competitive wholesale water concessions. Paraguay's experience shows that when small private providers are allowed to operate competitively in a stable environment, truckers will eventually find it in their economic interest to progress to piped distribution (chapter 7). In the meantime, however, private providers can better tailor their services to the socioeconomic and physical characteristics of the neighborhoods they serve.

Over time, these measures can transform Karachi's housing market. As the cost of formal housing declines, the proportion of households relying on the informal system of housing production will fall. And as governments take a more supportive approach to *katchi abadis*, the number of households lacking secure tenure and trunk infrastructure will decline as well.

Cultivating rural-urban synergies: Tanzania

Of all the developing regions, Sub-Saharan Africa has registered the weakest overall growth in the last 15 years. The area has become increasingly marginalized in the global economy, and its debt burden as a share of GDP is now the heaviest of any region. Sub-Saharan Africa is

also experiencing the fastest increase in its urban population. The prognosis for the continent, having brightened briefly in 1995–97, once again looks uncertain, however. For the typical, predominantly rural African economy such as Tanzania, globalization and urbanization open a small window of hope (box 8.6). How can Tanzania exploit these forces to galvanize its rural economy and make it an engine of growth for a country whose GDP is currently rising at 3–4 percent per year?

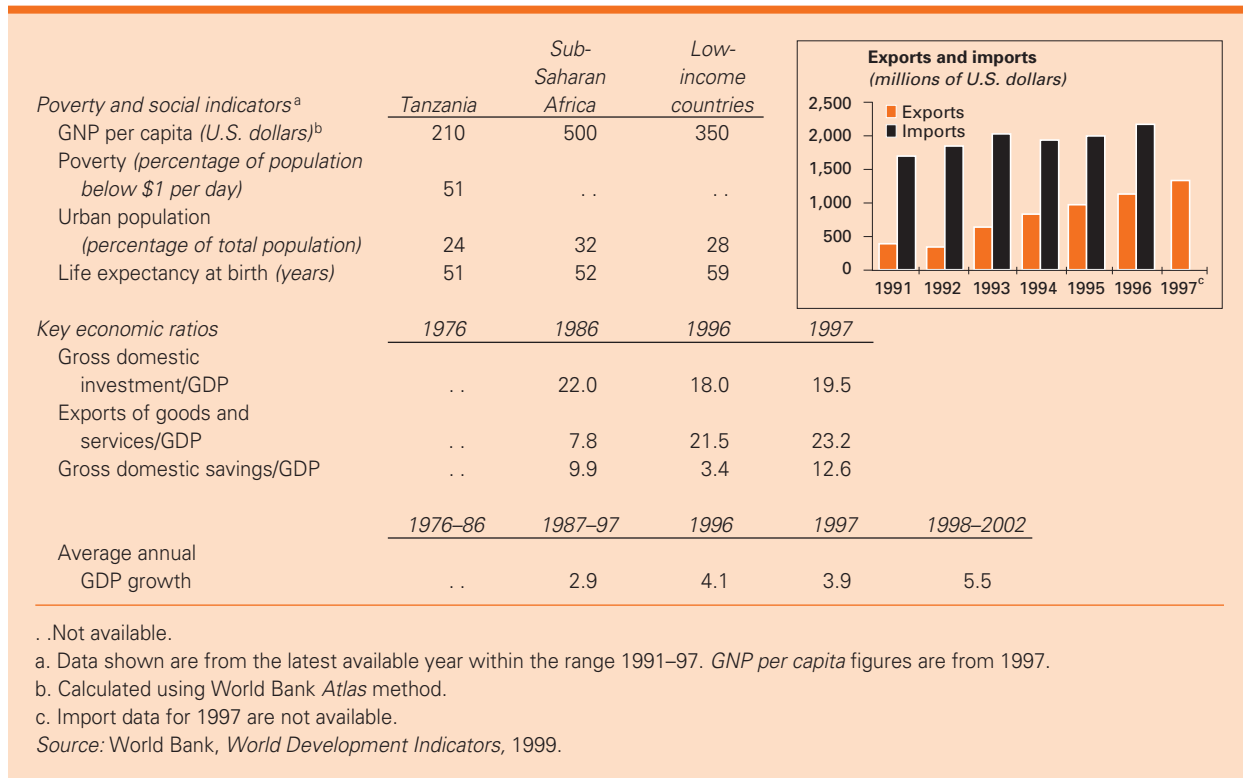
Initial conditions

Three-quarters of all Tanzanians live in rural areas, and agriculture accounts for over 50 percent of the country's GDP. Most farming is traditional land-extensive, low-input, subsistence agriculture. Agricultural production has increased in recent years, largely because farmers are cultivating more land (yields are low and have stagnated for almost three decades). Manufacturing contributes a bare 7 percent of GDP, a share that has declined over the past two decades as tariff barriers have been removed and the public sector has withdrawn from some loss-making production activities. The main activities are food processing, and manufacture of building materials and paper and packaging, largely for the domestic market. Tanzania's exports consist of unprocessed agricultural products and minerals and have diversified little since the mid-1980s. Export crops, which are produced mostly by smallholders, account for only around 8 percent of agricultural production, although sales of cut flowers are rising. Apart from these items and commodities like coffee, tea, cashews, maize, cotton, and fish, the main foreign exchange earner is tourism, a significant source of income for the country. Over the medium term, exports of gold could overshadow income from cash crops.

In 1998 Tanzania attracted \$140 million a year in foreign direct investment, as against \$70 million in the mid-1990s, most of it going into mining and the balance into infrastructure for tourism. The privatization of banks and utilities is beginning to draw funds into some other sectors, such as telecommunications. Domestic savings and public sector resource mobilization are modest, as they are in most African countries. But investment, financed in part by international aid, is fairly high relative to GDP.

Tanzania's urban population is growing at about 5 percent annually—a rapid but not unusual rate, given the country's relatively low level of urbanization (figure 8.1). The six largest cities generate over one-third of

Box 8.6 Tanzania at a glance



GDP, with Dar es Salaam accounting for 17 percent. If Tanzania is to achieve and maintain growth rates of 7–8 percent over the next two decades (as it must to make substantial progress against poverty), more growth must come from its cities. However, given the preponderance of the rural sector, overall economic performance will depend upon the multiplying of rural-urban linkages, the commercialization of agriculture, and the spread of nonfarm activities. Currently, agricultural diversification and productivity are at low levels, and nonfarm incomes are below the average for the Sub-Saharan Africa region. But such development is most likely to flourish in the periurban areas and then spread to the hinterland, deriving impetus from markets and agglomeration economies in cities.²⁹

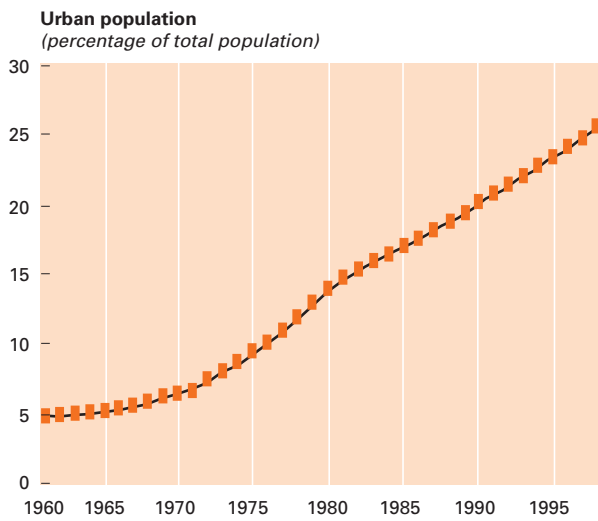
Urban-rural partnerships

How would an urban-rural partnership work? The experience of other low-income agricultural economies, such as China, Indonesia, and Vietnam, suggests four ways of improving the links between rural and urban areas that can help raise rural productivity. These include employing new technical and organizational

knowledge, expanding access to markets for agricultural produce, and harnessing new biological, chemical, and mechanical inputs. Tanzania can adapt these approaches by taking the following steps:

Step 1. Establish support networks that create trusting relationships between urban businesses and periurban and rural producers. With over 70 percent of its rural income dependent on agriculture, Tanzania has great scope for developing rural industry.³⁰ Furthermore, with only one-third of agricultural output currently marketed at all, rural-urban linkages have much to contribute to agricultural development. Tanzanian farmers lack information, infrastructure, transportation, and credit because of the small size and subsistence orientation of farming activities.³¹ In rural areas that are relatively close to cities, however, proximity to markets and information can help overcome these problems. Market transactions must operate against a backdrop of assurances that most of the time, obligations will be met, bills will be paid, goods will be delivered, and transactions costs will be manageable. Formal legal and insurance contracts are one mechanism for providing these assurances. But ties of ethnicity, religion, and kin-

Figure 8.1
The population in Tanzania
is increasingly urbanized



Source: World Bank, *World Development Indicators*, 1999.

ship are a source of social capital and support flexible production arrangements, subcontracting, and outsourcing schemes (see box 2). Such social networks flourish in eastern Nigeria along an axis that includes Aba, Nnewi, and Onitsha. In Nnewi, for example, members of the Igbo community have established a motor parts industry that relies on ethnic ties to reduce transactions costs.³²

Intermediaries with strong rural connections, play a large part in building such networks. Much depends on periurban-urban social relationships and on the willingness of urban business groups to reach out to the surrounding rural areas.³³ In such cities as Arusha and Moshi, an entrenched business elite—the Chaggas—may already possess a local network, along with adequate financing, that could serve as a basis for expansion. Likewise, Asian communities in Dar es Salaam, Lindi, and elsewhere could enlarge their marketing networks among the periurban villages. But a deepening of formal institutions that safeguard rights would supplement informal arrangements.

Step 2. Build infrastructure. A modern economy depends on efficient surface transportation and telecommunications, which link rural producers, service providers such as freight transporters and marketing firms, and urban businesses. In transportation, the government's imperative is to appreciably strengthen the road

system. Good roads are particularly needed in the immediate vicinity of the major urban areas in order to facilitate the integration of cities and the surrounding countryside. Only 12 percent of Tanzania's roads are in good condition, with the rest imposing excess vehicle operating costs equivalent to a third of export earnings in 1990.³⁴ The implications for the development of marketed crops are severe: in the past, when rising prices have resulted in a spurt in production, crops could not be moved because of inadequate transportation. As a result, farmers had difficulties selling their produce, and production quickly fell back again.³⁵

Improved transportation and communications are important not only because they will strengthen ties within Tanzania but also because they will link the country more closely with the global economy. To maintain close contact with foreign markets—and to ship and receive goods on exacting schedules—Tanzania's businesses need a well-managed infrastructure that keeps handling and user charges at seaports and airports to a minimum.³⁶ The same is true for international telecommunications rates. For Tanzanian exporters to compete effectively against suppliers in South Africa and South Asia, the country's infrastructure must deliver comparable services and charge similar rates. This requires the private sector to play a large role in building and operating the transportation, communication, and electricity infrastructure.

Step 3. Improve channels for agricultural and industrial research and extension services to bring new technology to the rural economy. The diffusion of technology, by private businesses, government research institutes, and the media, is vital to raising Tanzania's agricultural productivity, incomes, and demand for nonfarm products. It can also nurture processing and industrial activities in the belts around cities, where the potential returns from these activities are highest and most visible.³⁷

Specialized agricultural extension services managed from the top down have not worked well in East Africa.³⁸ But experience in other countries suggests that extension services can be made more effective. They must be client driven, customized to the needs of particular groups, and capable of delivering the newest technologies.³⁹ They must operate in areas with sound infrastructure, especially roads and electricity, ready access to modern agricultural inputs, and good market access, for example, in the vicinity of cities. These efforts must also be directed to those groups that are most likely to be innovative—that is, to groups that

have the educational level to exploit the opportunities new technologies present.

Providing effective research and extension services requires an understanding of the rural economy around cities, where the incentive to innovate is greatest. The services can then be oriented to the emerging periurban commercial agriculture with industrial linkages and can evolve with the changing economic environment. Trying to provide such services everywhere in the country will probably have a negligible payoff. But concentrating what capacity there is in areas where the scope for rural-urban synergy is greatest might create the dynamic clusters of growth that Tanzania so badly needs.

Step 4. Exploit the advantages of global business and intellectual linkages. Tanzania does have an indigenous business community connected to the Middle East, Europe, and South Asia (see chapter 1). But a history of government constraints on private sector activity has channeled much of the energies of this community into trade, wholesaling, and retailing activities.⁴⁰ Whether the objective is to encourage local businesses to expand and diversify or to make Tanzania more attractive to foreign investors, effective constitutional and legal rules are needed to safeguard property rights, enforce contracts, and reduce state interference.⁴¹ A free press can support these legal measures by acting as an agent of restraint and by helping enforce accountability of public as well as private bodies. The basic framework exists in Tanzania but lacks credibility in the eyes of investors, who recently ranked Tanzania as one of the world's most corrupt countries.⁴²

The progressive lowering of trade barriers will improve urban entrepreneurs' access to the equipment, inputs, and technology they need to build competitive business operations. But openness embraces more than free trade. It also involves subscribing to rules governing commercial codes, contracts, and individual rights. In this deeper sense, openness can reinforce the government's assurances to the business community on property rights and contractual agreements. It can also stimulate private domestic investment and increase the flow of foreign direct investment in industry.⁴³

A secure and open business environment is likely to lead to a reflux of skills from abroad and to generate the incentives that encourage individuals to acquire technical expertise. Several East Asian economies, after experiencing a brain drain from the 1960s through the early 1980s, established open and flexible business environments that drew back many of those who had left.

The entrepreneurship, knowledge, and capital from this reverse migration have helped these countries find new overseas markets. But reverse migration is at best a partial solution. Tanzania must expand its secondary education facilities and rebuild its tertiary education and research facilities. Tanzanian universities have been drained of talent and barely partake in the international commerce in ideas and research.⁴⁴ Strengthening the scientific culture and the competitiveness of universities are necessary steps to rapid and sustainable development in a globalizing environment where technology is one of the principal drivers.⁴⁵ For example, the promise of transgenic technology to enhance the yield and disease resistance of staple crops, such as maize, will only be realized by building the research base and biosafety regulatory capacity and by enforcing rules to protect breeders' rights. Without these, there is limited prospect that the country will participate as an informed stakeholder in the biotechnology business.⁴⁶

Laying the foundation for this new strategy requires political initiative. Tanzania's leaders must change the climate of opinion in the country, building a consensus among local and foreign businesses and following up their views with credible institutions. The government can signal its commitment to change by more actively pursuing privatization and transparent reforms in the banking industry.

Policies that support macroeconomic stability, liberalize the market, and build human capital should provide some of the conditions for future development in Tanzania. But Tanzania must do more in order to experience the kind of development that will substantially reduce poverty. The government needs to establish strong political and legal institutions that reduce the risk to local and foreign investors of doing business in the country. It must also invest in urban and periurban infrastructure, especially transportation and communication. Finally, by fostering openness the government can help create competitive markets, spread knowledge, and build human capital.

The shifting development landscape at the dawn of the 21st century

In 1990 many in the development community and elsewhere expected the raw vitality of market capitalism to lift billions of people out of poverty into a new era of sustainable development. These expectations have not been borne out. Some nations have achieved remarkable progress. But with nearly 1.5 billion people

living on less than \$1 a day and more than 2 billion on less than \$2 a day, the task is very far from completed.

Development policy is being rethought. The World Bank's Comprehensive Development Framework (CDF), this report, and the 2000/2001 report on poverty alleviation strive for better understanding of all aspects of development—drawing from experience and the forces that will shape the development landscape to provide pointers for the future course of development policy. This reexamination has been wide ranging. It suggests that no one element of development is above all others; no one future trend is all-encompassing; no one institutional or policy initiative is likely to be a panacea.

This report argues that two forces will significantly alter the development landscape in the early decades of the 21st century, with implications for how the development agenda can be tackled, who the relevant actors will be, and what forms their interactions are likely to take:

- *Globalization*—the continued integration of the world's economies through expanding flows of goods, services, capital, labor, and ideas and through collective action by countries to address global environmental problems
- *Localization*—the increasing demands of local communities for greater autonomy, which will be bolstered by the growing concentration of developing countries' populations in urban centers.

These forces interact in many ways. The urban centers discussed in chapters 6 and 7 have much to gain from the open world trading system of chapter 2 and the global capital flows of chapter 3. Foreign direct investment (chapter 3) will play a significant role in providing the needed urban services (chapter 7). Many more such connections have been drawn throughout the report. These disparate yet interrelated forces pose many challenges for the development process, each requiring a different type of institutional and policy response.

Three central implications for development policy

First, these forces underscore the *growing global interdependence across space, time, and issues*. The rapid spread of financial contagion from East Asia to the Russian Federation and Latin America in 1997–98 stands as a compelling testimonial to the growing interdependencies that can undermine economic growth and increase poverty.

The recognition that the health of a country's banking system can alter investor perceptions of the health of neighboring countries' banks has transformed the calculus of international cooperation. Yet, as chapter 3 pointed out, merely adopting common banking standards without adequately enforcing them is unlikely to restrain excessive risk-taking. Countries must not only adopt sound banking standards but must also devise institutional structures to ensure that these standards are enforced by insulating bank regulators from external pressures. They also need to consider establishing a system of regional surveillance of banking practices, as is taking place in the Manila Framework.

Some of the starkest examples of growing interdependencies appear in the discussion of the global commons in chapter 4. Although slow progress has been achieved in negotiating an agreement to substantially reduce greenhouse gas emissions, the growing recognition of the linkages among international environmental problems suggests that better policies and new institutions will be needed.

A second outcome of the forces of globalization and localization is a *more crowded development scene*. Nation-states will less and less be the sole agents for development. Instead, countries will increasingly act through multinational agreements, and through their interactions with multinational corporations, nongovernmental actors, and subnational entities, especially cities. Institutions and norms will have to evolve to define relations between these new actors and nation-states. This will have implications for the way global accords are negotiated, for how governments within a country manage central-local relations, and for how enduring partnerships are established within cities.

In describing the challenge of localization, chapter 5 offers suggestions for avoiding the pitfalls highlighted in the case study of Brazil. Chapter 7 points to the important role partnerships play in revitalizing cities and improving the quality of life for urban residents. Each of these developments requires new institutions that will accommodate the growing number of development actors.

Despite the new supranational and subnational challenges, governments will remain central players in the development process. National governments may well undertake fewer functions, ceding responsibility to other entities. But they remain the linchpin that holds the institutions of governance together. They alone can define the constitutional rules within their borders and shape their relations with each other.

The greater mobility of capital and labor between and within countries—and the potential competition among national, subnational, and urban governments for scarce resources—underlies the third implication of these forces: *the rewards for successful development strategies, and the punishments for failure, are likely to be greater and experienced more quickly than in the past.* For example, urban centers that provide stable property rights and an environment conducive to the accumulation of social and human capital can attract more foreign investment and more skilled migrants. The consequences of delays and partial, half-hearted attempts at reform, giving little thought to building long-term credibility, will become apparent much more immediately than in the past, as discussed in chapters 2, 3, and 6.

The central role of institutions

This report's focus on the institutions of governance does not diminish the key role government policymaking plays in development. Fostering the administrative and analytical capacity to formulate, innovate, and implement policies will remain essential to promoting development in the future.

However, government policies alone will not suffice. Responding to these new forces of globalization and localization requires robust mediating institutions, especially when countries commit to take actions in a crisis, separately or collectively. Institutions serve to balance the diverse interests of society and to determine how the forces of development distribute their benefits and advantages, and their costs and risks. Fortunately, developing countries do not need to create all of these institutional structures from scratch; in many cases, they can build upon existing international agreements and internationally recognized standards. Countries can use the procedures of the WTO to enhance the credibility of their unilateral trade reforms by binding reforms into their multilateral commitments, as discussed in chapter 2. By moving toward international banking standards, as discussed in chapter 3 and in the case study of Hun-

gary in this chapter, developing countries can use pre-existing and accepted global standards to guide and support the credibility of their reforms.

These institutions do not arise in a vacuum, and due regard must be given to how rules are negotiated and enforced. Whether the concern is global or local, far-sighted policymakers have to induce the participation of every actor with the capacity to enhance or reduce the collective welfare. No doubt some government entities will be tempted to “hold up” negotiations to press for greater benefits from such agreements. However, such tactics are likely to prove less and less successful: growing interdependencies will create linkages across issues, and pariahs will be shut out of the benefits of cooperation on many fronts.

These institutions, once established, will evolve in response to numerous factors: the changing needs of members, technological advances, growing or receding consensus among experts, and pressures from non-members. Such institutions will also have to be robust enough to handle rapid changes in sentiment—abetted by improvements in communications, disseminating new information faster to greater numbers of concerned parties.

The last 10 years have been a mixed blessing for developing countries. East Asian nations surrendered some previous gains in a crisis with substantial human and economic costs. Large parts of Africa have had yet another lost decade. No one wants to see these experiences repeated. We have learned from the past, and we have a better sense of the forces that will mold the development landscape over the coming decades. Globalization and localization are transforming many aspects of the human experience—so many that only a comprehensive, multi-layered response of policy and institutional reform will be adequate. If we fail to meet this challenge, we will condemn the world's poor to a cycle of instability, hunger, and despair. By seizing the opportunities presented at the dawn of the 21st century, together we can turn our dream into a reality—a world free of poverty.