PART ONE

RETHINKING THE STATE—THE WORLD OVER

THROUGHOUT HISTORY, NOTIONS OF THE STATE'S ROLE HAVE SHIFTED DRAMATically. For much of this century people looked to government to do more—in some cases a great deal more. But during the past fifteen years the pendulum has been swinging again, forcing the world to look at government from a range of conflicting perspectives. The end of the Cold War and the collapse of command-and-control economies, the fiscal crises of welfare states, the dramatic success of some East Asian countries in accelerating economic growth and reducing poverty, and the crisis of failed states in parts of Africa and elsewhere—all of these have challenged existing conceptions of the state's place in the world and its potential contribution to human welfare.

Governments are also having to respond to the rapid diffusion of technology, growing demographic pressures, increased environmental concerns, greater global integration of markets, and a shift to more democratic forms of government. And amid all these pressures remain the formidable—and persistent—challenges of reducing poverty and fostering sustainable development.

It is not surprising, then, that countries are again putting the state under scrutiny, asking what government's role ought to be and, critically, how that role should be played. This Report explores why and how some states have been more effective than others at playing a catalytic and sustainable role in economic development and the eradication of poverty. This part of the Report provides a broad historical and conceptual introduction to the issues (in Chapter 1) and examines the empirical evidence of the impact of state policies and institutions on development (in Chapter 2). It conveys three principal messages:

- Development—economic, social, and sustainable—without an effective state is impossible. It is increasingly recognized that an effective state—not a minimal one—is central to economic and social development, but more as partner and facilitator than as director. States should work to complement markets, not replace them.
- A rich body of evidence shows the importance of good economic policies (including the promotion of macroeconomic stability), well-developed human capital, and openness to the world economy for broad-based, sustainable growth and the reduction of poverty. But as our understanding of the ingredients of development improves, a deeper set of questions emerges: why have some societies pursued these actions with greater success than others, and how, precisely, did the state contribute to these differing outcomes?
- The historical record suggests the importance of building on the relative strengths of the market, the state, and civil society to improve the state's effectiveness. This suggests a two-part strategy of matching the role of the state to its capability, and then improving that capability. These are the subject, respectively, of Parts Two and Three.

CHAPTER 1

THE EVOLVING ROLE OF THE STATE

A CENTURY AGO, A CANADIAN FARMER AND AN Ivorian probably felt little connection with their governments, and none at all to each other. Government affected their lives only to the extent that it provided a handful of classic public goods, such as law and order and basic infrastructure, and collected taxes from them.

Today the state has expanded dramatically—and the world has shrunk. The same farmers' descendants send their children to government-run schools, receive medical treatment from publicly supported clinics, rely on an array of publicly provided services, and may benefit from government price controls on the seed and fertilizer they buy, or the wheat or coffee they sell. These later generations of Canadians and Ivorians are therefore likely to be much more concerned than their ancestors were about the effectiveness of government and the checks and balances on its decisions. And they are likely to be much more aware of how their own government's performance compares with others'. Vastly expanded communications, trade and investment, radio and television, friends and relatives traveling to foreign lands as tourists or migrant laborers—all of these give Canadians and Ivorians today a much better idea of how the government services they receive measure up to those in other countries. The state's behavior, and the consequences of that behavior, are being scrutinized like never before.

This scrutiny might lead to better government. But if states are unable to respond constructively to the challenges they face, the result could simply be further erosion of the state's credibility, as the gap between what the state can do, and what people ask it to do, widens even further. The terminal phase of this process is visible in the recent agonies of Angola, Somalia, and Zaire. The state collapses from within, leaving citizens bereft of even the most basic conditions of a stable existence: law and security, trust in contracts, and a sound medium of exchange. These crises recall Thomas Hobbes' insight, in his 1651 treatise *Leviathan*, that life without an effective state to preserve order is "solitary, poor, nasty, brutish and short."

This Report aims to show how every state, regardless of its point of departure, can improve its effectiveness and move ever further away from this doomsday scenario. Toward that end, this chapter begins with a reminder of how we got here. Surveying the history of the state from its early beginnings, it shows how notions of the state's role have evolved to produce, in both industrial and developing countries, a dramatic expansion of the state and, more recently, a change of emphasis from the quantity of government to the quality. The chapter then lays out a simple framework for rethinking the state, introducing a two-part strategy for greater state effectiveness that the rest of the Report explores. The message is that the state can rise to the challenges it faces, but only by, first, matching what it tries to do to what it can do, and second, working to increase the number of things it can do capably by reinvigorating public institutions.

Where the state began

From earliest times human beings have banded together into larger associations, starting with household and kinship groups and extending through to the modern state. For states to exist, individuals and groups have to cede authority in key areas, such as defense, to a public agency. That agency has to possess coercive power over all other organizational forms within a designated territory.

States have come in all shapes and sizes, depending on a mix of factors including culture, natural endowments, opportunities for trade, and distribution of power. The ancient Athenian state, for example, was underpinned by slavery and colonial spoils. Further east, elaborate state structures were built from early times on the basis of state ownership of land or, in Mughal India and

Box 1.1 State and government: Some concepts

State, in its wider sense, refers to a set of institutions that possess the means of legitimate coercion, exercised over a defined territory and its population, referred to as society. The state monopolizes rulemaking within its territory through the medium of an organized government.

The term *government* is often used differently in different contexts. It can refer to the process of governing, to the exercise of power. It can also refer to the existence of that process, to a condition of "ordered rule." "Government" often means the people who fill the positions of authority in a state. Finally, the term may refer to the manner, method or system of governing in a society: to the structure and arrangement of offices and how they relate to the governed. While keeping these distinctions in mind, we also use the terms *state* and *government* colloquially and sometimes interchangeably—as they are often used in discussion and writing around the world.

Government is normally regarded as consisting of three distinct sets of powers, each with its assigned role. One is the *legislature*, whose role is to make the law. The second is the *executive* (sometimes referred to as "the government"), which is responsible for implementing the law. The third is the *judiciary*, which is responsible for interpreting and applying the law.

Classifications of government are many but have tended to concentrate on two criteria: the arrangement of offices, which is more narrow in conception, and the relationship between government and the governed. The first classification is based on the relationship between the executive and the legislature. In a *parliamentary* system the executive's continuance in office depends on its maintaining the support of the legislature. Members of the executive are commonly also members of the legislature. A prime minister may be the most powerful member of the executive, but important decisions within the executive are usually made collectively by a group of ministers. In a *presidential* system the executive's position is independent of the legislature. Members of the executive are not normally also members of the legislature, and ultimate decisionmaking authority within the executive lies with one person, the president.

The second classification concentrates on the distribution of power between levels of government. In a *unitary* state, all authority to make laws is vested in one supreme legislature whose jurisdiction covers the whole country. Local legislatures may exist, but only with the sufferance of the national legislature. In a *federal* state, local legislatures are guaranteed at least a measure of autonomous decisionmaking authority. In a *confederation*, a group of sovereign states combine for specified purposes, but each state retains its sovereignty.

imperial China, highly developed systems of administration and tax collection. The combination of public ownership of land and a complex bureaucracy long impeded the emergence of modern, market-based economies in these regions.

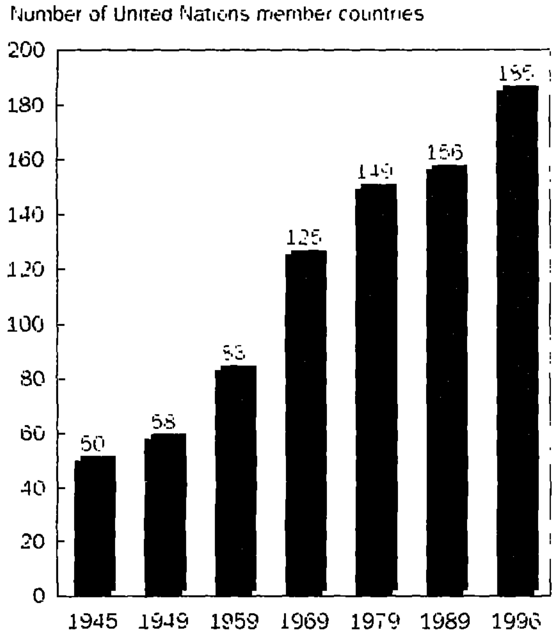
Yet despite this diversity of origins, states over time came to acquire several common and defining features worldwide. Modern states have a consolidated territory and population, and within these they play a centralizing and coordinating role. Sovereign authority commonly encompasses separate judicial, legislative, and executive functions (Box 1.1). Since the eighteenth century, through conquest and colonization, nation-states have incorporated most of the world into their own mutually exclusive territories. As empires disintegrated and minority groups established claims to statehood, the number of nations increased sharply. Membership in the United Nations jumped from 50 independent countries in 1945 to 185 in 1996 (Figure 1.1).

Modest beginnings

The configuration of states has varied widely across continents and centuries, but arguments over the proper roles of the public and private spheres have not. Whether in Niccolò Machiavelli's *The Prince*, Kautiliya's *Arthashastra*, Confucius' writings, or Ibn Khaldoun's *The Muqaddimah*, the discussion has revolved around the mutual rights and obligations of states and citizens. Almost all these traditions have included a role for the state in providing basic public goods (although the weight accorded to public, as opposed to private, goals has varied considerably). Using public resources to provide critical public goods and to raise private productivity is nothing new.

Beyond these minimal functions, however, there has been much less agreement on the appropriate role of the state in promoting development. Seventeenth-century mercantilists saw a major role for the state in guiding trade. Not until Adam Smith wrote *The Wealth of Nations* in the late eighteenth century was it generally recognized that the market was the best instrument for realizing growth and improving welfare. The state, on this view, was best held to certain core functions—providing public goods such as defense, ensuring the security of persons and property, educating the citizenry, and enforcing contracts—deemed essential for the market to flourish.

Figure 1.1 One world, many more states



Note: Data are as of the end of the year. Source: United Nations data.

But even then, state intervention went on to play a vital, catalytic role in the development and growth of markets in Europe, Japan, and North America. In the United States, where state involvement in the economy has historically been more limited than in Europe or Japan, government was instrumental in constructing the first telegraph line, which spurred development of the telecommunications industry, and in agricultural research and extension, which stimulated productivity gains (Box 1.2).

In the nineteenth century the state's role in redistributing income was still quite limited. Redistribution in Europe came mainly through private charity and other voluntary action. Tax systems were usually restricted to customs, excise, monopoly, and commodity taxes. Income taxation, which had been introduced in France and Britain by the end of the eighteenth century, was not a major source of revenue. The first faint stirrings of the modern welfare state were seen in Germany, at the end of the nineteenth century, where Chancellor Otto von Bismarck introduced the first nationwide systems of social insurance.

The expanding state in industrial countries . . .

States remained small by modern standards until well into this century. A series of dramatic events in the aftermath of World War I marked the turning point. The first was the Russian Revolution of 1917, which led to the abolition there of most private property and put the state in control, through central planning, of all economic activity. The second was the Great Depression of the 1930s, which caused such economic devastation in the noncommunist world that states were spurred to experiment with

Box 1.2 U.S. government action to support market development: Some examples

The United States is the country that produced and believes in the dictum that "That government is best that governs least." Whereas in many parts of the world the role of the government has evolved gradually, the United States was founded on a revolution. The framers of the Constitution explicitly asked, What should be the role of the government?

Yet even in the United States, where laissez-faire and distrust of government are central to the framing of the state's role in society, government action has often proved critical to the growth and development of markets. For example:

- The global telecommunications industry has its roots in U.S. government support for the first telegraph line between Washington and Baltimore in the early 1840s.
- The enormous increase in agricultural productivity in the nineteenth and twentieth centuries can be traced to the federally supported program of research and extension services dating from the Morrill Act of 1863.
- The Northwest Ordinances of 1785 and 1787 committed the government to supporting education, and to devoting the revenues from the sale of certain lands to that purpose. And in 1863 the federal government helped establish the public university system.
- In 1863, in the midst of the Civil War, the Congress recognized the need for a national financial system and passed the National Banking Act, establishing the first nationwide bank supervisory agency. In later years the government created the Federal Reserve System (the U.S. central bank) as well as a series of public financial intermediaries.
- The interstate highway system and federal support for the establishment of railroads are cases of vital public involvement in transport infrastructure that helped the development of markets in the United States.

countercyclical policies to restore economic activity. The third event, unleashed by World War II, was the rapid breakup of European empires. That geopolitical change—as well as the clamor for social insurance in the industrial economies—ushered in fifty years of policy debate focused around a more activist role for government.

The postwar paradigm coalesced around three basic themes, all of which commanded broad, if not uniform, agreement. This three-pillared consensus remained largely undisturbed until the first oil price shock of 1973. First was the need to provide welfare benefits to those suffering from transitory loss of income or other deprivation. Second was the desirability of a mixed public-private economy, which would often mean nationalizing a range of strategic industries. Third was the need for a coordinated macroeconomic policy, on the grounds that the market alone could not deliver stable macroeconomic outcomes that were consistent with individuals' objectives. In time, the goals of macroeconomic policy were made explicit: full employment, price stability, and balance of payments equilibrium.

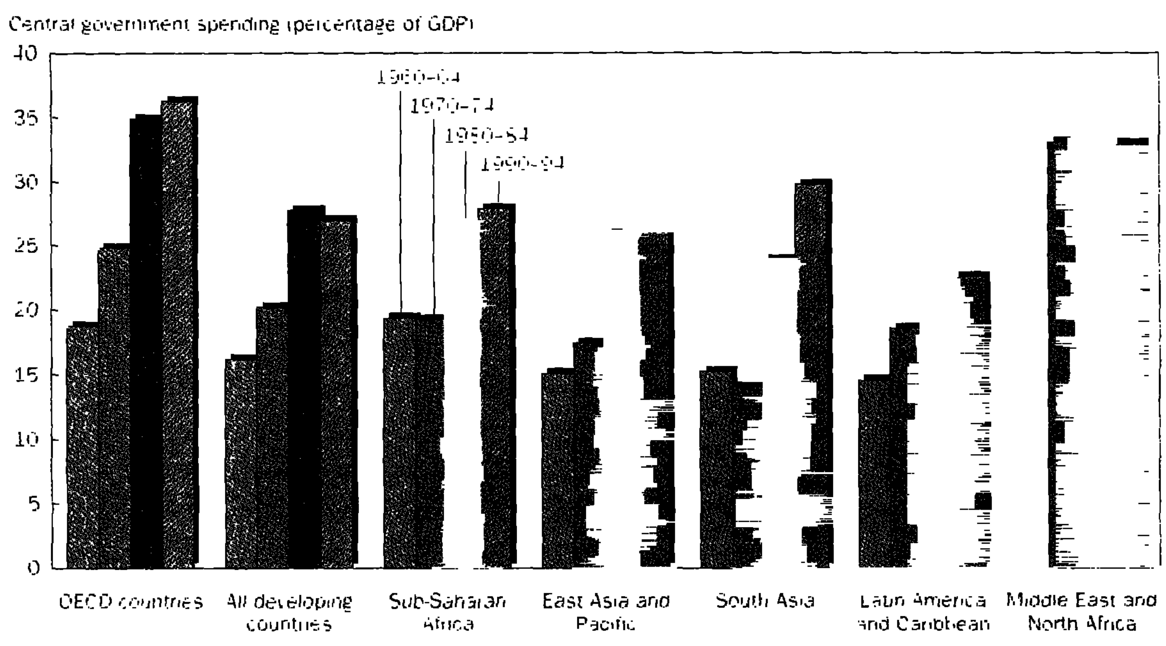
States thus took on new roles and expanded existing ones. By mid-century the range of tasks performed by public institutions included not only wider provision of infrastructure and utilities, but also much more extensive support for education and health care. In the three-and-a-half decades between 1960 and 1995, governments in the industrial countries swelled to twice their starting size (Figure 1.2), with much of the expansion driven by increases in transfers and subsidies.

Indeed, by the early 1990s it was fair to say that most industrial-country governments spent more time moving money around the economy in the form of transfers and subsidies than they spent providing traditional public goods. Spending on defense and on law and order had shrunk to some 10 percent of general-government outlays, while over half of all tax revenues were transferred to individual beneficiaries (Figure 1.3). Demographics accounted for some of the shift, as aging populations forced an increase in outlays for pensions and health care. But national preferences also made a difference. Thus, from a point of rough equivalence in 1960, the Swedish state grew to nearly twice the size of that in the United States by 1995, in terms of both spending as a share of income and public employment as a share of the population.

. . . And in developing countries

Governments in developing countries were also reaching into new areas. They, too, grew dramatically in the second half of the twentieth century (Figure 1.2). Initially, much of the growth came from state and nation building after

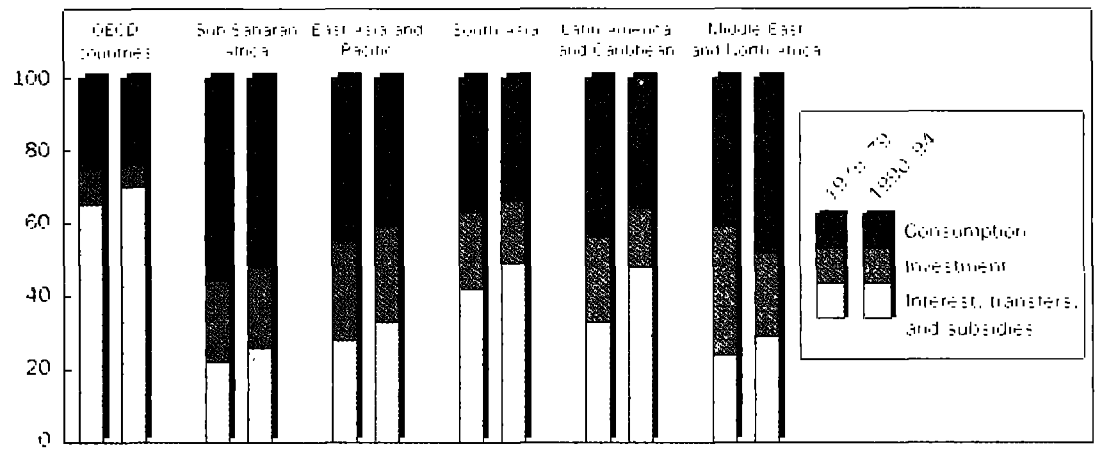
Figure 1.2 Governments the world over have expanded since 1960



Note: Data are in current national prices. Data for Middle East and North Africa for 1960–64 are unavailable. Source: IMF, various years (a) and (b); World Bank data.

Figure 1.3 Transfers and interest payments have grown

Composition of central government spending (percentage of total)



Note: Data are averages for the years indicated. Source: IMF, various years (a).

the collapse of colonialism. The ups and downs in international commodity markets also had an impact. Resource-rich economies such as Mexico, Nigeria, and Venezuela tended to use the revenue bonanzas from the oil price rises of the 1970s and other commodity booms to expand their public sectors, sometimes with reckless abandon. Oil-importing countries, under the imperative of fiscal austerity, were less able to expand their spending.

Perhaps more significant than these forces has been the shift in thinking about the role of the state over the past fifty years. Most developing countries in Asia, the Middle East, and Africa came out of the colonial period with a strong belief in state-dominated economic development. The state would mobilize resources and people and direct them toward rapid growth and the eradication of social injustice. State control of the economy, following the example of the Soviet Union, was central to this strategy. (How it was followed in one country, India, is described in Box 1.3.) Many Latin American, Middle Eastern, and African countries also followed this postwar pattern of state-dominated, import-substituting industrialization.

This belief was reinforced by the popularity of state activism worldwide. The Great Depression was seen as a failure of capitalism and markets, while state interventions—the Marshall Plan, Keynesian demand management, and the welfare state—seemed to record one success after another. The new interventionist credo had its counterpart in the development strategy of the day, adopted by many developing countries at independence, which emphasized the prevalence of market failures and accorded the state a central role in correcting them. Centralized planning, corrective interventions in resource allocation, and a heavy state hand in infant-industry development were part and parcel of this strategy. Economic nationalism was added to the mix, to be promoted through state enterprises and encouragement of the indigenous private sector. By the 1960s states had become involved in virtually every aspect of the economy, administering prices and increasingly regulating labor, foreign exchange, and financial markets.

By the 1970s the costs of this strategy were coming home to roost. The oil price shocks were a last gasp for state expansion. For the oil exporters they created a bonanza, which many threw into even greater expansion of state programs. As long as resources were flowing in, the institutional weaknesses stayed hidden. The oil-importing countries, for their part, got caught on a treadmill of heavy borrowing of recycled petrodollars to keep the state growing. The costs of this development strategy were suddenly exposed when the debt crisis hit in the 1980s and oil prices plunged.

The collapse of the Soviet Union—by then no longer an attractive model—sounded the death knell for a developmental era. Suddenly, government failure, including the failure of publicly owned firms, seemed everywhere glaringly evident. Governments began to adopt policies designed to reduce the scope of the state's intervention in the economy. States curbed their involvement in production, prices, and trade. Market-friendly strategies took hold in large parts of the developing world. The

Box 1.3 Evolution of the role of the state in India: The past fifty years

When India became independent in 1947, income per capita had been stagnating for half a century, and modern industry was minimal.

The Nehru years, 1947–64. India's first prime minister, Jawaharlal Nehru, saw industrialization as the key to alleviating poverty, and a powerful state with a planned economy as essential if the country was to industrialize rapidly, accelerate public saving and investment, and reduce the role of foreign trade and achieve self-sufficiency. Unlike many East Asian countries, which used state intervention to build strong private sector industries, India opted for state control over key industries. Believing the potential of agriculture and exports to be limited, Indian governments taxed agriculture by skewing the terms of trade against it and emphasizing import substitution. They saw technical education as vital for industrialization.

Garibi hatao, 1966–77. Under Prime Minister Indira Gandhi, two major shifts took place in the role of the state. First, the neglect of agriculture was reversed through state activism in subsidizing new seeds and fertilizers, agricultural credit, and rural electrification. The green revolution took off, and by the mid-1970s India was self-sufficient in grain. The second shift was the tightening of state control over every aspect of the economy. Under the slogan of *garibi hatao* ("abolish poverty"), banks were nationalized, trade was increasingly restricted, price controls were imposed on a wide range of products, and foreign investment was squeezed. The state achieved a stranglehold on the economy. Yet growth of gross domestic product (GDP) failed to accelerate, remaining during this period at 3.5 percent a year.

The spending boom and rising fiscal deficits, 1977–91. Between 1977 and 1991, most stringent controls on imports and industrial licensing were gradually relaxed, stimulating industrial growth. The government expanded antipoverty schemes, especially rural employment schemes, but only a small fraction of the rising subsidies actually reached the poor. Competition between political parties drove subsidies up at every election. The resulting large fiscal deficits (8.4 percent of GDP in 1985) contributed to a rising current account deficit. India's foreign exchange reserves were virtually exhausted by mid-1991, when a new government headed by Narasimha Rao came to power.

The reform phase, 1991 to the present. Rising interest payments on India's foreign debt meant that neither the central government nor the state governments could continue to finance both subsidies and heavy public investment. The former won out, and the government began to woo private and foreign investment. Thus, impending bankruptcy drove the reform process and changed the state's role from that of principal investor to that of facilitator of entrepreneurship. This shift was expected to free up government finances for more social spending, but in practice the fiscal crunch prevented a significant increase.

Rao's government abolished most industrial and import licensing, devalued the rupee, drastically reduced import tariffs, liberalized the financial sector and foreign investment, and allowed private investment in areas previously reserved for the government. The new coalition government that came to power in 1996 has by and large sustained these reforms. And the 1997 budget takes very positive steps in that direction.

Thus the old national consensus on socialism has given way over the course of a few years to a new consensus on liberalization. But formidable challenges remain. Most parties agree on the need for reform, yet no party is eager to retrench surplus labor, close unviable factories, or reduce subsidies. The reforms so far are a positive step but must be extended and accelerated if India is to catch up with the East Asian tigers.

pendulum had swung from the state-dominated development model of the 1960s and 1970s to the minimalist state of the 1980s.

As often happens with such radical shifts in perspective, countries sometimes tended to overshoot the mark. Efforts to rebalance government spending and borrowing were uncoordinated, and the good was as often cut as the bad. To meet their interest obligations, countries mired in debt squeezed critically important programs in education, health, and infrastructure as often as—or more than—they cut low-priority programs, bloated civil service rolls, and money-losing enterprises. Cuts came primarily in capital budgets and, in Africa, in operating and maintenance outlays, further reducing the efficiency of investment. The result, seen most starkly in Africa, the former Soviet Union, and even parts of Latin America, was neglect of the state's vital functions, threatening social welfare and eroding the foundations for market development.

The consequences of an overzealous rejection of government have shifted attention from the sterile debate of state versus market to a more fundamental crisis in state effectiveness. In some countries the crisis has led to outright collapse of the state. In others the erosion of the state's capability has led nongovernmental and people's organizations—civil society more broadly—to try to take its place. In their embrace of markets and rejection of state activism, many have wondered whether the market and civil society could ultimately supplant the state. But the lesson of a half-century's thinking and rethinking of the state's role in development is more nuanced. State-dominated development has failed, but so will stateless development. Development without an effective state is impossible.

Rethinking the state: A framework

A central difficulty in redefining the state's role is that the ground beneath governments' feet is always changing. If we consider how global economic and social forces have changed prevailing notions of the state, it is clear that it retains a distinctive role in providing the public goods that promote economic and social development. And market failures continue to offer powerful economic arguments for state intervention (Box 1.4). But changes in technology are transforming the nature of market failure: in infrastructure, for example, technology has created new scope for competition in telecommunications and electric power generation. And many of the most successful examples of development, recent and historical, entail states working in partnership with markets to correct their failures, not replacing them.

Equity also remains a central concern of the state. New evidence, especially from East Asia, shows that the familiar tradeoff between growth and equity is not inevitable, as was once thought. Appropriately designed policies in basic education and health care can reduce poverty and increase equity while promoting economic growth. Neglecting these social fundamentals of development can be fatal. But the mere fact of market failure, and other problems of inequality and insecurity, does not mean that only the state can—or should—resolve these problems. The state's coercive authority within its boundaries gives it unique strengths in seeking to address these concerns, but also unique weaknesses. Governments must keep a firm eye on both in deciding whether, and how, to respond.

The state's unique strengths are its powers to tax, to prohibit, to punish, and to require participation. The state's power to tax enables it to finance the provision of public goods. Its power to prohibit and punish enables it to protect personal safety and property rights. And its power to require participation enables it to minimize free riding: those who would reap the benefits of public goods can be made to pay their share of the costs. The same power can help resolve problems of collective action that would otherwise reduce the social benefits of insurance markets, or prevent mutually complementary private investments from being made, to take just two examples.

At the same time, however, the state confronts unique challenges both in clarifying its objectives and in ensuring that its employees pursue them. First, even though elections and other political mechanisms help mediate between citizens and the state, citizens' mandates can remain vague—and powerful special interests continually try to direct the focus of government in their favor. Second, monitoring performance is difficult in many government activities such as primary education, environmental protection, and preventive health care. This can make it hard to set standards or put other mechanisms in place to ensure accountability. Both problems can lead to state bureaucracies being granted enormous room for discretion. When that happens, state officials at all levels may pursue their own agendas rather than the society's. Haiti under the Duvaliers provides a vivid example of where the use of arbitrary public power for personal profit, rather than for the social good, can lead.

In many countries the voluntary sector has stepped in to address some of the gaps in collective goods and services left by market and by government failure. The voluntary sector brings its own strengths to the table, but also its own weaknesses. It does a lot of good in increasing public awareness, voicing citizens' concerns, and delivering services. Local self-help organizations are sometimes the preferred providers of local public goods and services, because of their closeness to local concerns. But their concern is often for certain religious or ethnic groups and not society as a whole, their accountability is limited, and their resources are often constrained. The challenge, then, for the state is to build on the relative strengths of private markets and the voluntary sector while taking into account and improving its own institutional capability.

All these considerations point to a two-part strategy to improve the state's ability to enhance economic and social welfare. The first task is to match the state's role to its existing capability—to establish the institutional rules and norms that will enable the state to provide collective goods and services efficiently. The second is to reinvigorate the state's capability through rules, partnerships, and competitive pressures outside and within the state.

Matching role to capability: What states do and how they do it

Part Two of this Report discusses the first part of the strategy: matching the state's role to its capability, to improve the effectiveness and efficiency of public resource use. It advocates ways in which states can provide the fundamentals for development, especially where capability is low

Box 1.4 The economic rationale for state intervention and some definitions

Market failure and the concern for equity provide the economic rationale for government intervention. But there is no guarantee that any such intervention will benefit society. Government failure may be as common as market failure. The challenge is to see that the political process and institutional structures get the incentives right, so that their interventions actually improve social welfare.

Market failure refers to the set of conditions under which a market economy fails to allocate resources efficiently. There are many sources of market failure and many degrees of failure. The implications for the role of the state and the form of public intervention can be quite different in each case.

Public goods are goods that are *nonrival* (consumption by one user does not reduce the supply available for others) and *nonexcludable* (users cannot be prevented from consuming the good). These characteristics make it infeasible to charge for the consumption of public goods, and therefore private suppliers will lack the incentive to supply them. National public goods, such as defense, benefit an entire country; local public goods, such as rural roads, benefit a smaller area. *Private goods* are those that are both rival and excludable, *common property goods* are nonexcludable but rival (an example is groundwater irrigation), and *club goods* are nonrival but excludable (examples are interurban highways and toll roads).

Externalities arise when the actions of one person or firm hurt or benefit others without that person or firm paying or receiving compensation. Pollution is an example of a *negative externality*, which imposes uncompensated costs on society; the broader benefit to society at large of a literate population is a *positive externality* of primary education. Governments can curb negative and promote positive externalities through regulation, taxation or subsidy, or outright provision.

A *natural monopoly* occurs when the unit cost of providing a good or service to an additional user declines over a wide range of output, reducing or eliminating the scope for competition. But left to operate freely, monopoly providers can restrict output to increase prices and profits. Governments have addressed this problem by regulating private monopolists or providing the good or service themselves. Changes in technology have created new scope for competition in services once considered natural monopolies, such as telecommunications and power generation.

Incomplete markets and *imperfect* or *asymmetric information* are pervasive problems and can result in inefficient outcomes. Markets are incomplete whenever they fail to provide a good or service even though the cost would be less than what individuals are willing to pay. Imperfect information on the part of consumers can lead to systematic undervaluation of some services, such as primary education or preventive health care. Asymmetry of information—when suppliers know more than consumers, or vice versa—can lead to excessive or supplier-induced demand, for example in the provision of medical care. Problems of adverse selection and moral hazard can lead to the failure of insurance markets. *Adverse selection* occurs when buyers of a service tend to impose higher-than-average costs on the service provider, or when sellers are able to exclude such high-cost customers. Health insurance provides an example: those who are more likely to need care are more likely to buy insurance, and more likely to be turned down by insurers. *Moral hazard* is present when persons carrying insurance have an incentive to cause or allow the insured-against event to happen. An example is the tendency of health care consumers to seek, as well as providers to provide, more treatment than they need when a third party, the insurer, is paying most of the cost. Governments have sought to address these problems by ensuring widespread coverage and holding down costs. They have done this by either regulating private insurance, financing or mandating social insurance, or providing health care themselves.

Equity may prompt state intervention even in the absence of market failure. Competitive markets may distribute income in socially unacceptable ways. Persons with few assets may be left with insufficient resources to achieve acceptable living standards. Government action may be required to protect the vulnerable.

(Chapter 3). Chapter 4 looks at more demanding state functions, such as regulation and industrial policy, and shows how getting the right fit between roles and capabilities is vital for improving the state's effectiveness. Table 1.1 presents a framework for thinking about these issues. It classifies the functions of government along a continuum, from activities that will not be undertaken at all without state intervention to activities in which the state plays an activist role in coordinating markets or redistributing assets:

- Countries with low state capability need to focus first on basic functions: the provision of pure public goods such

Table 1.1 Functions of the state

	Addressing market failure			Improving equity
Minimal functions	*Providing pure public goods:* Defense; Law and order; Property rights; Macroeconomic management; Public health			*Protecting the poor:* Antipoverty programs; Disaster relief
Intermediate functions	*Addressing externalities:* Basic education; Environmental protection	*Regulating monopoly:* Utility regulation; Antitrust policy	*Overcoming imperfect information:* Insurance (health, life, pensions); Financial regulation; Consumer protection	*Providing social insurance:* Redistributive pensions; Family allowances; Unemployment insurance
Activist functions	*Coordinating private activity:* Fostering markets; Cluster initiatives			*Redistribution:* Asset redistribution

as property rights, macroeconomic stability, control of infectious diseases, safe water, roads, and protection of the destitute. In many countries the state is not even providing these. Recent reforms have emphasized economic fundamentals. But social and institutional (including legal) fundamentals are equally important to avoid social disruption and ensure sustained development.

- Going beyond these basic services are the intermediate functions, such as management of externalities (pollution, for example), regulation of monopolies, and the provision of social insurance (pensions, unemployment benefits). Here, too, the government cannot choose whether, but only how best to intervene, and government can work in partnership with markets and civil society to ensure that these public goods are provided.
- States with strong capability can take on more-activist functions, dealing with the problem of missing markets by helping coordination. East Asia's experience has renewed interest in the state's role in promoting markets through active industrial and financial policy.

Matching role to capability involves not only *what* the state does but also *how* it does it. Rethinking the state also means exploring alternative instruments, existing or new, that can enhance state effectiveness. For example:

- In most modern economies the state's regulatory role is now broader and more complex than ever before, covering such areas as the environment and the financial sector, as well as more traditional areas such as monopolies. The design of regulation needs to fit the capability of state regulatory agencies and the sophistication of markets, and give greater emphasis to personal responsibility.
- Although the state still has a central role in ensuring the provision of basic services—education, health, infrastructure—it is not obvious that the state must be the only provider, or a provider at all. The state's choices about provision, financing, and regulation of these services must build on the relative strengths of markets, civil society, and state agencies.
- In protecting the vulnerable, countries need to distinguish more clearly between *insurance* and *assistance.* Insurance, against cyclical unemployment for example, aims to help smooth households' income and consumption through a market economy's inevitable ups and downs. Assistance, such as food-for-work programs or bread subsidies, seeks to provide some minimum level of support to the poorest in society.

Reinvigorating the state's capability

Reinvigorating the state's capability—the second, equally vital part of the reform strategy—is the subject of Part Three. Its theme is that such improvements are possible only if the incentives under which states and state institutions operate are changed. Improving capability is not easy. The modest successes, and many failures, of technical assistance efforts over the decades underscore that it is a matter of changing the incentives that determine behavior as much as it is one of training and resources. The key is to find rules and norms that create incentives for state agencies and officials to act in the collective interest, while restraining arbitrary action. This can be achieved through:

- *Rules and restraints.* Mechanisms for enforcing the rule of law, such as an independent judiciary, are critical foundations for sustainable development. Along with appropriate separation of powers and the presence of watchdog bodies, they also restrain arbitrary behavior.
- *Competitive pressure.* Competitive pressure can come from within the state bureaucracy, through recruitment of civil servants on the basis of merit. It can come from the domestic private sector, through contracting out for services and allowing private providers to compete directly with public agencies. Or it can come from the international marketplace, through trade and through the influence of global bond markets on fiscal decisions.
- *Voice and partnership.* The means to achieve transparency and openness in modern society are many and varied—business councils, interaction groups, and consumer groups, to name a few. Institutional working arrangements with community groups can contribute to greater state effectiveness by giving citizens a greater voice in the formulation of government's policies. And partnerships between levels of government and with international bodies can help in the provision of local and global public goods.

All three mechanisms are a recurrent theme of Part Three, which starts (in Chapter 5) by looking at the basic building blocks of a more effective public sector. The emphasis there is on rules and forms of competition to enhance the three basics: policymaking, service delivery, and the lifeblood of the public sector, the civil service. But history tells us that rebuilding public trust in government—and therefore its capability—will involve putting restraints on arbitrary action. These issues are taken up in Chapter 6, which analyzes the checks and balances in the constitutional structure of the state and the best ways to control arbitrary behavior and corruption.

A third layer, which supports the other two, is efforts to open up the government and make it more responsive. A remote, imperious state, whose deliberations are not transparent, is much more likely to fall into the downward spiral of arbitrary rule and decreasing effectiveness. Chapter 7 looks at the benefits of making government reach out to people and grant them a greater role in deciding and implementing policy. And it shows how, carefully pursued, decentralization—the transfer of powers and resources to lower levels of government—can support this effort. Finally, Chapter 8 provides a reminder that collective action increasingly involves looking across national borders. The chapter examines the various ways in which national governments can and must cooperate to meet demands that, although felt at home, can only be addressed effectively at the international level.

Strategic options: Initiating and sustaining reforms

This two-part strategy for improving state effectiveness is far easier said than accomplished. The difficult job for reformers will be not only devising the right kind of reforms but combating the deep-seated opposition of those with a vested interest in the old ways. Matching role to capability means shedding some roles, including some that benefit powerful constituencies. Proponents of a more capable state will quickly discover that it is in many people's interest to keep it weak. Nevertheless, politicians have an incentive to undertake reforms if they result in net gains to important constituencies. Windows of opportunity occasionally open in response to crisis or external threat, and effective political leadership is skilled at devising strategies for building consensus or compensating losers.

Part Four explores the challenge of initiating and sustaining reforms of the state (Chapter 9). Its central argument is that constraints on reform are largely political and institutional. Hence fundamental institutional reform is likely to be long term, but reform opportunities arise, or can be created, and these must be seized. Finally, Chapter 10 lays out the prospects for change and the reform agenda for each developing region. The message is that reform will be difficult and must be tailored to its circumstances, but the special challenge of collapsed states provides a salutary reminder of the risks of failure.