Rethinking the state

The important thing for government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all.

—JOHN MAYNARD KEYNES,
"The End of Laissez-Faire"

The agenda for reform that has emerged in the course of this Report calls for governments to intervene less in certain areas and more in others—for the state to let markets work where they can, and to step in promptly and effectively where they cannot. In many countries this calls for a stronger orientation toward the market and a more focused and efficient public sector role. History suggests that this is the surest path to faster growth in productivity, rising incomes, and sustained economic development.

Judging by their recent activities, many governments in industrial and developing countries have come around to this view. But economic policy cannot be implemented in laboratories; it has to be made to work in the real world. Reformers face a variety of political constraints on their actions. In many developing countries, one of the obstacles to reform has been its political costs, actual or potential. Political instability and other political considerations go a long way toward explaining why, in the first place, many of these countries adopted, to their economic disadvantage, the policies they did. And they underline the difficulty many countries face in changing course swiftly. So it is important to ask whether sufficiently broad support for the sorts of reforms that have been recommended can be built. It has often been argued, for instance, that democracy and structural adjustment do not mix well. Is this true?

Governments also have other objectives in addition to faster economic growth. Employment generation is a related goal. Most think it right to alter the distribution of income in helping the poor or in improving equity. How is this best achieved? Do such policies serve the goal of faster economic growth, or act as an additional constraint? And in the narrower economic domain, how is the public sector's performance to be improved? These questions also are all part of reconsidering the role of government in development.

The political economy of development

Political instability is a fact of life in many countries. The past forty years have seen scores of racial, tribal, communal, and guerrilla wars. Coups d'état have occurred in many of the Latin American countries (except in Mexico, Costa Rica, and a few of the Caribbean island nations); in many North African and Middle Eastern countries (for example, Algeria, Egypt, the Islamic Republic of Iran, Iraq, Lebanon, Libya, the Syrian Arab Republic, and Turkey); and in many parts of Asia and Sub-Saharan Africa. Since 1948, there has been at least one coup attempt per developing country every five years (Table 7.1).

And there is more to political stability than merely avoiding coups. Separatist movements, regional rivalries, ethnic frictions, and other sometimes violent social conflicts can plague even the most secure executive. Repressive governments can create a semblance of stability even when they

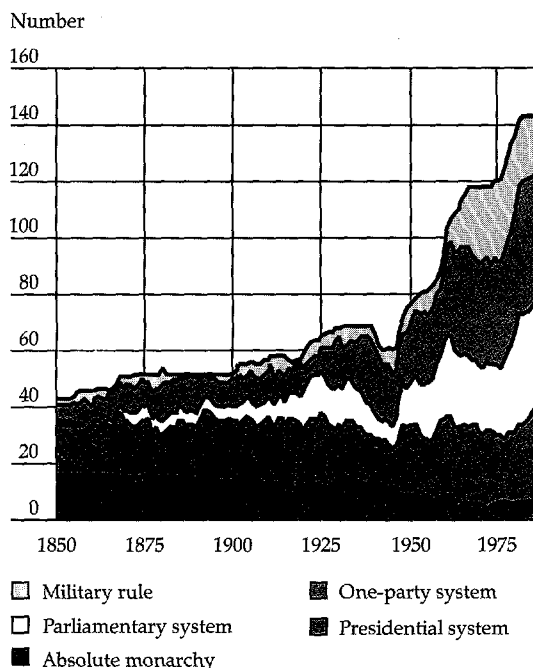
entirely lack popular support, as Eastern Europe showed until recently. In 1987, roughly half of the world's governments were not democratic (Figure 7.1), whereas about three-fifths of nonindustrial countries fell into that category.

Social consensus helps governments to establish legitimate authority to govern. Without this authority, even the most basic functions such as taxation and allocation of public spending can become problematic. When it began its modernization in the second half of the nineteenth century, Japan's per capita income was the lowest among the countries which are today classified as industrialized. However, the country was already politically well-developed, and this was undoubtedly a great asset. The government was not democratically elected, but it was perceived to be legitimate by the population; it had a strong administration and a broad tax base. All this helped it to undertake its major reforms after the Meiji Restoration in 1868.

As the industrial countries have discovered in the course of their history, economic modernization creates new sources of wealth. This can shake the coalition on which traditional social order was established. A transition of this sort affects many developing countries today. Fragile social consensus, entrenched special interests, and weak administrative capacity have influenced their choice of economic policies, and the outcomes.

To a large extent, governments everywhere tend to tailor economic policies to balance conflicting interests. Political rather than economic considerations explain why the governments of many OECD countries intervene in support of ailing industries or regions. The resurgence of protectionism among OECD countries in the 1980s, the problems encountered in the current round of GATT negotiations, and the slow pace at which some industrial countries addressed their macroeconomic imbalances in the 1970s and 1980s highlight how, even in societies with secure institutions, much-needed economic reforms can be blocked.

Figure 7.1 Nation-states by type of government, 1850-1987



Sources: Vanhanen 1979, 1990.

Constituencies and interventions

In many developing countries, political and economic instability have put the social consensus under strain. Such difficulties are hardly new. For many years they have tended to subordinate economic policy to the task of securing the support of influential groups for the government. The crude policy instruments which many governments often have as a result of these skewed priorities, combined with their often-weak administrative ca-

Table 7.1 Irregular executive transfers: average occurrence per country, 1948–82

Income group	*1948-52*	*1953-58*	*1959-64*	*1965-70*	*1971-76*	*1977-82*
Low-income	1.0 (21)	1.1 (24)	1.2 (39)	1.4 (51)	1.3 (53)	0.9 (55)
Middle-income	1.6 (30)	1.7 (32)	1.4 (41)	0.8 (47)	0.9 (51)	0.6 (55)
High-income	0.0 (23)	0.2 (23)	0.1 (24)	0.2 (25)	0.1 (28)	0.1 (28)

Note: Number of countries considered is in parentheses. Both successful and unsuccessful executive transfers are included. Irregular successful executive transfers are changes in the office of the national executive from one leader to another, outside conventional legal or customary procedures for transferring power. Unsuccessful irregular executive transfers are failed attempts at such irregular transfers. Countries are ranked according to their per capita income in 1988.
Sources: Taylor and Jodice 1983; data base supplied by the Inter-University Consortium of Political and Social Research. Income group classifications are from the World Bank.

pacity, have compounded the problem—and made it potentially more damaging. Typically, governments have tended to centralize economic resources and decisionmaking. This tendency was reinforced by the prevailing belief in the 1950s, 1960s, and 1970s, among many policymakers and development economists, and sometimes in external aid and finance agencies, that developing countries could not rely upon markets and the private sector alone to develop their industries.

In the 1950s and 1960s, utilities, oil companies, plantations, and assorted manufacturing industries were nationalized in many developing countries, including Algeria, Brazil, Chile, Egypt, Sri Lanka, and Tunisia. Governments regarded themselves as too weak administratively at the time to tax and regulate private enterprises at arms' length. The nationalization of the major private Bolivian mining companies in 1952 followed decades of attempts by governments to tax the families that owned the mines. An inability to regulate and supervise the banking system led many governments to nationalize banks or intervene directly in the allocation of credit. Interventions in agriculture have followed a similar pattern. Farming in Sub-Saharan Africa, for example, has been highly taxed through currency overvaluation, state marketing boards paying low procurement prices, and export taxes.

In many developing countries, it is common to find tariffs, tax incentives, or special regulations designed to protect special-interest groups. In some cases, "predatory" states have designed policies and programs to transfer resources to very narrowly defined interest groups, and they have resorted to coercion when the legitimacy of such policies was questioned. The strength of urban interests in Latin American and Africa helps to explain why the industrialization strategies adopted by many countries in these regions were strongly biased against farming.

Many governments have assumed the role of employer of last resort, partly as a result of concerns about the social and political implications of unemployment. Until recently, university graduates had guaranteed employment in government in several Sub-Saharan African countries. In the Gambia, the civil service doubled between 1974 and 1984. The central governments of Argentina and Sri Lanka reckon that a fifth of their staffs are redundant; Brazil's government puts the figure at half.

State-owned enterprises (SOEs) have been used to create employment (though seldom for the poorest), raise incomes in certain regions, or meet the demands of powerful groups such as the military. In the 1970s and early 1980s, the Sri Lankan government built several textile factories and sugar refineries in backward areas with high rural unemployment. In Argentina throughout the 1970s, industries run by the military were highly protected.

Programs of public expenditure have financed the underpricing of utilities—water, electricity, telecommunications, railway, or city transport—and supported untargeted food subsidies. Most staple foods in Egypt and Mexico were subsidized until recently, as was wheat flour in Brazil. These subsidies usually benefited the politically active urban population at the expense of the agricultural areas where most of the poor live. Uneconomic public investment projects are often politically motivated: a very large power project in Zaire, for instance, was intended to improve the government's control over an unruly region. In some such cases, corruption in the execution of expenditures is also a problem (see below), sometimes involving foreign suppliers.

The costs

By the 1980s, persistent difficulties in financing external and public sector deficits made the costs of these interventions plain to see. When the supply of external finance dwindled after 1982, demands for special treatment outran the economy's capacity to deliver.

Buying support at the cost of economic efficiency was, in the end, self-defeating. Governments reacted to mounting civil service wage bills by letting nominal wages lag behind inflation; this generated the resentment of public servants and led to low morale and poor service. Together with discretionary interventions, their situation fueled corruption. Then, in some countries, corruption brought the government down. The hope of employment in government induced migration from rural to urban areas, aggravating the problem of urban unemployment. Underpriced and overstaffed utilities meant poor services—chronic power cuts, silent telephones, bad public transport. This caused further dissatisfaction. More generally, this highly interventionist approach slowed growth, which in many countries again undermined political stability.

Piecemeal interventions also made it harder to establish essential public institutions. For instance, direct control of the financial system meant there

was no effort to build capacity in banking supervision. High tariffs and the inflation tax made it less necessary to broaden tax bases. The expansion of agricultural state banks, which was intended to make credit widely available to farmers, made it less urgent to develop cadastres and clarify ownership rights—that is, to address the underlying reasons for the high cost of rural credit. Meanwhile, in many developing countries the agricultural banks have failed to deliver, so farmers are as badly off as before.

Market failure and government failure

As the earlier chapters of this Report made clear, intervention by the public sector is not undesirable in itself. On the contrary, many sorts of intervention are essential if economies are to achieve their full potential. An abbreviated list of indispensable interventions would include the maintenance of law and order, the provision of public goods, investments in human capital, the construction and repair of physical infrastructure, and the protection of the environment. In all these areas (and arguably more) markets "fail" and the government must step in. But the countless cases of unsuccessful intervention suggest the need for caution. Markets fail, but so do governments. To justify intervention it is not enough to know that the market is failing; it is also necessary to be confident that the government can do better.

Governments are prone to fail, at least in economic terms, for a variety of reasons. As noted above, economic goals may not be their highest priority. A combination of political objectives and constraints and weak administration may lead governments to intervene in ways that are economically harmful. Also, the consequences of economic interventions are difficult to predict. For instance, in the 1950s many Latin American countries protected their industries to (among other things) reduce their dependence on imports. Later it became evident that they had increased their dependence, because the new urban manufacturing sector that evolved under protection relied heavily on imported inputs and machinery.

Private firms are not always better at making decisions or predicting their consequences. But tests of performance are usually clearer to private firms, which enables them to take corrective action faster. Furthermore, without the help of the government, it is harder for private firms to shift the costs of their mistakes onto taxpayers.

Another difficulty is that government intervention creates vested interests which make it difficult to change the policy. Not all interventions need to be reversed: investments in infrastructure, for example, can generate enough resources to cover their costs. But protection for manufacturing in the early stages of industrialization can only succeed, if at all, as long as it is temporary. Once protection is granted, however, it is exceptionally difficult to remove.

Protection creates rents: owners of some labor, capital, or land obtain higher returns than they would in the absence of intervention. This draws new resources to the protected industry until, at the margin, the rents disappear. Removing the protection penalizes not only the owners who first received the rents as a windfall, but also those who came later, seeking normal returns. Removing the tariff, in this case, can force into loss the firms that gained least. Thus, even when protection has not been created by industrial interests, protection creates industrial interests. These then become a formidable obstacle to liberalization.

Corruption

Excessive intervention breeds corruption. Again, the problem is by no means confined to governments, or to the developing countries. In some countries, it has grown to alarming and destructive proportions.

Corruption weakens a government's ability to carry out its functions efficiently. Bribery, nepotism, and venality can cripple administration and dilute equity from the provision of government services—and thus also undermine social cohesiveness. Corruption was identified as a serious problem in ancient China and India, in the Ottoman Empire in the fourteenth century, in England in the early 1800s. Every other year a scandal is a reminder that it continues in Europe, Japan, and the United States. Corruption has also contributed to the fate of many governments: it was a major justification for the military overthrow of the Ghanaian civilian government in 1981 and the Nigerian one in 1983; an important theme in the 1982 Mexican presidential campaign; a major reason for the fall of the government in the Philippines in 1986; and a problem the authorities consider of the utmost gravity in the USSR.

Corruption manifests itself in a variety of ways. A common one is bribery of customs officials, who then allow in illegal imports, or legal imports at below-legal duties, or expedite clearance procedures. This has been a serious problem in nu-

Box 7.1 Fighting corruption

Being a tax official in the Philippines Bureau of Internal Revenue (BIR) in the early 1970s was so lucrative that jobs and transfers to the bureau were sold. Manila's most "extensive, expensive, and lavish assortment of cars" was in the BIR's parking lot. Then-president Ferdinand Marcos's New Society, announced in 1972, aimed to alleviate poverty and fight corruption, a fight that intensified in 1975 when 2,000 government officials suspected of improper conduct were fired. In that sweep, the BIR's commissioner was replaced by Justice Efren Plana.

Problems

After a few months, Plana identified a number of serious problems. Chief among these were practices whereby officials would require payments to process a tax matter, provide a record, or make a routine clearance; accept bribes to lower tax assessments or stop the harassment of taxpayers with no tax obligations; embezzle funds; illegally print fiscal labels and stamps; succumb to cash, nepotism, and influence for personnel decisions, such as transfers and appointments; and break down the internal auditing systems (officials in charge of investigating others routinely accepted bribes from those being investigated).

The bureau was virtually free of corruption when Plana left it in 1980 to become deputy minister of finance and, shortly thereafter, a justice of the supreme court.

Solutions

Plana's success was based on six innovations. First, supervision and auditing were improved by using a group of highly skilled outsiders teamed with irreproachable incumbent senior officials. Second, administrative systems were introduced to monitor performance on the basis of objective criteria such as the number of tax assessments and taxes collected. Third, about 100 high-level corrupt agents were punished by being dismissed or reorganized. Fourth, tax laws were simplified to make them more efficient and reduce the discretion left to tax officials. Fifth, control systems were tightened—tax payments began to take place through banks rather than tax agents, and confirmation letters were sent to check tax-payers' payments. Sixth, personnel practices were improved. Recruitment became meritocratic, an antinepotism regulation forbade the appointment of even distant relatives, and promotions were based on performance. But these achievements—in a country where corruption remained widespread—did not last. In the early 1980s, nepotism became a problem once again, and tax assessments and tax collections dropped significantly.

merous countries: in the United States at the turn of the century, in Singapore in the 1960s, in Indonesia in the 1970s, and in Cameroon in the 1980s. Police indulgence of extortion and other crimes in Hong Kong led to the creation of an anticorruption office in the 1970s. In the late 1970s, an inquiry in Massachusetts revealed that 76 percent of a sample of public buildings had at least one "structural" defect that could not have occurred without inspectors' complacency. Two-thirds of the names on the civil service roster in 1978 in Zaire were fictitious. These and less malign forms of corruption—absenteeism, moonlighting, or lack of dedication—undercut public administration.

Corruption can seldom be reduced unless its larger underlying causes are addressed. It flourishes in situations where domestic and international competition is suppressed, rules and regulations are excessive and discretionary, civil servants are underpaid, or the organization they serve has unclear or conflicting objectives. In Cameroon, obtaining all the authorizations and permits necessary to start a new business takes two years even for a well-connected businessman; the law requires twenty-four different steps involving twenty separate offices. Anticorruption campaigns are periodically undertaken, sometimes with success (Box 7.1). But often the root causes remain: weak agencies fighting market forces with controls society considers excessive, discretionary, or illogical.

Remedies: democracy and institutions?

Authoritarianism often has been seen as a useful, if regrettable, expedient for effective policymaking in the face of political instability. A strongly held view from the 1950s through the 1970s was that development policies took time to bear fruit, and that this was inconsistent with the politics of short-term electoral cycles. Democracies were seen as having a built-in inclination toward populist policies (Box 7.2). Benevolent authoritarian regimes (led by philosopher-despots) were needed, it was argued, to push through unpopular reforms and tame an unruly or otherwise ineffective ad-

ministration. Economies managed with varying degrees of authoritarianism have made progress at different times in the past, for example, Brazil, Chile, Spain, and some of the East Asian economies. Yet at the same time, some democracies—old ones as in India or new ones as in the Philippines—have been unable so far to make rapid progress.

During the 1980s, however, severe disenchantment with authoritarian regimes set in. Now it is better understood that such regimes are no less likely to yield to the interests of narrow constituencies. Few authoritarian regimes, in fact, have been economically enlightened. Some of the East Asian NIEs are the exceptions, not the rule. Dictatorships have proven disastrous for development in many economies—in Eastern Europe, Argentina, Central African Republic, Haiti, Myanmar, Nicaragua, Peru, Uganda, and Zaire, to name only a few.

Democracies, conversely, could make reform more feasible in several ways. Political checks and balances, a free press, and open debate on the costs and benefits of government policy could give a wider public a stake in reform. The need to produce good results in order to be reelected could help, rather than hinder, economic change: it increases governments' incentives to perform well and keeps predatory behavior in check.

Experience allows no hard and fast conclusion. Peru is going through one of the worst economic crises in its history, mostly as a result of policies implemented in the late 1980s by a democratically elected government. Bolivia has been unable to improve its government's administrative capacity despite almost a decade of democracy. Literacy rates in China in 1950 were similar to those in India, and four decades later they are twice as high. Yet India is one of the oldest and most sophisticated democracies in the developing world.

Democratic governments are not necessarily more adept at managing reform, either. Transitional democratic governments, perhaps because their political base is still fluid, appear to be particularly vulnerable (Tables 7.2 and 7.3). Democratic governments have a better record than authoritarian governments in countries that are not politically polarized; the reverse seems to be true in polarized societies. On the whole, the evidence suggests that the democratic-authoritarian distinc-

Box 7.2 Populist experiments

The populist experiments in Latin America—Allende in Chile (1971-73), Peron in Argentina (1946-49), and Garcia in Peru (1985-88)—are extreme examples of the interaction between political and economic processes. Populist policies have emphasized growth and short-run distributional goals, brushing aside the risks of inflation and excessive deficits and ignoring external constraints and the responses of firms and households to their aggressive anti-market policies. Addressing poverty and income distribution issues, which populist regimes viewed as the source of social conflict and political instability, could not be done, however, through unsustainable economic policies.

In a typical populist cycle, the new administration sets in motion a marked shift in policies. Excess capacity and the availability of foreign reserves at first support higher output growth, which in many cases is accompanied by an increase in real wages. Inflation is kept low with the help of price controls. But bottlenecks soon appear as a result of the strong expansion in domestic demand; because of dwindling foreign reserves, these cannot be bypassed by increasing imports. Shortages, accelerating inflation, and declining reserves lead to capital flight and the demonetization of the economy. The budget deficit worsens as subsidies increase, and taxes decline in real terms. In this unsustainable position, the government is forced to devalue the currency and cut subsidies. Inflation accelerates and real wages fall.

The Chilean experience of 1970-73 clearly illustrates this sequence of events. To achieve rapid growth and improve the living conditions of low-income groups, the government stepped up public spending. Public sector wages were increased, adding to the fiscal deficit. Agrarian reform was intensified, and the mining and banking sectors as well as parts of the industrial sector were nationalized. The combination of price controls and expansionary demand policies fueled repressed inflation; the parallel market flourished. Foreign reserves were so low that it was impossible to meet the surge in demand by increasing imports. By 1972, the government was forced to devalue the escudo and adjust public sector prices. It was unable to control wages, however. Between 1970 and 1973, inflation increased from 35 percent to about 600 percent a year, and the fiscal deficit jumped from 2.7 to 24.7 percent of GDP. GDP growth accelerated to 9 percent in 1971 but turned negative in 1972 and 1973, when output fell by 5.6 percent.

Table 7.2 The success of economies with differing political systems in implementing an IMF adjustment program
(percent)

Percentage of adjustment years	*Continuous democratic systems*	*Continuous authoritarian systems*	*Transitional democratic systems*
In which fiscal deficits fell	49	50	25
In which expenditures as percentage of GDP fell	38	46	29
In which credit expansion slowed	61	62	43

Note: Based on reform episodes in seventeen countries from the 1950s through the 1980s.
Source: Haggard and Kaufman 1990.

Table 7.3 The success of economies with differing political systems in controlling rapid inflation

Measure	*Democratic systems*	*Authoritarian systems*
Percentage of inflation episodes which ended in stabilization		
In nonpolarized environments	75	62
In polarized environments	29	67
Percentage of adjustment programs that led to breakdown of system twelve months or less after program started	11	14

Note: Based on 114 standby arrangements from 1954 to 1984 signed by nine Latin American countries.
Source: Remmer 1986.

tion itself fails to explain adequately whether or not countries initiate reform, implement it effectively, or survive its political fallout.

But as indicated in Chapter 2, there is suggestive evidence that links features of democratic systems positively with overall aspects of development and welfare. A further result emerges from the empirical literature on the relation between economic performance and political systems: by developing human resources and, more particularly, by investing in education, countries have been found to strengthen the basis for open political systems. Some studies suggest that for a given level of income, improvements in social indicators are associated with freedom and liberty. Other studies suggest that political instability declines not only as income rises but also as education improves—although further research is necessary to confirm this finding.

Institutions and development

Another approach to the problems of political instability, fragile social consensus, and weak governance is to build more effective institutions. This is an extremely broad concept. It encompasses the public bodies through which the state discharges its most fundamental responsibilities: maintaining law and order, investing in essential infrastructure, raising taxes to finance such activities, and so on. But the idea goes further. It extends to the conventions that govern the way people deal with each other: property rights, contracts, and norms of conduct. The discussion of how society's institutions affect economic performance has been one of the liveliest in the economic literature in the past two decades. Although understanding of these issues is far from complete, it is clear that a primary task of institutional development is to improve allocative efficiency and reduce transactions costs—the costs of people dealing with people (Box 7.3).

People's values and ideologies affect institutions, and these in turn affect the economy. Analyzing the role in development of such factors as culture, religion, law, and politics has a strong intellectual foundation in the work of Hayek, Hegel, Marx, and Weber. Centralized political institutions backed by a strong bureaucracy are argued to have stifled entrepreneurship and productivity growth in ancient China—even though technologically the country was far ahead of what is now the West. At the level of organizations, recent research suggests that the superior performance of Japanese manufacturing results (among other factors) from norms of behavior that promote the flow of information between workers and supervisors; these lower firms' internal transactions costs and help them adapt to markets demanding high-quality products with short life cycles. Another study has found that when workers in the United States get a share of their firm's profits, it seems to have a favorable effect on their productivity.

Often, the institutions of government can affect economic performance more directly. Fiscal deficits have led to very high inflation in Latin America but not in South Asia, where central banks are more independent. Credit programs for small and medium-size industries have been much more successful in Sri Lanka—where they have been implemented by a competent and motivated civil service relatively independent of political interference—than in Bangladesh. For the same reason, rural development programs have enhanced productivity in some parts of South Asia, but less so in

Box 7.3 The contribution of institutional innovations to development

Over the centuries, market-mediated transactions have been a major force in institutional development, which in turn has been a major force in economic development. As markets have expanded, market participants spontaneously have defined rights, formulated contracts, and evolved norms of behavior with a view to improving the efficiency of their interactions.

The letter of credit, a contract that emerged in the Middle Ages in Italy, increased the scope of exchange and contributed to the expansion of international trade. By better defining creditors' rights in regard to a firm's assets, public liability companies—an innovation in late-eighteenth-century England—allowed firms to take risks and attract resources to activities that otherwise could not have developed. Since the 1970s, leasing contracts have allowed enterprises to reduce the risks associated with large investments in equipment. In Bangladesh, the Grameen Bank found innovative ways to lend to low-income groups while keeping defaults low. This was achieved by establishing contracts that made the community, not only the borrower, responsible for payments.

Behavior also adapts to market needs and influences transactions costs. Stealing and trading have the same linguistic root in various languages because of the dishonesty of early traders. Only after markets become established, transactions become regular, and competition increases do traders have an incentive to establish and maintain their reputation. Traders in industrial market economies are more honest not only because sanctions are administered more efficiently, but also because a good reputation reduces transactions costs.

Norms of behavior not yet adapted to the needs of a modern economy substantially increase transactions costs. Pilferage is serious in the ports cities of many developing countries partly because stevedores are more loyal to their families, clans, or tribes than to the organization employing them. Not pilfering and being honest deprives their families of a source of additional income—behavior families would consider dishonest.

Africa and Latin America. State-owned enterprises have been efficient in Singapore and Taiwan, China, where they were subject to competition and their access to the budget was restricted—but not in Argentina, Bolivia, and Nigeria.

In many instances, the state has stimulated growth by restructuring institutions: the abolition of feudal arrangements and the standardization of currency, taxes, weights and measures, and internal tariffs in revolutionary France in the 1790s; patent laws in nineteenth-century Europe and the United States; the integration of customs, commercial, and civil and commercial law in both Germany and Italy in the nineteenth century; the modernization of Meiji Japan in the second half of the 1800s, and that of Turkey in the early part of this century; Brazil's company-law reforms in the early 1970s; the creation of stock exchanges in East Asia and the economic integration of Western Europe after 1945. All of these depended on state action. They molded the framework of enterprise in ways which increased entrepreneurial security and eased the flow of resources and people. In most developing countries, strengthening or creating institutions remains a difficult but necessary task (Box 7.4).

Supporting institutional development requires a state with well-developed administrative structures and agencies responsive to markets' needs. The political weaknesses of developing countries are often, however, manifested in the efficiency of their bureaucracies. By itself, an efficient bureaucracy does not guarantee successful development, nor can it substitute for market forces. As indicated above, it can even retard development. Nonetheless, an efficient bureaucracy enables governments to govern. It was key to the survival of ancient civilizations such as Egypt (3000 B.C.) and China—where the well-structured bureaucracy which had existed since at least 200 B.C. was still operating less than a hundred years ago. The basic principles of bureaucracy were already well understood by the ancient Chinese. The civil servants, the mandarins, were recruited by competitive examination. There were systems of promotion, career patterns, and job security. Serving the state was a privilege reserved only for those with demonstrated talents. Building efficient bureaucracies was also an essential step in the process of nation-making in Europe—but remains a priority in many developing countries.

Nongovernmental organizations

Nongovernmental organizations (NGOs) have become an important force in the development process which, to some extent, has mitigated the costs of developing countries' institutional weaknesses, which often include administrative shortcomings

Box 7.4 Setting priorities for institutional development: easier said than done

The priorities for institutional development naturally vary with a country's history, culture, economic policies, and stage of development. For most of Eastern Europe, the priority is to establish the institutions necessary for a market economy to function efficiently: property rights, corporate and bankruptcy laws, commercial courts, banking legislation, and stock exchanges. For low-income Africa and Latin America, the priority is to improve the management of the public sector, a goal that often requires a simultaneous reduction in the size of the government and a strengthening of its capacity.

Elsewhere priorities may be less clear-cut. Particular countries have their own accomplishments and needs:

- In South Asia and some parts of Latin America, training and visit programs have had a strong effect on agricultural productivity.
- In Sri Lanka, a recent change in civil courts procedures has greatly improved the workings of bankruptcy laws and reduced financial intermediation costs, after several years of complaints from the banking community.
- In Brazil, mechanisms are being devised to improve the flow of information among universities, research institutes, and industry—making research more responsive to industry's needs.
- In Malaysia, a recently created government bond-rating system is expected to reduce private firms' financing costs significantly.
- In northern Brazil, Egypt, India, Indonesia, and Sri Lanka, the improvement of cadastres and land titling is overdue and could greatly improve the efficiency of rural credit markets and reduce the generally extremely high costs of rural credit.
- In many countries, better banking supervision is important for successful financial liberalization.

Identifying institutional needs is not easy, however. First, institutions essential in industrial societies may prove superfluous in developing countries. Stock exchanges, treasury-bill markets, credit-rating bureaus, land-titling offices, and metrology and standards bureaus are expensive to set up, and it is difficult to decide whether they are being developed ahead of market needs. Second, some institutions are unproductive in the presence of systemwide problems. For instance, an underpaid civil service renders most public institutions a hindrance rather than a help to markets. Poorly planned public spending deprives institutions of current inputs and reduces their efficiency. Third, there are no simple indicators of institutional needs and priorities. There is scope, however, to develop quantitative indicators of the efficiency of public institutions; for example, how long does it take to register a business, obtain a passport, clear customs, get an import license, or pay taxes?

and an inability to carry out efficiently essential development tasks, such as providing social services or protecting the environment. In response, NGOs have grown rapidly in recent years, both in numbers and in the volume of resources they mobilize. In 1987, NGOs transferred about $5.5 billion from industrial to developing countries—nearly $1 billion more than the International Development Association.

Most of NGOs' resources (about 60 percent) are raised by themselves. The rest ($2.2 billion in 1987) are from official aid agencies, which channel funds through NGOs because such organizations are more effective in bringing about popular participation, in working at the grassroots level, and in operating in remote areas. NGOs have also been important in sensitizing governments and international aid and finance agencies to the social and environmental aspects of development. In addition, in many countries, they have taken the lead on controversial development issues such as family planning. Although many developing-country governments are suspicious about some NGOs' self-appointed role as agents of change, governments of countries such as Bolivia, Egypt, India, Jordan, Mexico, the Philippines, Togo, and Uganda are seeking ways to encourage more NGO action.

NGOs vary in coverage and effectiveness. In Bangladesh, NGOs specialized in health and family planning reach only one-sixth of the country's 80,000 villages. Many small NGOs' managerial capacity needs to be developed before they can be effective. For others, little is known about fund-raising costs. In addition, even the most effective NGOs cannot fulfill all the gaps left by the commercial and public sectors. Aside from their growing numbers and the volume of resources they mobilize, the importance of NGOs lies in their ability to involve communities and grassroots organizations more effectively in the development process and in addressing poverty.

Equity and redistribution

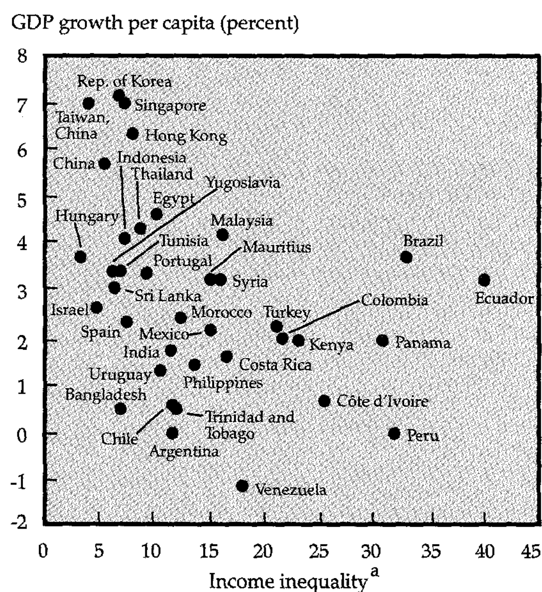
Governments have always been concerned with equity. Income transfers in OECD countries (excluding interest payments but including social security payments) amount to 40 percent of government expenditure and are as high as 20-30 percent of GDP in Austria, France, Germany, the Netherlands, and Sweden. A better distribution of income may facilitate economic management. Political scientists have suggested that mechanisms to redistribute income by sharing the benefits of growth more equally have helped some OECD governments to diffuse opposition against market-oriented reforms; the short-term victims of change are cushioned.

An analysis of thirty-two countries (twenty-five developing and seven OECD countries) showed that the higher the risk of term of trade shocks that a nation faces in international markets, the more likely it is to increase trade barriers. It also showed that the larger its social-insurance programs, the less likely it is that the government will be protectionist (Bates, Brock, and Tiefenthaler 1991). Other recent research suggests that wage negotiations through nonmarket mechanisms (negotiations between unions, industrialists, and governments) that take equity into account may explain the relatively low unemployment in the Nordic countries (Jackman, Pissarides, and Savouri 1990). Some economists have also suggested that the relatively egalitarian distributions of income in Asia allowed countries there to adjust to the external shocks of the 1970s more rapidly than their Latin American counterparts.

Despite such evidence, greater equality of income is still considered by some to be inimical to growth. Increasing the capital stock, it is argued, requires high saving rates; this in turn implies a distribution of income that is tilted toward the (high-saving) rich. The Republic of Korea's tax reform of 1973 largely excluded capital income (interests, dividends, capital gains, and other returns on assets) from the tax base. The conventional wisdom among industrial countries as well as policymakers in developing countries has been that things ought to be done "one at a time": first, economic growth; second, social equity; third, civil and political liberties.

In fact, there is no evidence that saving is positively related to income inequality or that income inequality leads to higher growth. If anything, it seems that inequality is associated with slower growth (Figure 7.2). The notion of a trade-off between growth and equity, which helped to entrench antigrowth policies in socialist economies and antiequity policies in conservative ones, has been further discredited by the many economies that consistently outperform the rest on both counts: Costa Rica, Indonesia, Japan, Korea, Malaysia (Box 7.5), and the Scandinavian economies.

Figure 7.2 Income inequality and the growth of GDP in selected economies, 1965-89



a. The ratio of the income shares of the richest 20 percent and poorest 20 percent of the population. Data on income distribution are from surveys conducted mainly in the late 1960s and early 1970s.
Sources: World Bank data; Berg and Sachs 1988.

Greater equality is not achieved through income transfers—except in the case of safety nets for vulnerable, small, and well-targeted groups of the population. *World Development Report 1990* showed that the pattern of development has strong distributional implications. Industrial protection and discriminatory taxes on farming help to explain why income inequality is more severe in Latin America than in Asia. The bulk of developing countries' revenues generally consist of indirect taxes, which are generally less progressive than income taxes. Subsidies for capital (in the form of tax incentives, subsidized credit, or currency overvaluation) invariably lead to more capital-intensive modes of production, and thus worsen distribution.

Another lesson is that public expenditure can have powerful redistributive effects. Various

Box 7.5 The politics of inclusion: Malaysia and Sri Lanka

Similar starts

Both Malaysia and Sri Lanka were British colonies—until 1963 and 1948, respectively. Both had well-developed, export-oriented, tree-crop plantations in the 1960s—rubber and palm oil in Malaysia, rubber and tea in Sri Lanka. Both had sophisticated bureaucracies. Both had advanced democratic political institutions. And both had relatively well-educated populations, with 90 percent primary school enrollment. Both countries also had problems caused by the presence of highly differentiated ethnic groups, with a majority that was economically underprivileged but politically dominant. In Malaysia, Bumiputras (Malays and other sons of the soil) accounted for 55 percent of the population, Chinese 35 percent, and Indians 10 percent. In Sri Lanka, Sinhalese accounted for 72 percent of the population, Tamils 18 percent, and other groups 10 percent. Both countries adopted discriminatory policies specifically to improve the lot of the majority groups (legislatively in Malaysia and de facto in Sri Lanka).

Both countries used public enterprises not only in the plantation sector, but also in other areas such as airlines, cement, banks, and manufacturing. They supported rice farmers through subsidized fertilizer, credit, and irrigation. They gave preferred access to public employment and public procurement to the majority ethnic group. And they emphasized education and health services for all—but biased higher education in favor of the majority.

Different results

In the early 1960s, Malaysia's per capita income (at $320) was twice Sri Lanka's. Three decades later, Malaysia's per capita income is five times Sri Lanka's. Malaysia has also contained conflict among its ethnic groups without serious violence. By contrast, since 1983, ethnic and regional conflicts in Sri Lanka have claimed tens of thousands of lives. The cost of destroyed infrastructure and forgone income from disrupted economic activities has been estimated to be close to two-thirds of GDP. In addition to its superior growth, Malaysia has reduced the incidence of poverty from 50 percent in 1970 to 10 percent today—and reduced the inequalities between and within ethnic groups.

Reasons for the difference

Unlike Sri Lanka (until 1977, when the economy was liberalized) Malaysia's authorities adjusted the antigrowth elements of their policies—such as foreign investment and industrial licensing rules—when growth rates faltered. Trade policies were kept open, with moderate tariff levels (although, in selected important cases, highly effective protection was retained). Private enterprises did not need permits to expand production or invest. Nor were they harassed by currency controls, extensive quantitative trade restrictions, or the threat of nationalization without compensation. Minority businesses that were discriminated against in domestic markets were thus not shut out from business opportunities abroad. They could use their income to buy abroad goods and services (such as education) that were being denied them at home.

Sri Lanka's heavy regulatory framework before 1977 gave ample opportunities for discretion and discrimination. Economic controls ended up becoming controls on individuals—despite Sri Lanka's democratic traditions. Travel was restricted because of exchange controls, and simple business transactions (such as obtaining a permit to invest, to import, or to expand production) often ended up being highly politicized. The perception was that government could influence, and was influencing, the distribution of assets among ethnic groups.

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studies have found that education is the most important single variable influencing income inequality. Investments in education, health, and nutrition—if well-designed and -implemented—can improve distribution and at the same time promote development in other ways. The reform programs of the 1980s and 1990s thus have emphasized more and more the need to protect social programs during fiscal adjustment.

When markets work well, greater equity often comes naturally. For instance, labor markets are fragmented in many countries. People with similar attributes are unable to obtain similar rewards or employment: sex, ethnicity, location, and industrial occupation consistently appear as determinants of wages, regardless of productivity. Helping women to participate in labor markets has been an important reason for the improving distribution of income in Malaysia and Indonesia. Government spending on improving infrastructure and the delivery of social services has traditionally been the main mechanism to integrate markets, and this remains of major importance. A variety of other public programs that can reduce inequalities while improving allocative efficiency and spurring growth—for example, programs designed to improve access to infrastructure, credit, and land.

Land reform often seems to have raised the incomes of the poor. China, Japan, and Korea are all regarded as outstanding examples of economies

that have succeeded at land reform. The evidence on its effect on agricultural efficiency is more mixed, however. It is hard to separate the effects of land redistribution from the effects of the complementary investments and institutions oriented toward increasing agricultural productivity that have typically accompanied land reform. There does appear to be evidence, however, that the social stability resulting from land reform has contributed to faster growth.

For all these reasons, efforts to improve equity can sit comfortably within reform programs aimed at promoting growth. It is clear, however, that market-distorting and overzealous redistribution can quickly pose overwhelming financial problems. For example, the cost of food subsidies in Brazil in the late 1970s, and more recently in Egypt, ballooned as international food prices went up. Subsidies to protect declining industries have to rise continuously to achieve the same effect, because maintaining preference requires that dynamism elsewhere in the economy must be offset. In Europe, for instance, maintaining farm incomes relative to other incomes has become more and more expensive because of faster growth in other sectors.

Also, crude transfers through market-distorting interventions almost always end up worsening the distribution of income rather than improving it. Fertilizer subsidies in Bangladesh, Brazil, Ecuador, Egypt, India, and Pakistan accrue mainly either to fertilizer manufacturers or to better-off farmers. The large subsidy on wheat in the 1970s in Brazil reduced the demand for beans grown by small farmers. Production of beans declined. Farmers sold their land and migrated to the cities, where they increased the demand for subsidized wheat. Rich commercial farmers bought the migrants' land at distress prices.

Reforming the public sector

In about the fourteenth century, an Arabic treatise argued: "Commercial activity on the part of the ruler is harmful to his subjects and ruinous to the tax revenue . . . crowds out competitors; dictates prices for materials and products which could lead to the financial ruin of many businesses. When the ruler's attacks on property are extensive and general, affecting all means of making a livelihood, the slackening of business activity too becomes general" (Ibn Khaldun 1981). One of the most striking legacies of the 1980s is the rediscovery of these ancient truths. Many governments are reconsidering their involvement in the economy, reviewing their spending priorities, and undertaking fewer commercial activities. For this reappraisal to succeed, the administrative capacity of the state will need to be improved—and governments will have to cope with opposition from the vested interests created by decades of excessive intervention.

Rationalizing public expenditure

Government expenditure accounts for slightly more than 20 percent of GDP in low-income countries, and close to 30 percent in middle-income ones. These ratios are much lower than in industrial countries today, but much higher than in industrial countries at a comparable stage of development (Tables 7.4 and 7.5). The evidence suggests that many of the developing countries' public spending programs provide very low returns.

PUBLIC INVESTMENT. The quality of public investment significantly depends on the quality of the economic climate (see Chapter 4). But some developing countries are experiencing economic difficulties because the projects themselves, very often financed with the support of external agencies, were ill-advised. A loss-making silver-smelting plant in Bolivia, a value-subtracting shoe fac-

Table 7.4 Percentage share of government expenditure in GNP or GDP, industrial countries, 1880–1985

Year	*France*	*Germany*	*Japan*	*Sweden*	*United Kingdom*	*United States*
1880[a]	15	10	11	6	10	8
1929[a]	19	31	19	8	24	10
1960[b]	35	32	18	31	32	28
1985[b]	52	47	33	65	48	37

a. GNP.
b. GDP.
Source: World Bank, various years.

Table 7.5 Percentage share of government expenditure and consumption in GNP or GDP, industrial and developing countries, 1972 and 1986

	Expenditure[a]		*Consumption*[b]	
Economy group	*1972*	*1986*	*1972*	*1986*
Low-income	19	23	12	13
Lower-middle-income	15	27	11	14
Upper-middle-income	25	27	12	14
Industrial market	28	40	14	19

a. GNP.
b. GDP.
Source: World Bank, various years.

tory in Tanzania, and irrigation systems with low rates of return in Sri Lanka are only a few of countless possible examples. The costs can be considerable. In Zaire, the hydropower and transmission-line project that was mentioned earlier in this chapter cost almost $3 billion in 1990 prices—about a third of the country's external debt. The project has never operated at more than 30 percent of its capacity, and it is now in the midst of extensive rehabilitation, although it began operating only in 1982. This is an extreme case, but unproductive projects on a less spectacular scale are all too common.

WAGES AND THE CIVIL SERVICE. Wage bills are a large part of government expenditure in most countries. Before the reform programs, the wage bill absorbed more than 60 percent of current revenues in the Central African Republic—and more than 40 percent in the Gambia. The tendency to overstaff and underpay that in the last few decades has prevailed in many developing countries means that much of this spending is wasted. The problem of poor motivation has often been compounded by ill-defined career structures, and by politicized recruitment and senior appointments. In some countries the institutional structures and systems originally established to staff and operate the civil service have collapsed. In Uganda, a civil service census turned up not only numerous nonexistent workers but also entire nonexistent schools.

As a result, in Latin America, South Asia, and Africa, civil service reform has become a high priority for many governments. Civil service reform programs generally have three components. The first is a retrenchment effort to downsize the civil services to more manageable numbers of employees. The second is pay and grading restructuring to increase incentives, reduce moonlighting and corruption, and provide a better framework for career development. The third is institutional rebuilding to create the control structures and operating procedures needed to manage a modern and efficient civil service.

Most civil service reform programs have moved on all fronts simultaneously. The more successful African programs have cut back on the numbers of public employees (Ghana, the Gambia, and Guinea). But their progress has been limited to improved pay structures and some reform of institutional structures. No African country's ongoing reform program has completely rebuilt its civil service structures. The Ghanaian program, in operation since 1985 and probably the farthest-reaching, has yet to establish an effective system to control recruitment.

None of the programs now under way appears to embrace a serious examination of government functions to determine which can be privatized, delegated to the local community, or stopped altogether. Given the need for smaller, more efficient public sectors and a more dynamic private sector, future civil service reform efforts would definitely benefit from tackling such larger issues.

SUBSIDIES AND TRANSFERS. Expenditure on subsidies and transfers accounts for about 3 percent of GDP on average for a large sample of countries. It is difficult to generalize about them because they are one of the most heterogeneous categories of spending. Moreover, reporting systems are weak in most countries. The real cost of subsidies and transfers could easily be twice what is on the books. Subsidies often result from government interventions in prices, and they may apply to all manner of goods and services: wheat in Egypt and the Soviet Union; bus travel in Sri Lanka; fertilizer in Bangladesh, Ecuador, and India; and so on. Transfers are usually made to state-owned enterprises. They become necessary either because the SOEs are inefficient, or because price controls and other restrictions force them to operate at a loss. These transfers, however, are generally insufficient to meet the enterprises' needs for capital investment; as a result, standards of service have deteriorated dramatically in some countries. The telephone system and railways in Argentina and the bus service in Egypt, for instance, have suffered from far too little investment.

MILITARY SPENDING. The world spends $1,000 billion on the military every year. In the late 1980s, military expenditure totaled $860 billion a year in high-income countries and $170 billion a year in developing ones. Of this $170 billion, $38 billion was spent on imports of arms, mostly from industrial countries.

If global military expenditure were reduced, the world would undoubtedly be a better place. But is this realistic? Humanity is no stranger to wars and conflicts—twentieth-century humanity least of all (Box 7.6). The recent war in the Gulf region; ensuing conflicts there; continued violence in Afghanistan, Angola, Central America, and Indochina; civil wars in Ethiopia, Mozambique, Somalia, and Sudan; and the snail's pace of superpower disarmament—all make it only too clear

how difficult progress toward lasting peace will be.

Unsurprisingly, military spending is higher in the developing countries that face external or internal threats. Military spending is more than 10 percent of GDP in several countries. After the ethnic conflict that erupted in 1983, Sri Lanka's military expenditure has increased from less than 1

Box 7.6 War and development

The two world wars involved unprecedented numbers of nations and resulted in unprecedented loss of life. But regional wars and civil upheavals since 1945 have also claimed lives and have devastated individual countries, many of them in the developing world (Box table 7.6). The commonly reported estimates of 450,000 deaths in the Iran-Iraq conflict equal about 1 percent of those countries' combined populations at the start of the conflict in 1979. The 2 million losses in the Ethiopian Civil War constitute more than 7 percent of the country's 1974 population.

Battlefield death tolls underestimate war's impact. War makes heavy claims on the most productive workers. In World War I, only 4.5 percent of Germany's fatalities were more than forty years old; 63 percent were between ages twenty and thirty. In addition, soldiers are not the only ones to die. Civilians succumb directly fighting and from war-related famine and disease; military mobilization results in lower birth rates. Totaled this way, the loss of life during the period 1914-21 (which includes the Soviet civil war) may exceed 60 million. Only about 8 million of these were mobilized men.

The costs of fighting involve more than the cost of bullets, uniforms, and equipment. The 1969 Soccer War between Honduras and El Salvador lasted just 100 hours. About 2,000 people died. But 100,000 people became refugees. The fighting destroyed half of El Salvador's oil refining and storage facilities and paralyzed the Central American Common Market. Military expenditure and forgone output during the first five years of the Iran-Iraq conflict cost more than $400 billion. The cost by the end of the war in 1988 was much higher. Economic disruption is similarly severe in civil wars. The conflict in northern Ethiopia's Eritrea territory has cut the labor force; bombs and mines have caused farmers to avoid some land, thus effectively taking it out of production—40 percent of land was estimated to have been left idle in 1987, which partly explains the food shortfalls in the region.

Inevitably, war retards development. The combined costs of replacing lost equipment, providing health care for the wounded, and enduring lower productivity are paid long after armistice. In the Nigerian Civil War of 1967-70, the government sought to finance the war without triggering high inflation or causing deterioration in the balance of payments. It restricted bank credit to restrain internal demand; it raised taxes, cut capital investment, and sharply decreased nondefense expenditures, including those for general administration, social and community welfare, and economic services. But because of the high cost of importing weapons and of forgone exports, these policies could not prevent the deterioration of Nigeria's balance of payments position.

Box table 7.6 Deaths during wars, 1900–89

	Number of wars		*Deaths during international wars (thousands)*			*Deaths during civil wars (thousands)*			*Total deaths as percentage of world*
Period	*Civil*	*International*	*Civilian*	*Military*	*Total*[a]	*Civilian*	*Military*	*Total*[a]	*population*
1900-09	10	6	230	12	243	25	139	166	0.02
1910-19	15	9	7,045	13,470	20,556	1,140	139	1,327	1.13
1920-29	11	8	21	42	109	39	111	371	0.02
1930-39	11	8	933	838	1,770	646	1,109	1,796	0.17
1940-49	13	7	20,176	19,110	39,285	1,007	5	2,182	1.70
1950-59	20	5	1,073	1,926	3,031	1,571	253	1,879	0.17
1960-69	12	9	622	605	1,256	1,827	1,222	3,301	0.13
1970-79	18	7	639	606	1,246	3,543	1,236	4,957	0.16
1980-89	29	6	702	931	1,733	1,899	179	2,081	0.08
1900-89	141	63	31,440	37,539	69,229	11,697	4,393	18,059	. .

Note: All but 11,000 of the war deaths following 1949 took place in developing countries. All numbers are estimates and are subject to significant error. Domestic conflicts are not always clearly definable as civil wars, and thus coverage of these statistics varies among studies. A variety of civil disruptions are excluded. For example, estimated deaths during purges and collectivization in the Soviet Union during the 1930s, which range from 5 to 20 million people, are not included. Figures for deaths resulting from other such events after World War II are also excluded because of poor data. Rough estimates for these range up to 15 million. Also, some wars are counted as civil even when foreign intervention occurred. Deaths during the Korean War, deaths during the Viet Nam War for the 1965-75 period, and the war in Afghanistan for the 1978-89 period are included under international wars.

a. Totals include total estimated deaths. When breakdowns are unavailable, deaths are omitted from civilian and military subcategories. Totals may also differ as a result of rounding. Deaths were prorated when reporting periods spanned more than one decade.

Sources: Sivard 1988, 1989.

Table 7.6 Public expenditure on the military compared with that on social sectors, 1986
(percentage of GNP)

Military expenditure	*Expenditure on health and education*					
	1–1.9	*2–4.9*		*5–9.9*		*10 and above*
Less than 1		Brazil Ghana	Mexico Niger	Barbados Cyprus	Gambia	Costa Rica Luxembourg
1–1.9	Nigeria Paraguay	Argentina Bangladesh Cameroon Colombia Dominican Rep. Ecuador Guatemala	Haiti Nepal Philippines Romania Rwanda Sierra Leone	Algeria Central African Rep. Côte d'Ivoire Fiji Jamaica Malta	Papua New Guinea Swaziland Trinidad and Tobago Venezuela	Austria Finland Ireland Japan Switzerland
2–4.9	Uganda Zaire	Burundi Benin Bolivia Burkina Faso El Salvador Guinea	India Indonesia Mali Myanmar Turkey Uruguay	Bulgaria Chile Congo Czechoslovakia Gabon German Dem. Rep. Hungary Italy Kenya Lesotho Liberia Madagascar	Malawi Mauritania Poland Senegal Somalia South Africa Spain Tanzania Thailand Togo Yugoslavia Zambia	Australia Belgium Botswana Canada Denmark France Germany, Fed. Rep. Netherlands New Zealand Norway Panama Portugal Sweden
5–9.9		Chad China Pakistan Peru	Sri Lanka Sudan United Arab Emirates	Bahrain Cuba Egypt Ethiopia Greece Honduras Korea, Rep. of Kuwait	Malaysia Morocco Singapore Tunisia United States Yemen, Arab Rep.	United Kingdom Zimbabwe
10 and above		Angola Iraq		Iran, I.R. of Israel Jordan Oman	Syria USSR Yemen, P.D.R.	Guyana Libya Nicaragua Saudi Arabia

Note: The ranges given in this table are illustrative of the differences in expenditures in the different categories; they are not necessarily indicative of precise differences across countries because of some differences in the definition of the categories. The estimates of social expenditure do not cover those by local bodies.
Source: Sivard 1989.

percent of GDP to about 5 percent. Many poor countries expend more on the military than on social sectors (Table 7.6). During the past three decades, military and civilian regimes appear to have spent roughly the same share of their GDP on their armed forces.

In high-income countries, military spending has been increasing at the same rate as GDP. In developing countries, military expenditure has been declining—from 6–7 percent of GDP in the late 1970s to about 5 percent in the second half of the 1980s. This was mainly the result of a drastic reduction of military spending in the Middle East (especially in Syria and Egypt) and in Latin America (after the fiscal crisis of the 1980s). But 5 percent of GDP is still an enormous sum; in many countries it would be more than enough to double government spending on infrastructure or on health and education.

Governments need to take every possible step to reduce military expenditure. Costa Rica is an outstanding example of a government which decided to reduce military spending and focus its efforts on the provision of health and education—an approach which improved equity and achieved a degree of political stability unusual in the developing world. Costa Rica's poor soils and sparse natural resources meant, however, that the country had few enemies; its experience may not be easy to replicate.

Many countries have to deal with bigger internal and external threats than those facing Costa Rica; even so, these threats hardly justify the sums being spent today on armed might. Aid and finance agencies are entitled to ask whether it makes sense to help governments whose first priority is not to develop but to add to their military strength.

Privatizing and reforming state-owned enterprises

In the 1980s and 1990s so far, transferring state-owned enterprises to the private sector has been an important government objective both in OECD countries such as New Zealand and the United Kingdom, and in developing countries such as Argentina, Brazil, Chile, Ghana, the Republic of Korea, Malaysia, Mexico, Nigeria, Togo, and Turkey. In most of these countries, privatization has meant much more than merely transferring assets to the private sector. It has been part of a broader exercise aimed at stabilizing and liberalizing the economy on several fronts—regulation, prices, trade, the financial sector. Governments have consciously set out to redefine the economic role of the state. As part of this shift, they have curtailed the SOEs' privileged access to the budget or credit system, tariff or nontariff protection for their products, and regulatory protection from private competitors. They have signaled a new determination not to pursue narrow distributional goals at the expense of efficiency.

Many countries have taken the view that unless privatization were part of such a broad program of reform, it would be an empty gesture. It would merely transfer the control of rents from the public to the private sector. There have been variants on this general approach. In China, deregulation has been accompanied by new institutional arrangements that allow the government to retain ownership while improving the enterprises' efficiency. In Argentina, and in Mexico to a lesser extent, privatization with heavy foreign participation has been used to reduce external debt and increase investment in basic infrastructure, such as energy and telecommunications. In Argentina and Brazil, revenues from privatization are also expected to contribute significantly to balancing the fiscal deficit.

PROBLEMS OF IMPLEMENTATION. Privatization has proven to be an arduous exercise, however. Thin markets for domestic capital, adverse economic conditions, and the resistance of trade unions and civil servants have slowed the process virtually everywhere. Except for relatively advanced economies such as Argentina, Brazil, and Mexico, the infrastructure of privatization—lawyers, accountants, merchant bankers, and entrepreneurs—is largely missing in most developing countries. The need to build up this infrastructure is particularly acute in Eastern Europe, where it is difficult even to find qualified individuals to serve as directors of companies. Departments competent to handle privatization must be created, then adequately staffed and funded: a challenge in itself during times of financial stringency.

Legal issues also complicate privatization. In Mexico, constitutional amendments had to be passed in 1983 before privatization could go forward. In Turkey, sales were canceled when the courts deemed them illegal. In socialist economies, laws must be passed defining property rights, legalizing private ownership, establishing guidelines for articles of incorporation, and protecting minority shareholder interests; all these are necessary if the legality of a private purchase of a company is to be established. Similarly, the legality of the seller must be established. Contrary to popular belief, governments in socialist countries did not hold clear titles to firms. In some instances, assets were nationalized shortly after World War II, but the promised compensation, which would have legalized the nationalizations, was never made. Czechoslovakia and the former German Democratic Republic established new laws granting previous owners priority rights to compensation or the return of their original property. Uncertainty over whether there is a prior claim on the firm's assets has made many potential investors wary of privatization.

Previous attempts at decentralization in socialist economies had given workers in many enterprises rights that traditionally belong to shareholders in Western countries. Workers' councils in Poland have the right to decide on mergers and enterprise dissolution, asset sales, and appointment of chief executive officers; in Yugoslavia, workers' rights are codified even more extensively. In addition, state-owned assets are one of the few positive legacies of years of communist rule; the people insist on a fair distribution of this wealth as partial compensation for the suffering of the past. As a result, there is strong resistance to passing it into the hands of the old communist *nomenklatura*—the managerial class, linked through party ties, who ran the economy. Yet this group is among the richest, and it has the best information on the real worth of enterprises and the business connections

to make firms run. These is a fear that an open market sale of assets will restore the *nomenklatura* to its earlier dominance.

The experience of the former German Democratic Republic suggests that, even under favorable financial, legal, and technical conditions, selling enterprises will take some time. The 9,000 state enterprises to be privatized in eastern Germany correspond to about 30,000–40,000 firms in a market economy. Even though state enterprise sales by Germany's privatization agency (Treuhandanstalt) have now reached 300 per month (compared with 25 per month during ten years in the British privatization program), it will take years to complete the process. Uncertainty about the value of the companies was initially so great that purchase prices were to be settled later by arbitration. Although asset and enterprise values are now clearer, price contingency clauses are being included in most sales contracts to enforce commitments by buyers.

Overall economic conditions, political considerations, and technical aspects of the process also complicate privatization. In Chile, some of the firms privatized during the period 1974–78 were renationalized within a few years to salvage them from the bankruptcies that followed the deep economic crisis. In the mid-1980s in Nepal, a privatization was reversed because of opposition to the transfer of the enterprise to a minority ethnic group. In Bangladesh, unresolved questions of share pricing and debt overhang led privatized firms to neglect investment in maintenance and new capacity. Instead, the firms concentrated on generating immediate cash flow—and much of the efficiency gains expected from privatization evaporated. In the former German Democratic Republic and Hungary, the first heads of the privatization agencies resigned within a year; in Argentina, alleged corruption in some privatizations led to a cabinet reshuffle. Even where privatization has encountered fewer setbacks, achievements have often been modest. In Mexico, for instance, two-thirds of SOEs have been privatized—but these sales account for less than 20 percent of the SOEs' total assets.

A REVOLUTION NONETHELESS. The recent change in government thinking on privatization has been, despite such difficulties, extraordinary. Much of what has been achieved would have been unthinkable ten years ago. In Argentina, the government has privatized two television stations, and awarded sales contracts for the telephone company, the national airline, some components of the national petroleum company, and the main distributor of electricity. More privatizations are expected in the near future. In Chile, privatizations have reversed the emergency nationalizations of the preceding years; sectors traditionally dominated by the government, such as steel, petroleum, and telecommunications, may be privatized in the near future.

In Côte d'Ivoire, the private sector, already involved in water supply, is also going into power generation; in Togo, textile firms have been sold to foreign investors. More privatizations are expected soon in Brazil, Peru, Sri Lanka, and Turkey. Liquidations of nonviable SOEs are going ahead in several African countries.

The first phase of drafting and implementing new legal statutes has been largely completed in Czechoslovakia, Hungary, Poland, and Yugoslavia. Czechoslovakia and Poland seem committed to a quicker pace of privatization and to the creation of a broader shareholding base. Hungary has opted to go more slowly; it is creating joint-stock companies whose shares are deposited with a state holding company until the enterprises can be valued and sold through public offerings. It expects to privatize about two hundred companies in this way during 1991.

In Poland most shops, gas stations, and trucks are already owner-operated, and a significant portion of housing is now private. Typically, the assets have been leased, not bought outright. Auctions of small assets, coordinated by the central authorities, have already started in Czechoslovakia. For the larger firms, programs of "free" distribution of shares are being planned to accelerate privatization. The Polish plan calls for the conversion of several hundred large firms into joint-stock companies, with most shares allotted to workers, pension funds, banks, and other financial intermediaries (acting as trust funds for the population at large); the remaining shares will be sold to private investors. Similar arrangements may be worked out in Czechoslovakia.

LESSONS. Privatization is necessary and highly desirable, even though difficult and time-consuming. It is not to be undertaken as end in itself, but as a means to an end: to use resources more efficiently. Removing price distortions and controls as quickly as possible is essential for that purpose. Unless prices are true indicators of costs and consumer demand, the true profitability of an enterprise can not be known, so its asset cannot be

properly valued. Selling the enterprise at an appropriate price may be impossible, and meanwhile managers will be unable to make informed decisions on investment and production. Letting the price system work as it should means removing distortions such as price controls, distorted transfer prices between enterprises, subsidized loans, and preferential access to the budget and credit system; it also means getting macroeconomic policy right, and that includes avoiding an overvalued exchange rate.

It would be difficult to privatize all SOEs in the near future even if governments wanted to. Meanwhile efforts to raise productivity cannot wait. Governments need not hesitate to liquidate inherently unprofitable enterprises, and the remaining SOEs can be managed much more effectively. Soft budget constraints, interference in management and recruitment, and restrictions on competition (either in product or factor markets) need to be reduced or eliminated. Efficient state enterprises are to be found in many economies: for instance, Brazil, Ethiopia, France, Italy, Korea, Malaysia, and Singapore. These show that SOEs can be run as efficient commercial concerns responsive to consumers. In many developing countries, improving the performance of SOEs is as urgent as privatization in its own right.

The challenge of reform

The challenge for governments is to implement reforms in the face of sometimes trenchant political opposition. Structural reforms may hurt powerful interests. Streamlining the civil service threatens urban workers with unemployment, especially in Africa, where the public sector often employs up to half the salaried work force. Groups that can organize against reform have to be reckoned with; the beneficiaries are often dispersed and unorganized, making it difficult for the government to count on their support.

Box 7.7 From a centrally planned to a market economy

Transforming a centrally planned economy into a market economy requires complex and unprecedented reforms. There is no experience to guide transitions of the current magnitude. And most countries in transition are simultaneously creating a new political order. There is relatively little disagreement that the transitions have to be made, but there is much controversy about the theory, timing, scope, speed, and sequencing of reforms.

Three sets of issues arise. One concerns the economic implications of a policy sequence: will one kind of reform achieve its objectives while other economic distortions remain? Another question is political: will mounting opposition derail reforms scheduled near the end of the sequence? Finally, there is technical feasibility. New legal, accounting, and financial systems will require greater technical expertise and longer gestation periods than reforms that include only price deregulation.

One school of reform proposals puts change in ownership at the head of the sequence before or alongside changes that address macroeconomic stability and markets. The rationale is partly political. With early privatization, there is less risk that the economy will remain state-controlled and greater pressure for complementary market-oriented reforms. But another school of thought begins with macroeconomic and market-building reforms: it leaves privatization—at least for large state enterprises—to a second stage. (Under both proposals some agricultural, retail, and residential assets would be privatized early.) The rationale is that private ownership requires financial institutions, experience, and expertise that do not yet exist in the transitional economies. Without this infrastructure, rapid privatization could lead to widespread corruption and economic and political chaos. Within each school there are further differences on the proper order for addressing particular distortions.

No single reform sequence will fit all the transitional economies. Reform histories vary; unlike others, Hungary has had more than two decades of experience with decentralized economic decisions. Macroeconomic conditions range from great instability (the Soviet Union) to relative stability (Czechoslovakia). Private sector activity has been relatively higher in predominantly agricultural countries such as China and Viet Nam but negligible in more industrialized nations.

A preferred sequencing (Box figure 7.7) would include early steps to stabilize the macroeconomy and deregulate domestic- and external-sector prices to give clear, accurate signals for economic activity and for the valuation of enterprises. These steps would be accompanied and followed by intense efforts to rationalize enterprises, improve economic decisionmaking, reform trade policy, and build managerial skills and a strong financial sector. Privatization of large state enterprises would become the next priority. Protection

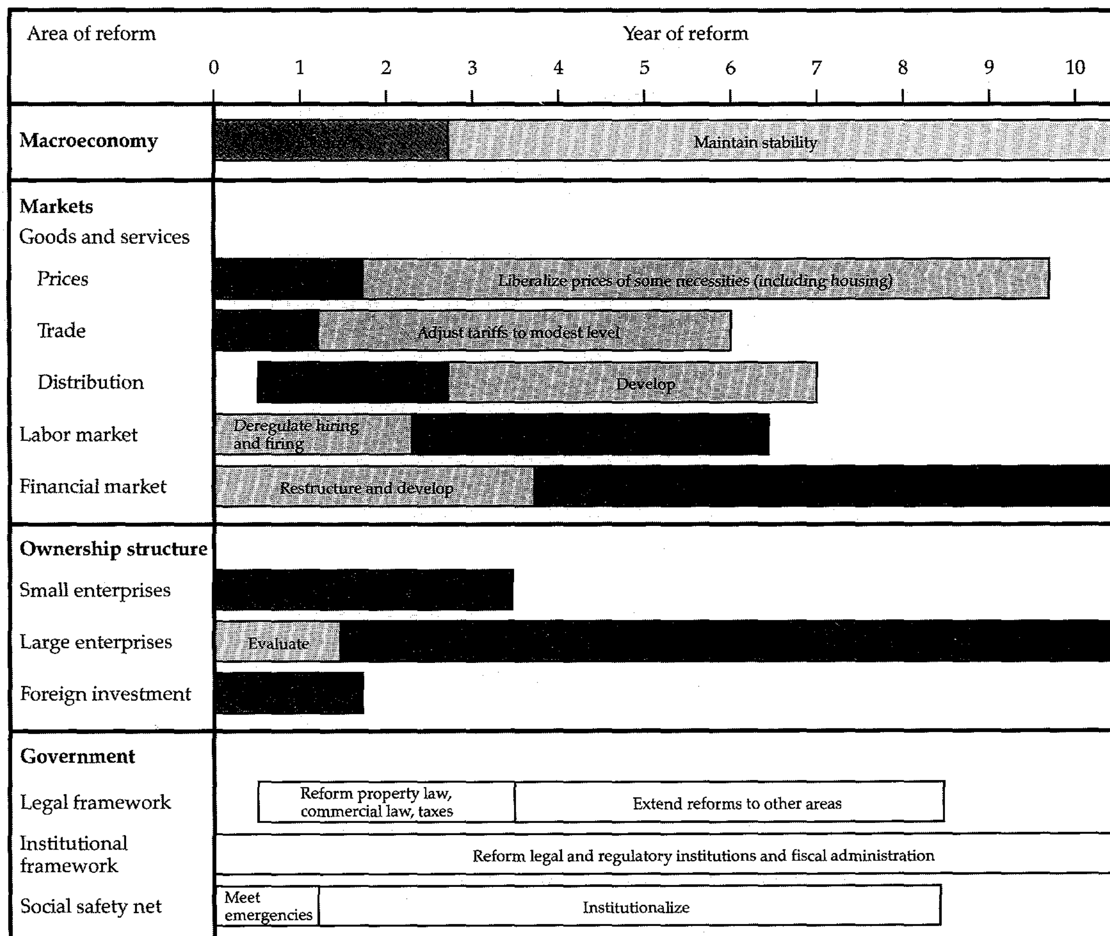
Box 7.7 *(continued)*

would be cut and the economy would be opened to foreign competition on a firm, preannounced schedule—first in goods and later in capital markets. Institution building would be a basic theme from the start and at all levels: the legal contractual system, the structure of ownership, and the roles of key organizations in the economy would require reform and restructuring.

Large-scale privatization would not be at the head of the sequence, but to address the risk in delaying it, there would be early legal commitments (the distribution of shares) that would guarantee private ownership within a reasonable time. The program would be fast, in that each type of reform would move at the maximum rate consistent with developing institutional capacities. Indeed, a three-to-five-year time span seems optimistic in light of the progress achieved so far in the transitional economies.

Reforms will surely involve painful adjustments. Inflation and unemployment will worsen as price controls are removed and the real economic losses of some activities are revealed. Political opposition may mount with these developments and with the rise in income inequality that comes after radical change in the incentive structure. But progress in exports and the availability of consumer goods could soon follow. And, given the relatively strong human resource endowments in Eastern Europe, prospects for growth could be excellent.

Box figure 7.7 The phasing of reform



Note: Darker shading indicates intensive action. QRs, quantitative restrictions.

If output responds quickly to a program of reforms, support for the program will increase and the changes can be consolidated. Rapid growth in exports bolstered reforms in Indonesia, Korea, and Turkey. Strong export growth can also help to prevent policy reversals caused by balance of payments problems and dwindling foreign exchange reserves. Reforms that improve the investment climate are more likely to be sustained because new investors will add to the forces in support. Expanding output and investment would enlarge the tax base, raise tax revenues, and reduce the budget deficit. All this argues for reforms that are bold enough to elicit a prompt supply-side response. Timid programs are unlikely to win converts to the cause of reform. Many reformers in Eastern Europe have taken these lessons to heart (Box 7.7).

Despite the political difficulties, many governments have shown great ingenuity in implementing controversial reforms. For instance, the governments of Bolivia, Ghana, Korea, and Mexico strived to convince the public of the costs of inaction and to explain the thinking behind their reforms. International diplomacy can lend credibility to the cause. Agreements with the EEC helped Greece, Israel, Portugal, and Spain adopt trade reforms in the 1960s; accession to the GATT helped Mexico in 1986. Some governments have negotiated social pacts to distribute the burden of adjustment equitably between labor and business, as in Mexico in the 1980s and Israel in 1986. In Chile in the early 1980s and Sri Lanka in the mid-1980s, the success of trade liberalization gradually changed the orientation of the manufacturers' association from import substitution to export promotion. In general, governments committed to addressing their societies' problems have rarely lost power because of this determination.

Of course, there are limits to persuasion. Often, it seems, reform can be born only of a full-blown economic or political crisis. Examples range from Meiji Japan to contemporary Argentina, Ghana, Peru, and Poland. Sometimes, even in the face of economic collapse, reform is blocked by the government's key supporters. In such cases, external lenders and aid agencies face an extremely uncomfortable fact: despite the country's need of external resources, such support may do more harm than good by helping to keep the anti-reform administration in power.

In countries that are not paralyzed by political forces, and where reform can go forward, the task for external aid and finance agencies is to promote it. They can do this by avoiding support for unproductive activities or for new projects that would be implemented under severely distorted conditions. In many countries, external agencies must help to strengthen the public institutions without which development assistance is likely to be ineffectual. Reform sometimes imposes heavy costs on those least able to bear them: the poor. Well-designed safety nets (such as the emergency adjustment funds introduced in Bolivia and Ghana in the 1980s) can help the most vulnerable and, in doing so, broaden the constituency for development.

Reform will remain a formidable task, requiring political courage and economic vision. Combining the many different elements described here and in other chapters is, in itself, enormously difficult. The appropriate combination of factors will vary from country to country, according to circumstances. And even when reform is well-designed, governments are sure to encounter unforeseen setbacks, some of them entirely beyond their control. Development is indeed a challenge—but, as history tells us, one that can be met.