

REFOCUSING ON THE EFFECTIVENESS OF THE STATE

Men are powerless to secure the future; institutions alone fix the destinies of nations.

—Napoleon I, *Imperial séance* (June 7, 1815)

FIFTY YEARS AGO, WORLD WAR II HAD ENDED AND reconstruction was under way in much of Europe, the Soviet Union, and Japan. Many developing countries were starting to emerge from colonialism, and the future seemed full of promise. The difficulties of economic development were not yet haunting us. Improving people's lives looked so achievable, a simple matter of applying the right ideas, technical expertise, and resources. And so it proved—in some cases. But in others progress was meager. Despite five decades of effort, enormous disparities remain in the quality of life of people around the world. Indeed, by some measures the gap between rich and poor has widened.

Explanations for these huge international differences in living standards have changed over the years. For centuries, access to natural resources—land and minerals—was considered the prerequisite for development. Much of Africa, Asia, and the Americas was colonized to acquire these resources, and countries went to war over them. Gradually, however, the thinking changed, and physical capital—machines and equipment—was held to be the key to development. “Industrialized” became synonymous with “developed.” But around the middle of this century economic theorists realized that even this was too simplistic. Embodied in machines and equipment was technology—knowledge and ideas. But no one could explain in simple terms why technology developed better and faster in some parts of the world than others.

Other factors, such as human capital, have since attracted much attention as possible solutions to the puzzle. Investment in human capital both leads to new knowl-

edge and ideas and increases the speed with which they are absorbed, disseminated, and used. Since the 1980s the focus has shifted to the role of sound policies in explaining why countries accumulate human and physical capital at different rates. This, in turn, has led to yet another shift of focus, to the quality of a country's institutions. New, more complex questions have emerged. What institutional arrangements best allow markets to flourish? What is the role of the state both as a direct agent (mostly in the provision of services) and as a shaper of the institutional context in which markets function? How do policies and institutions interact in development?

The answers to these questions are central to our understanding of the deeper sources of differences in development outcomes—and of why the response to economic reform often varies so widely from one country to another. They help explain, for example, why investment and economic activity have revived more strongly following the embrace of the market in Poland than in Russia. They also help explain why many countries in Africa and Latin America have yet to see much of the improvement in the quality of life they were promised when they embarked on their economic reforms a decade ago.

The state has much to do with whether countries adopt the institutional arrangements under which markets can flourish. Not only is the state the arbiter of rules; through its own economic activity it shapes the environment for business and the rest of the economy. For good or ill, the state sets the tone.

This chapter makes the empirical case for shifting the focus of our thinking about development toward the

quality of a country's institutions and the capability of the state—for bringing institutions into the mainstream of our dialogue about development. That case is supported by three new sets of findings:

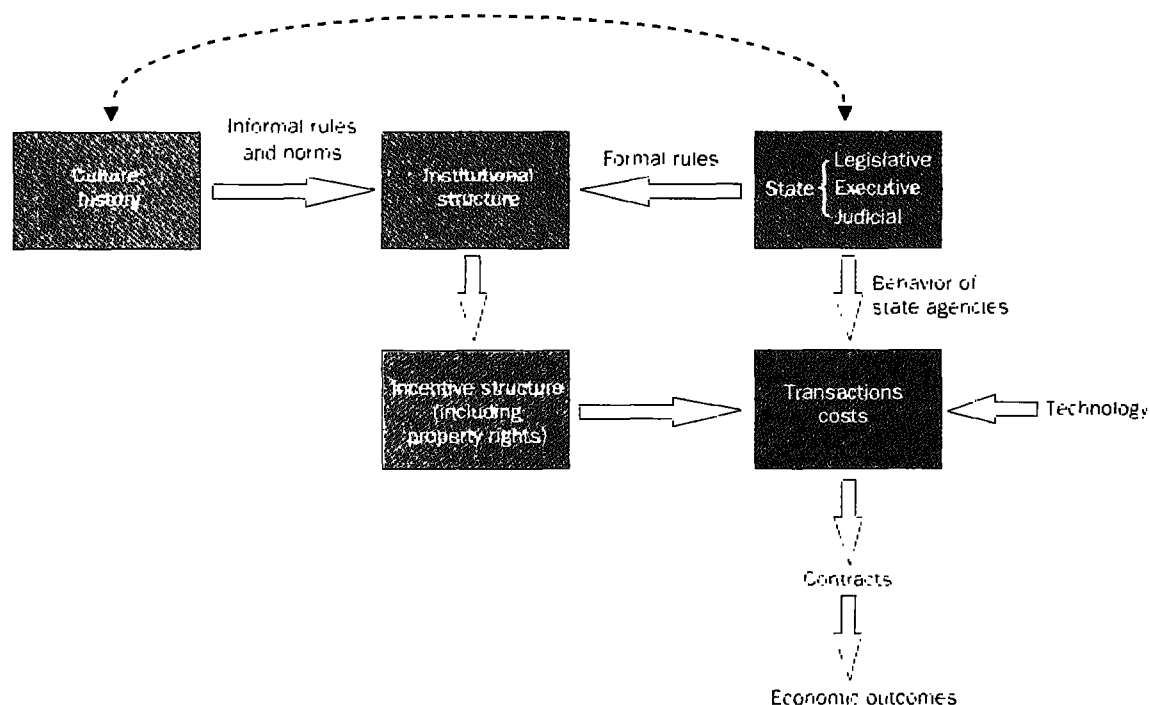
- First, panel data analyzed for this Report, covering thirty years and ninety-four industrial and developing countries, show that policies and institutional capability matter for economic growth and for other indicators of the quality of life, such as infant mortality.
- Second, and taking the analysis a step further, are the results of a survey, specially commissioned for this Report, of over 3,600 domestic firms in sixty-nine countries (including local affiliates of international firms). These results, too, provide strong evidence that institutional capability—or the lack of it—has a major impact on growth and investment.
- The third set of findings explores how institutional capability affects not just the environment for business, but also the overall setting for a country's development. Using the results from the survey on institutional capability, we show that these cross-country differences help

explain much of the difference between countries in rates of return on development projects.

The state, institutions, and economic outcomes

What does the state do? For one thing, it sets the formal rules—laws and regulations—that are part and parcel of a country's institutional environment (Figure 2.1). These formal rules, along with the informal rules of the broader society, are the institutions that mediate human behavior. But the state is not merely a referee, making and enforcing the rules from the sidelines; it is also a player, indeed often a dominant player, in the economic game. Every day, state agencies invest resources, direct credit, procure goods and services, and negotiate contracts; these actions have profound effects on transactions costs and on economic activity and economic outcomes, especially in developing economies. Played well, the state's activities can accelerate development. Played badly, they will produce stagnation or, in the extreme, economic and social disintegration. The state, then, is in a unique position: not only must it establish, through a social and political process, the formal rules by which all other organizations

Figure 2.1 The state, institutions, and economic outcomes



must abide; as an organization itself, it, too, must abide by those rules.

Examples of the power of the state to improve the quality of people's lives are not hard to find. From the clean water and sanitation systems of ancient Rome to the elimination of smallpox in this century, public actions in the areas of health and sanitation have achieved repeated breakthroughs in public health. And states have long played a vital role in stimulating lasting development gains by providing infrastructure, security, and a stable macroeconomy. The Internet is only the latest in a long line of remarkable scientific and technical advances made possible by early and significant public support (Box 2.1).

Distilling the lessons of centuries, we see that the state can improve development outcomes in a number of ways:

- By providing a macroeconomic and a microeconomic environment that sets the right incentives for efficient economic activity

- By providing the institutional infrastructure—property rights, peace, law and order, and rules—that encourages efficient long-term investment, and
- By ensuring the provision of basic education, health care, and the physical infrastructure required for economic activity, and by protecting the natural environment.

Yet history also teaches that the state can do enormous harm:

- The wrong kind of rules can actively discourage the creation of wealth. For example, the state may penalize private wealth by distorting prices—through an overvalued currency, for example, or by creating agricultural marketing boards that tax farmers' output and give them little in return.
- Even if the rules themselves are benign, they may be applied by public organizations—and their employees—in harmful fashion. They may, for example, impose

Box 2.1 Building the Internet: A contemporary example of fruitful public-private interaction

The precursor of what we today call the Internet was launched in the United States in 1969. Then called ARPANET, the system comprised just four interconnected computers. By mid-1996, however, the Internet was accessible in 174 countries and on all seven continents, linking together nearly 13 million host computer systems. By 2000 that number could well be 100 million.

ARPANET owed its existence to the economics of defense research in the 1960s. Its original purpose was to link government computers in far-flung locations and so avoid duplication of what were then quite costly computing resources. In 1968 the U.S. Department of Defense invited proposals from 140 private companies to design and build the first four interface message processors, or routers. With these in place, public contracts with leading universities then led to development of the crucial set of protocols that could link diverse computer networks. It was these protocols that later made the Internet possible.

Complementary to this public financial support has been the partnership of academia, business, and government led by the U.S. National Science Foundation (NSF). Initially this partnership primed the connection of university computer science departments, but its influence soon expanded. NSFNET replaced ARPANET in 1990. Besides providing the critical

finance for a high-speed backbone infrastructure for the system, the NSF made grants available to universities to encourage them to form regional networks that would feed into the system. But the networks were also told that they would have to become self-sustaining.

The private sector's involvement has deepened over time. The NSF encouraged commercial carriers of electronic mail to link to the Internet. Companies also began to create their own backbone facilities, and the number of firms supplying access to the Internet multiplied. These trends were accelerated by the creation and rapid growth of the multimedia part of the Internet—the World Wide Web. Developed at the laboratories of the European Organization for Nuclear Research in Switzerland—another publicly supported agency—the Web drew in talent from universities and firms, leading to yet another explosion in use: from 130 sites in July 1993 to over 230,000 in June 1996.

In 1995 NSFNET was replaced by a fully commercial system. Major telephone companies now provide not only backbone facilities but also Internet access to their customers. Cable and direct broadcast satellite companies are also entering the market. The public sector is still involved in some advanced research, but its focus has shifted to such questions as how to ensure equitable access (for example, through pricing rules), freedom of expression, protection from fraud, and privacy.

huge transactions costs, in the form of red tape or bribery, on entrepreneurs setting up new businesses or restructuring old ones.

- But potentially the largest source of state-inflicted damage is uncertainty. If the state changes the rules often, or does not clarify the rules by which the state itself will behave, businesses and individuals cannot be sure today what will be profitable or unprofitable, legal or illegal, tomorrow. They will then adopt costly strategies to insure against an uncertain future—by entering the informal economy, for example, or sending capital abroad—all of which impede development.

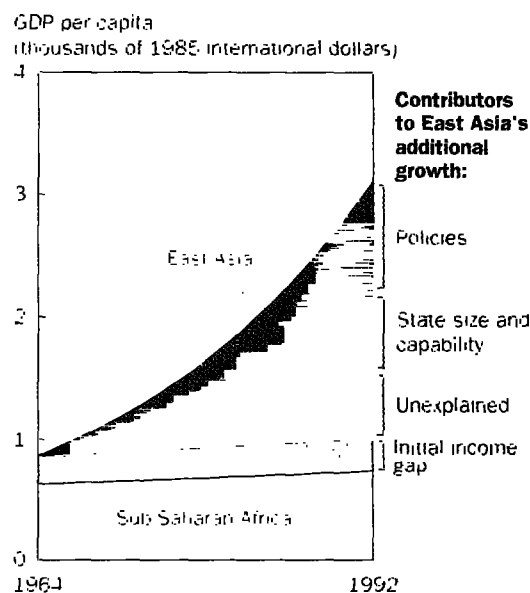
Economic growth and the state

Government's enormous impact on development is well illustrated by the contrasting economic performance of developing countries in Sub-Saharan Africa and East Asia. In 1960 incomes per capita in much of East Asia were only a little higher than in Africa. Governments in the two regions were also similar in size, although not in composition: African governments were already spending more on consumption, primarily on public employment. By the mid-1990s, however, incomes in East Asia were more than five times those in Africa. And government consumption in Africa, relative to GDP, had ballooned to one-and-a-half times that in East Asia. The sources of this divergence are complex, but it is widely believed that the superior performance of the state in East Asia—the limits it set on its own growth, the soundness of the policies it adopted, and the effectiveness with which it delivered services—made a powerful contribution to the growing gap in the quality of life experienced by the average citizen between these two parts of the world (Figure 2.2).

In considering the effect of government size on growth, it is useful to distinguish between public consumption and public investment (Box 2.2). Where government consumption spending is very high, it has generally been found to be a drag on growth: a net tax on society with few corresponding benefits. Conversely, certain types of public investment spending, particularly investment in infrastructure, have tended to exert a positive effect on growth, in part by raising the returns to private investment. Complicating the picture is the fact that some public consumption—teachers' salaries, for example, or purchases of medicine—can affect people's lives for the better, and even raise the efficiency of investment. Cutting consumption indiscriminately to boost equally indiscriminate investment is clearly not the answer.

But even sophisticated measures of the size of the government only tell part of the story. As noted above, governments also play a leading role in setting the broader

Figure 2.2 Good government helps explain the income gap between East Asia and Africa



Note: Results are based on an instrumental variable regression for the period 1964–93, controlling for initial income, education, and other variables. "Policies" includes the effects of openness to trade and investment, lack of price distortions, relative absence of black market exchange rate premiums, and high levels of education and investment. See the Technical Note. Source: World Bank staff calculations based on data in Commander, Calvo, and Lee, background paper.

institutional environment for behavior: the incentive structure to which economic agents respond. The private sector's ability to function will depend critically on the reliability and effectiveness of institutions such as the rule of law and the protection of property rights. None of these benefits—and costs—of the quality of government are ever likely to appear in the national accounts.

The analysis in this section tries to show this distinction between what the state does and how well it does it, by reporting on both policy content and institutional capability. Figure 5 in the Overview showed the effect of both factors on income growth over the last three decades across a large sample of industrial and developing countries. In countries with weak state capability and poor policies, income per capita grew only about half a percent per year. In contrast, in countries with strong capability and good policies, income per capita grew at an average rate of about 3 percent per year. Over a thirty-year period, these differences in income growth have made a huge difference to the quality of people's lives. A country with an

Box 2.2 Measuring the state—its size, its policies, and its institutional capability

A common measure of government size is the ratio of government expenditure to the economy's total expenditure or total output. But such data are generally not comprehensive, and coverage of public enterprises is especially sketchy in many developing countries. This measure of size also tends to ignore important off-budget items. Government expenditure itself can be broken down into consumption and investment. Government consumption—which mostly consists of the public wage bill—gives a narrow but more precise indicator of consumers' current benefits from government spending. Transfers, such as pensions or disability benefits, can be included in government expenditure, but transfers only redistribute resources. Further complicating matters, nominal and real ratios for expenditure will vary significantly over time. An alternative measure of government size that avoids these problems is government employment, but this, too, has its drawbacks. For example, it ignores changes in the productivity of government workers.

The results reported in this chapter use data on real government consumption, because the concern is mainly with how the division of output across public and private goods affects performance. Information on physical investment is also used, but this is normally

available only as an aggregate of public and private investment. To facilitate cross-country comparisons over time, these ratios are translated into international or purchasing-power-parity (PPP) values—a not entirely innocuous transformation, particularly for low-income countries where much of government consumption is labor intensive. For these countries, using international prices markedly increases the government consumption ratio.

A more inclusive picture of the economic presence of government requires a measure that captures key government interventions through policy and institutions, in addition to fiscal interventions. We summarize a government's policy stance over time through an index that combines three key indicators: the openness of the economy (the share of trade in GDP), overvaluation of the currency (the black market exchange rate), and the gap between local and international prices. We also attempt to evaluate the quality of a key component of government, its bureaucracy. This evaluation is drawn from survey responses by foreign investors (in the next section we evaluate the responses of local investors) that focus on the amount of red tape involved in any transaction, the regulatory environment, and the degree of autonomy from political pressure.

average income per capita of \$600 in 1965 (in international PPP dollars), with distorted policies and weak institutional capability, would after thirty years have reached an average income of only about \$678 at 1965 prices. On the other hand, a country with strong institutional capability and good policies would have more than doubled its average income, to \$1,456 at 1965 prices. Many countries in East Asia have done even better than that.

Good policies by themselves can improve results. But the benefits are magnified where institutional capability is also higher—where policies and programs are implemented more efficiently and where citizens and investors have greater certainty about government's future actions. Thus, good policies such as those being pursued more recently by many countries in Latin America and Africa would increase growth in income per capita by around 1.4 percent per year. Such a country starting with an average income of \$600 in 1965 would see it rise to around \$900 after thirty years. But it would rise even higher with good policies *and* strong institutions. The lesson is that reform-

ers cannot afford to focus solely on improving policies; they must also look for ways to strengthen the institutional environment those policies have to work within.

Important though income growth is, it is only one of several measures of well-being. Our interest in the wide range of factors that make people better or worse off suggests that countries' performance should also be judged by other standards of well-being, such as infant mortality. High-quality government institutions lower infant mortality by improving outcomes for a given amount of social spending. Thus, the capability of the state has an important role in the quality of human life generally—not simply the pace of income growth. This explains why countries at the same income level can have widely disparate quality-of-life indicators—why Sri Lanka, for example, had an infant mortality rate of only 18 per 1,000 live births, whereas some countries with higher incomes per capita had substantially higher rates: 67 per 1,000 live births in Egypt, and 68 per 1,000 in Morocco, for example. The amount of social spending as

well as the care with which services are delivered makes a huge difference.

**Understanding institutional capability better:
The private investor's view**

As this chapter has already stressed, the mark of a capable state—besides its ability to facilitate collective actions—is its ability to set the rules that underpin markets and permit them to function. Although private arrangements can sometimes supplement formal property and contract rights, they can only take the development of markets so far. Governments, of course, have to do more than establish sound rules of the game; they also have to make sure those rules are enforced consistently and that private actors—business, labor, trade associations—can have confidence that the rules will not be changed overnight. States that change the rules frequently and unpredictably, announce changes but fail to implement them, or enforce rules arbitrarily will lack credibility, and markets will suffer accordingly.

How good are governments at providing credible rules that will nurture the development of markets? Hard evidence is difficult to come by. To begin with, credibility is tricky to measure: it depends as much on perceptions as on hard facts. At first glance, for example, one would think that the number of times a country has changed its government might be a good indicator of the degree of uncertainty about market rules, and therefore of the government's credibility. Yet businesses in Thailand generally considered their environment to be relatively stable, despite numerous coups and changes in government. By the same token, the environment for business can be highly volatile and unpredictable even if the government does not change. Peruvian entrepreneurs reported severe credibility problems in the 1980s because rules were being drawn up hastily, implemented by presidential decree, and often overturned soon thereafter.

Measures of corruption might seem another good signal of government credibility. But simple estimates of corruption, like measures of political instability, may not capture entrepreneurs' concerns. Some forms of corruption entail large uncertainties and risks, whereas others may be more predictable and act more like speed money. In the words of one entrepreneur, "There are two kinds of corruption. The first is one where you pay the regular price and you get what you want. The second is one where you pay what you have agreed to pay and you go home and lie awake every night worrying whether you will get it or if somebody is going to blackmail you instead." The best way to understand the problems holding back private sector development is to ask entrepreneurs directly.

To this end a large-scale survey of the private sector was conducted for this Report. The aim was to capture the full array of uncertainties that entrepreneurs face and to build an overall measure of the credibility of rules in a given country. The responses showed that in many countries private investors give the state very poor marks for credibility indeed.

Credibility: How private investors perceive the state

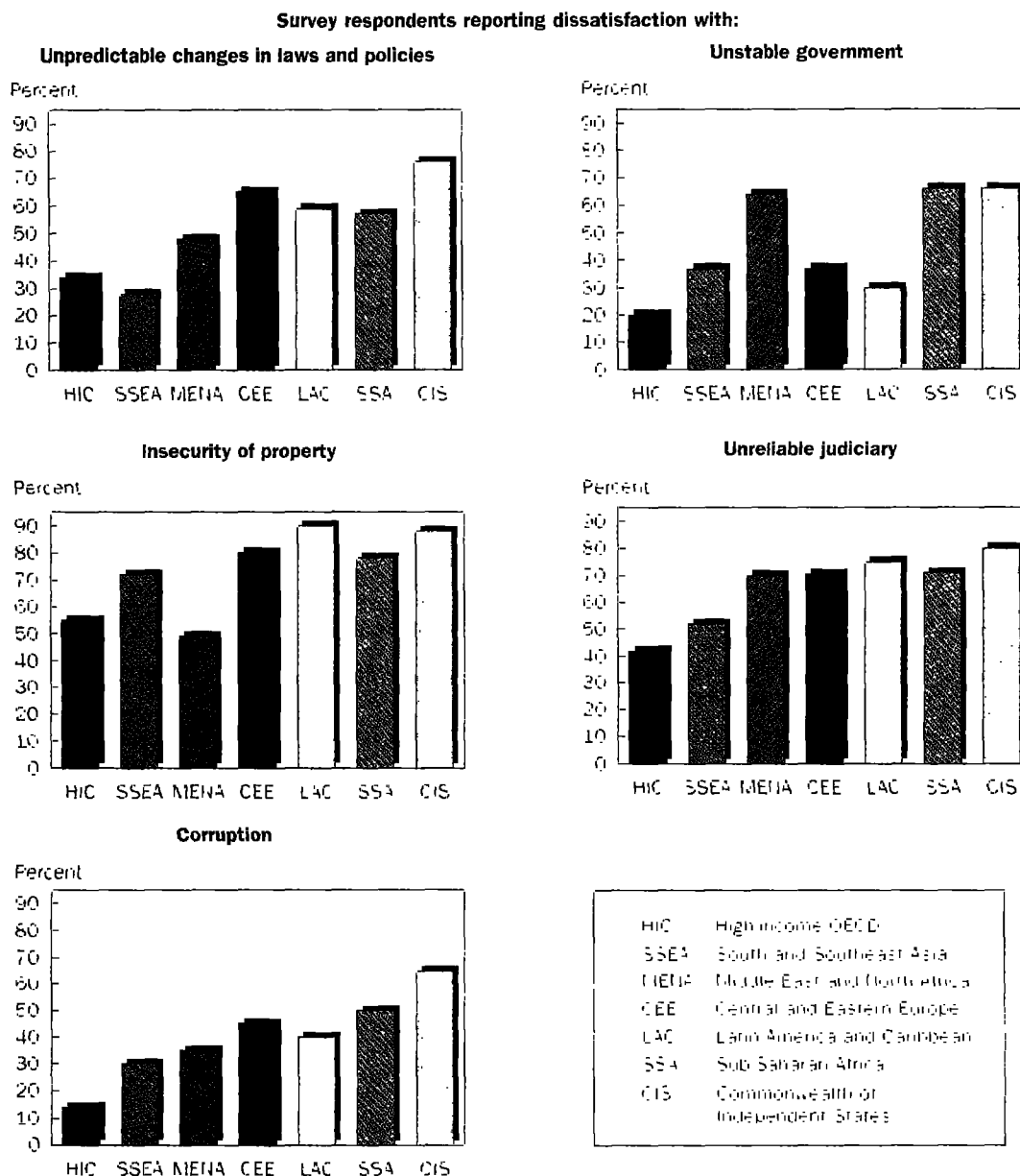
The private sector survey covered sixty-nine countries and over 3,600 firms. Entrepreneurs were asked for their subjective evaluation of different aspects of the institutional framework in their country, including security of property rights, predictability of rules and policies, reliability of the judiciary, problems with corruption and discretionary power in the bureaucracy, and disruptions due to changes in government.

Sometimes the source of uncertainty is the instability of the rules to which firms are subject. Two key indicators included in the survey were:

Predictability of rulemaking: the extent to which entrepreneurs have to cope with unexpected changes in rules and policies about which they have had no say.

- The survey showed that entrepreneurs in some parts of the world live in constant fear of policy surprises. In the Commonwealth of Independent States (CIS) almost 80 percent of entrepreneurs reported that unpredictable changes in rules and policies seriously affected their business. In Central and Eastern Europe (CEE), Latin America, and Sub-Saharan Africa around 60 percent of entrepreneurs voiced the same complaint. By contrast, in the industrial countries and in South and Southeast Asia, only about 30 percent of respondents considered this a problem for their business (top left panel of Figure 2.3). A large part of the unpredictability of rule changes came from companies' having little or no role in the state's decisionmaking process; indeed, they may not even be informed of important rule changes before they take place. This problem appeared to be particularly severe in the CIS, CEE, and Sub-Saharan Africa, whereas Asian entrepreneurs (even small ones) considered themselves well informed—even better informed, in fact, than their industrial-country counterparts did. Unsurprisingly, perhaps, the survey also revealed that small companies tend to have less knowledge of, and involvement in, the drafting of new regulations and were therefore more subject to policy surprises.

Figure 2.3 Reliable institutions make for credible states



Note: Results are from a survey of over 2,000 firms in sixty-nine industrial and developing countries conducted in 1996. Regions are listed from left to right according to their overall credibility index (see Box 2 in the Overview). SSEA and MENA are represented by only three countries each. See the Technical Facts on the private sector survey for details. Source: Bruneo, Freund, and Weder. Background paper for

Perceptions of political stability: whether changes in government (constitutional or unconstitutional) are usually accompanied by far-reaching policy surprises that could have serious effects on the private sector.

- Entrepreneurs in many regions felt that the institutional framework was not well enough entrenched to withstand changes in government without serious disruption. In the CIS, Africa, and the Middle East over

60 percent of entrepreneurs said that they constantly feared government changes and the painful policy surprises that tended to go with them (top right panel of Figure 2.3).

Uncertainty may relate less to the rules themselves than to the way they are enforced. The relevant indicators here were:

Crime against persons and property: whether entrepreneurs felt confident that the authorities would protect them and their property from criminal actions, and whether theft and other forms of crime represented serious problems for business.

- Private entrepreneurs in many countries complained of the lack of even the most basic institutional infrastructure for a market economy. Across the globe, crime and theft were listed as serious problems, which substantially increased the cost of doing business. A complete institutional vacuum seems to prevail in some countries, leading to crime, violence, and a generalized insecurity of property rights. In Latin America, Sub-Saharan Africa, the CIS, and CEE almost 80 percent of entrepreneurs reported a lack of confidence that the authorities would protect their person and property from criminals (middle left panel of Figure 2.3).

Reliability of judicial enforcement: whether the judiciary enforces rules arbitrarily, and whether such unpredictability presents a problem for doing business.

- A well-functioning judiciary is a central pillar of the rule of law. Unfortunately, in many countries it seems to be the exception rather than the rule. In developing countries over 70 percent of entrepreneurs said that judicial unpredictability was a major problem in their business operations (middle right panel of Figure 2.3). Disturbingly, in most regions entrepreneurs felt that these problems had increased over the last ten years.

Freedom from corruption: whether it is common for private entrepreneurs to have to make irregular additional payments to get things done, and whether, after paying a bribe, they have to fear blackmail by another official.

- The survey confirmed that corruption is an important—and widespread—problem for investors. Overall, more than 40 percent of entrepreneurs reported having to pay bribes to get things done as a matter of course. In industrial countries the figure was 15 per-

cent, in Asia about 30 percent, and in the CIS over 60 percent (bottom panel of Figure 2.3). Furthermore, over half the respondents worldwide did not regard a bribe as a guarantee that the promised service would be delivered, and many lived in fear that they would simply be asked for more by another official.

Lack of credibility reduces investment, growth, and the return on development projects

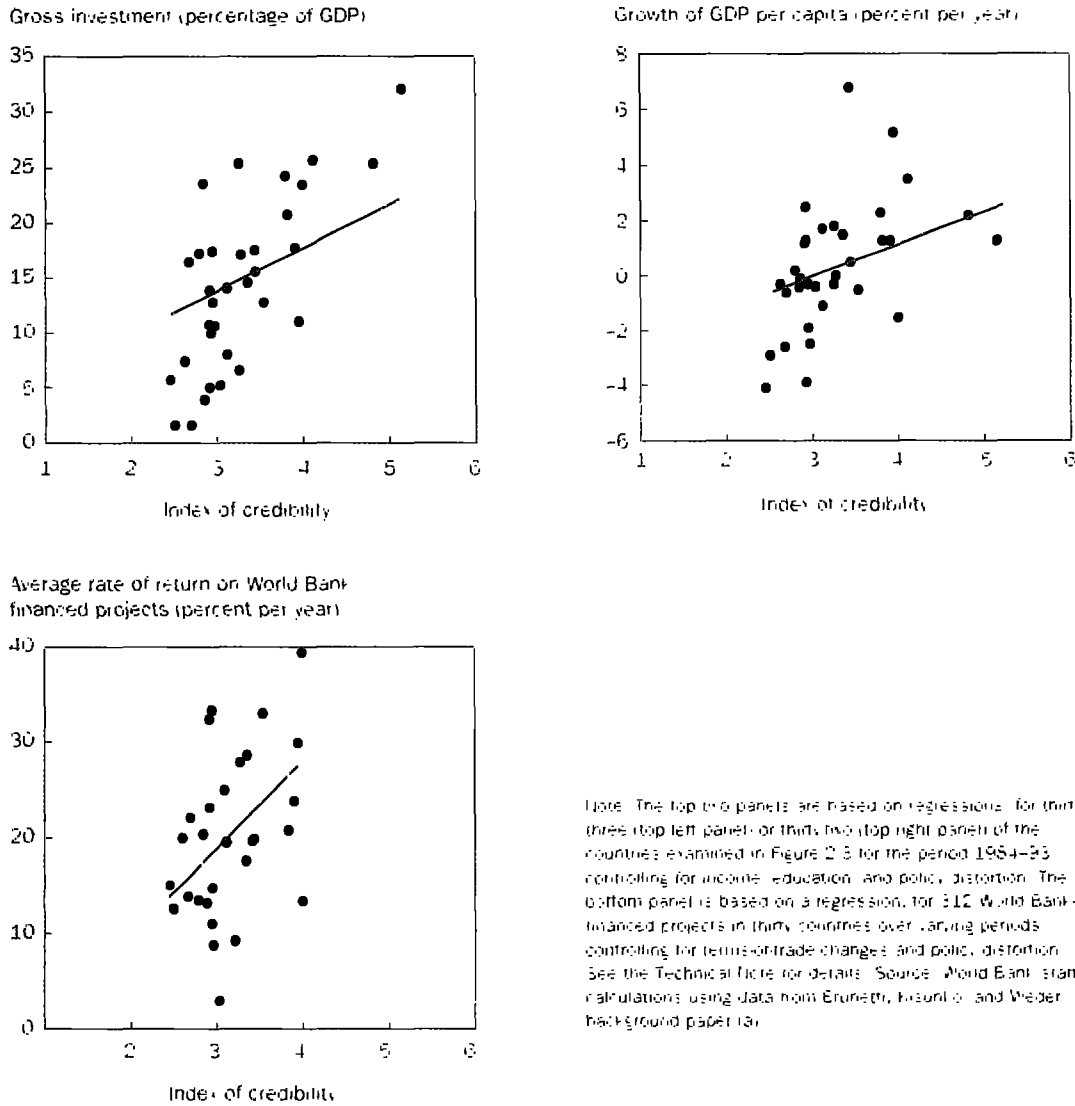
When the private sector does not believe that the state will enforce the rules of the game, it responds in a variety of ways, all of which worsen economic performance. An unreliable judiciary forces entrepreneurs to rely on informal agreements and enforcement mechanisms. A corrupt bureaucracy that is allowed too much discretion creates incentives to seek economic rents rather than in productive activity. A generalized environment of crime and insecurity of property rights prompts entrepreneurs to enlist the help of private security agents, or forces them to pay organized crime for “protection”—if it does not put them off going into business altogether.

Investment suffers because entrepreneurs choose not to commit resources in highly uncertain and volatile environments, especially if those resources will be difficult to recover should the business environment turn unfavorable. Where even the most basic types of property are not protected, investors move their resources to other countries, or invest them in projects that offer lower returns but require less capital commitment. Thus, trade and services may survive even in low-credibility environments, but manufacturing and, especially, high-technology projects are unlikely to flourish. A similar distortion occurs when highly talented people choose to become tax inspectors or customs officials rather than train to become engineers. Therefore, credibility affects not only the level of investment in physical and human capital but also its quality. As a consequence, in a low-credibility environment, growth suffers.

The top two panels of Figure 2.4 show how credibility relates to investment and growth in the countries surveyed for the period 1985–95. After controlling for other economic variables, countries with high credibility had investment rates significantly higher than countries with low credibility; a shift from a low- to a high-credibility environment makes a substantial difference in growth as well. Low credibility may also help explain why many countries do not see the expected private sector response after implementing stabilization and structural adjustment programs.

Finally, the credibility of rules affects not only the business environment, but also the environment for the implementation of development projects. The same fac-

Figure 2.4 Perceived credibility and economic performance go hand in hand



Note: The top two panels are based on regressions for thirty-three (top left panel) or thirty-two (top right panel) of the countries examined in Figure 2.3 for the period 1984–93, controlling for income, education, and policy distortion. The bottom panel is based on a regression for 312 World Bank-financed projects in thirty countries over varying periods, controlling for terms-of-trade changes and policy distortion. See the Technical Note for details. Source: World Bank team calculations using data from Brunetti, Fisman, and Weder background paper (a).

tors—crime, corruption, uncertainty about policy, and judicial behavior—affect the outcome for all such projects. One reason is that these concerns are part and parcel of any contractual environment. If corruption affects the private sector, it is likely to affect the outcome of development projects as well. A second reason is that many public projects are implemented by private contractors who, in an environment of weak institutions, are subject to the same behavioral problems that affect private firms. The contractor is awarded a project, pays off corrupt officials, and gets more projects regardless of how the first turns out. Pilfering, theft, and enforcement problems are

even more widespread in many public projects than in the private sector. As a result, many projects are delayed because of cost overruns.

The bottom panel of Figure 2.4 shows the correlation between government credibility and rates of return for 312 development projects in thirty countries. On average, in countries with a low-credibility environment rates of return are substantially higher than in countries with a high-credibility environment. These results take account of differences in economic policies and other project- and country-specific factors. The lesson, once again, is that institutions make an enormous difference to development

outcomes. Napoleon's insight, cited at the beginning of this chapter, is as true today as it was in 1815.

Strategic options: Refocusing on the state's institutional capability

A clearer understanding of the institutions and norms embedded in markets shows the folly of thinking that development strategy is a matter of choosing between the state and the market. As this brief review of the evidence on the relationship between institutions and development has confirmed, the two are inextricably linked. Countries need markets to grow, but they need capable state institutions to grow markets.

Reformers the world over need to apply this lesson by refocusing attention on institutional capability. The task is particularly urgent in many developing countries, where weak and arbitrary governments are feeding the uncer-

tainties that have kept markets weak and underdeveloped. Countries suffering from such an institutional vacuum risk postponing economic and social development indefinitely. There is also a danger that dissatisfaction with the state—whether expressed through social protest, capital flight, or the ballot box—will undermine economic prospects even further.

The state's capability—its ability to deliver collective goods efficiently—is central to providing a viable institutional framework for development. As we have seen, many developing countries are starting out from a very low base indeed in this regard. But the state's ability to provide the institutional support that development requires can be improved over time, through matching the state's role to its capability, and then rebuilding that capability by focusing on the incentives that drive the behavior of the state. We turn to these issues in Parts Two and Three.