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AS PART ONE HIGHLIGHTED, AN EFFECTIVE STATE PROVIDES VITAL INGREDIENTS for development. This part of the Report argues that governments will achieve better results by being realistic in what they set out to accomplish. They must strive to match what they do—and how they do it—to their institutional capabilities, not to some idealized model.

Where government has a long record of failure, seeking a better match between the state's role and its capability can sound like a recipe for dismantling the state altogether. But market development without a functioning state is not an option. Rather, as Chapter 3 explains, the point is to prioritize. In many countries the state is still not securing the economic and social fundamentals: a foundation of lawfulness, a benign (and stable) policy environment, basic social services, and some protection of the vulnerable. At the same time, it is overproviding many goods and services that private markets and voluntary initiative could deliver instead. For development to proceed, such governments need to go back to the basics.

Chapter 4 explores how governments can find the right match between role and capability in a second area of policy where the state's behavior will inevitably make a large difference to development outcomes: regulation, liberalization, and

industrial policies designed to foster markets. Markets and society need and benefit from effective regulation of certain activities. But many states are stifling private sector development by overregulating or, often, monopolizing large chunks of the economy by attempting complex strategic interventions in industry that are beyond their institutional capabilities. Deregulation, privatization, and less demanding approaches to regulation and industrial support in these circumstances will deliver large and immediate payoffs.

These chapters carry four basic messages for policymakers:

- States at all levels of institutional capability should respect, nurture, and take advantage of private and voluntary initiative and competitive markets.
- States with weak institutional capabilities should focus on providing the pure public goods and services that markets cannot provide (and that voluntary collective initiatives underprovide), as well as goods and services with large positive externalities, such as property rights, safe water, roads, and basic education.
- Credibility is vital for success. States with weak institutional capabilities should also focus on the tools for policymaking and implementation that give firms and citizens confidence that state officials and organizations will not act arbitrarily and will live within their fiscal means.
- Matching role to capability is a dynamic process. As institutional capability develops, states can take on more difficult collective initiatives (initiatives to foster markets, for example), and use efficient but difficult-to-manage tools for collective action, such as sophisticated regulatory instruments.

SECURING THE ECONOMIC AND SOCIAL FUNDAMENTALS

WEAK STATES MUST TAILOR THEIR AMBITIONS TO their capability, yet some tasks are inescapable. The challenge, addressed in this chapter, is to find ways for states—even states with relatively weak capability—to get those basic government tasks right. Sustainable, shared, poverty-reducing development has five crucial ingredients:

- A foundation of law
- A benign policy environment, including macroeconomic stability
- Investment in people and infrastructure
- Protection of the vulnerable
- Protection of the natural environment.

The importance of these fundamentals for development has long been widely accepted. But as is shown below, new insights are emerging on the appropriate mix of market and government activities for achieving them. It is now much clearer that markets and governments are complementary, that government action can be vital in laying the institutional foundations for markets. Also much clearer is that faith in governments' ability to sustain good policies can be as important for attracting private investment as the policies themselves.

The track record of developing countries in managing the fundamentals has been mixed. Many countries in East Asia—plus others elsewhere such as Botswana, Chile, and Mauritius—have done a good job. But others have not. As Box 3.1 reveals, private firms in many developing regions are seriously constrained by the absence of such basic state functions as the protection of private property. Institutional impediments are largely to blame and will be hard to overcome. Yet windows of opportunity for reform can open and widen even in the most inhospitable of settings. And a major theme of this chapter is that even a modest shift in policy priorities in favor of the bare essentials can

do much to put long-stagnant economies back on track. We address the various approaches to government's role in effective environmental protection in Chapter 4.

Establishing a foundation of law and property rights

Markets rest on a foundation of institutions. Like the air we breathe, some of the public goods these institutions provide are so basic to daily economic life as to go unnoticed. Only when these goods are absent, as in many developing countries today, do we see their importance for development. Without the rudiments of social order, underpinned by institutions, markets cannot function.

The lawlessness syndrome

Markets cannot develop far without effective property rights. And property rights are only effective when three conditions are fulfilled. The first is protection from theft, violence, and other acts of predation. The second is protection from arbitrary government actions—ranging from unpredictable, ad hoc regulations and taxes to outright corruption—that disrupt business activity. These two are the most important. Unhappily, as Figure 3.1 makes evident, and as the regional patterns in Figure 3.2 highlight, in many countries neither is in place. The third condition is a reasonably fair and predictable judiciary. This is a tall order indeed for countries in the earliest stages of development, yet firms in more than half the countries surveyed considered it a major problem.

The absence of these critical supports for property rights gives rise to what this Report terms the lawlessness syndrome. Firms in twenty-seven of sixty-nine countries surveyed—including more than three-fourths of those in the CIS, and about half in Latin America and Africa (but none in the OECD)—are subject to this triple curse on markets: corruption, crime, and an unpredictable judiciary that offers little prospect of recourse.

Box 3.1 Weaknesses in fundamentals constrain firms the world over

In many countries the fundamentals needed to allow firms to go about creating wealth are not in place. The survey of businesspeople described in Chapter 2 asked firms to rank the relative importance of eight distinct obstacles to economic activity, to identify which aspects of government action most need improving. As the table below shows:

- Obstacles associated with uncertain property rights and dealing with arbitrariness—corruption and crime—rank among the top three everywhere except among the high-income countries of the Organization for Economic Cooperation and Development. Regulation does not emerge directly as a major obstacle.

- Policy-related problems—notably regarding taxation and the operation of financial markets—also tend to rank high (except in Latin America). But it is impossible to tell from the survey results alone whether these widespread perceptions reflect the universal desire of firms to pay lower taxes and to borrow more at lower interest rates, or whether they are symptomatic of fundamental policy shortcomings. More telling is the perception in countries of the CIS that policy instability is a major constraint.
- Poor infrastructure emerges as the leading constraint in South Asia and the Middle East and North Africa, and as one of the top three constraints in Latin America and Sub-Saharan Africa.

Firms' rankings of obstacles to doing business

(Worst = 1)

Obstacle	Sub-Saharan Africa	Latin America and Caribbean	East and South Asia	Middle East and North Africa	CIS	CEE	High-income OECD
Property rights							
Corruption	1	1	3	2	3	3	5
Crime and theft	5	3	8	8	4	6	6
Regulation	8	8	7	7	8	8	4
Policy							
Taxes	2	5	2	3	1	1	1
Financing	6	4	5	4	5	2	2
Inflation	4	7	4	6	6	4	8
Policy instability	7	6	6	5	2	7	7
Public investment							
Poor infrastructure	3	2	1	1	7	5	3

Source: Private sector survey conducted for this Report.

Corruption emerged from the survey as a major problem. Its consequences often do not end with paying off officials and getting on with business. Arbitrary government entangles firms in a web of time-consuming and economically unproductive relations. More than half of senior managers in firms surveyed in the CIS—but only about 10 percent of those in the OECD countries—reported spending more than 15 percent of their time negotiating with government officials over laws and regulations (Figure 3.2). The burden of red tape is less in other developing countries, but still consistently worse than in the OECD countries. Chapter 6 examines in some detail how the scourge of corruption can be tamed.

The high ranking by CIS firms of the two other elements of the lawlessness syndrome—crime and judicial unpredictability—partly reflects the unique institutional vacuum created by the rejection of central planning in the transition economies. Yet indicators from other regions suggest that institutional decay is widespread. In Latin

America, for example, between 1980 and 1991 the murder rate rose from 12.8 per 100,000 people in 1980 to 21.4 per 100,000 in 1991, with increases evident in virtually all countries and subregions.

Much remains to be learned about how to reverse lawlessness among private citizens. But the solution is likely to embrace many of the reform priorities highlighted by this Report, including better protection of the vulnerable and stronger overall capability of state institutions. A community's descent into lawlessness can evoke a sense of helplessness among the law-abiding. But as Box 3.2 describes, a recent initiative in Cali, Colombia, has shown that, even under the most difficult of circumstances, civic action can start a reversal from despair to hope.

More complex institutional underpinnings

Containing lawlessness is necessary to secure property rights, but it may not be sufficient. Information and coordination problems can also impede development by under-

mining markets and property rights, a problem often found in low-income countries.

Information problems occur because people and firms inevitably have limited information and understanding, or because the rules of the game are unclear. The scope of property rights—including the right to use an asset, to permit or exclude its use by others, to collect the income generated by the asset, and to sell or otherwise dispose of it—may not be well defined. People and firms may lack knowledge of profit opportunities, or of the probity of potential business partners. The costs of seeking out such information decline as markets thicken and their supporting institutions develop, making economies more information intensive. In developing countries, however, the costs of learning can be high.

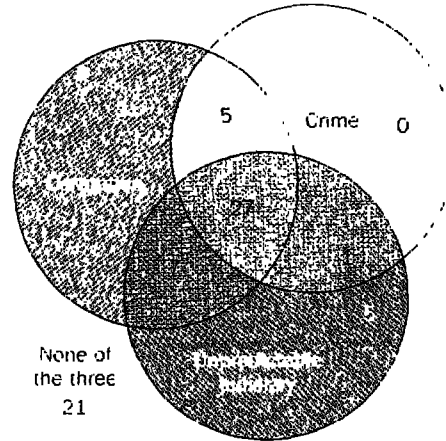
Coordination of economic activity is difficult because self-interested people and firms behave strategically—they generally are willing to share information only when they do not lose by doing so. The presence of moral hazard—the risk that other parties might opportunistically renege on agreements—hinders firms from taking advantage of opportunities for mutual gain. As markets develop, institutional arrangements evolve to facilitate cooperation among firms. Again, however, in developing countries where those institutions are underdeveloped, such cooperation can be difficult to achieve.

Spot markets can emerge even when information and enforcement mechanisms are weak, since the fact that the exchange is simultaneous makes it more difficult to cheat. But for other transactions the costs of providing adequate information and enforcement mechanisms to enable business to proceed can be formidable.

Well-functioning institutions can reduce these transactions costs. History provides abundant examples of the

Figure 3.1 The lawlessness syndrome

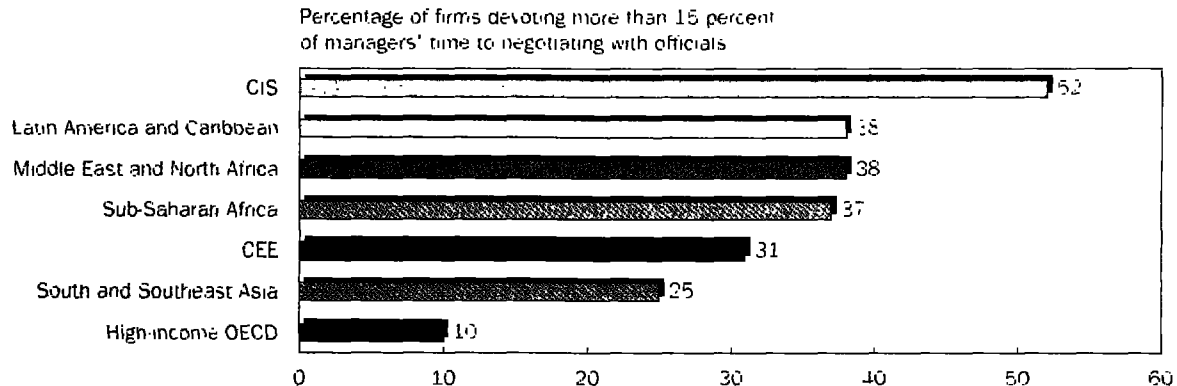
Number of countries where one or more aspects of lawlessness are serious obstacles to doing business



Note: A country falls within a circle if half or more of its responding firms scored the problem as 1 or 2 on a scale of 1 to 6, with lower values indicating greater severity, and within an intersection if at least 40 percent of firms scored both problems as 1 or 2 and the average of the two percentages exceeded 50 percent. Source: Private sector survey conducted for this Report.

symbiotic development of markets and institutions: new industries create demand for more-complex institutions, which in turn enable the industry to develop further. Consider the example of mining in the “Wild West” Nevada territory of the nineteenth-century United States.

Figure 3.2 Negotiating with government officials can be arduous



Source: Private sector survey conducted for this Report

Box 3.2 Standing up to crime in Cali, Colombia

One of the centers of the illegal world trade in cocaine, Cali saw its homicide rate leap from 23 per 100,000 citizens in 1983 to over 100 per 100,000 in the early 1990s. Many murders could be directly attributed to drug trafficking, but many more seemed due to a spreading culture of violence. Fed up with the growing lawlessness, in 1992 the city elected as mayor a respected physician who put combating violent crime at the center of his political platform.

Within months the new mayor had mounted a major anticrime initiative, the Program for the Development of Safety and Peace. Starting from the principle that prevention should take precedence over repression—and after an exhaustive analysis of the patterns of crime—the program worked to combat crime across a variety of fronts:

- Organizations of civic order were upgraded. Special education and housing programs were established for police officers, and improvements were made in the quality of services (including legal aid and conciliation services) available in the frontline inspectorate offices where citizens file complaints of criminal action.

In the 1850s a few hundred miners worked a forty-square-mile area of seemingly marginal value. Only loosely tied to the U.S. polity, they operated under entirely unwritten and informal ownership agreements. The discovery of the gold- and silver-bearing Comstock Lode in the late 1850s precipitated a flood of prospectors. Within five months the new miners had established a formal mining camp government, which enacted written rules on private holdings and enforced them through a permanent claim recorder and an ad hoc miners' court.

By 1861 the surface ore was exhausted and miners resorted to subsurface mining—a substantially more expensive and capital-intensive undertaking. With more at stake financially and with disputes over underground mining rights increasing in complexity, the miners pressured for, and won, creation of a formal territorial government with a more extensive judiciary—subsidized in part by the U.S. Congress.

By 1864, with mining production still expanding, the territorial judicial system was overwhelmed by a massive case load, which could have taken up to four years to clear. At the end of that year Nevada was admitted to the union as a state, and within a year some important judicial rulings resolved disputes over subsurface rights. Property rights stabilized, and legal uncertainty ended.

- Public education campaigns promoted tolerance and respect for the rights of others. Community leaders were trained in peaceful dispute settlement; children were encouraged to join a Friends of Peace program; humorous TV commercials aimed to re-educate citizens to follow the rules of everyday life, such as obeying traffic signals, or waiting in line to board a bus.
- Public services were directed at reducing inequities. Primary and secondary schools were expanded in depressed areas of the city; water, light, and sewerage services were introduced into squatter areas; and youth centers and enterprise development programs worked to bring teenage gang members back into society's mainstream.
- Catalysts of violent crime were directly confronted. The city banned the carrying of handguns on certain high-risk weekends, and sales of alcohol were restricted late at night and during holidays.

In 1995, after seven consecutive years of increase (to a peak of over 120 murders per 100,000 people), Cali's murder rate finally began to decline.

The progress of land titling in Thailand is a more contemporary illustration of how the formal specification of property rights can unleash "locked-up" assets and accelerate private sector-led development. Thailand has issued more than 4 million title deeds since 1985, in two land titling projects. A third project to title another 3.4 million parcels is under way. Land is an ideal form of collateral, so possession of secure title has improved access to formal credit. Three years after the first titles were issued, Thai farmers who had received titles had increased their borrowing from the formal sector by 27 percent. By enhancing security of tenure, title to land can boost investment in land improvements (irrigation, fencing, destumping). Newly titled Thai farmers increased their use of inputs by 10 to 30 percent, their rate of capital formation by 30 to 67 percent, and their investment in land improvements by 37 to 100 percent. Even after adjusting for other factors, productivity on titled land was between 12 and 27 percent higher than on untitled land.

Not every country is in a position to achieve such results. In Thailand certain background conditions played an important role. First, formal credit markets were already well developed, and lack of formal title (and hence of collateral) was the only reason why many farmers could not get loans. By contrast, in a number of African coun-

tries with weak credit markets, no measurable impact of titling on borrowing and investment could be discerned. Second, the Thai titling projects took place against a backdrop of land disputes that threatened security of tenure but could no longer be adequately resolved through traditional mechanisms. This is not always the case. Indeed, where land is cultivated individually but owned communally, strengthening traditional, community-based systems of land administration could increase security at a fraction of the cost of establishing individual titles. This is a particularly attractive option where communities can switch to individual titles once the efficiency gains from allowing sales to outsiders, and from being able to collateralize land for borrowing, outweigh the benefits associated with communal tenure.

But some complex transactions can proceed even with simple judicial systems. A well-functioning judiciary is an important asset, which developing countries would do well to build up. As Chapter 6 details, creating a workable formal judicial system from scratch can be slow and difficult. But the best should not become an enemy of the better. Even less-than-perfect judicial systems that are cumbersome and costly can help sustain credibility. What matters is not so much that judicial decisionmaking be fast but that it be fair and predictable. And for that to happen, judges must be reasonably competent, the judicial system must keep judges from behaving arbitrarily, and legislatures and executives need to respect the independence and enforcement capability of judiciaries.

Without a well-developed judicial system, firms and citizens tend to find other ways of monitoring contracts and enforcing disputes. These can often make quite complex private transactions possible. In the early Middle Ages, for example, European merchants devised their own sophisticated legal code, the *lex mercatoria*, to govern commercial transactions; the code helped revive long-distance trade. A widespread alternative to legal mechanisms is social enforcement, based on long-term personal relationships. Cheating is deterred, not by the law, but by the “long shadow of the future”: both parties pass up the one-time gains from cheating in expectation of the larger gains from a long-term business relationship. The extended family plays just this role in supporting business transactions in many Latin American countries. Although family size limits the number and variety of possible transactions, families find ways to, in effect, expand their membership, for example through marriage among business families or “adoption” of trading partners as godfathers, uncles, and aunts.

The extensive business networks created by Chinese clans, some of which have global reach, are another example of social enforcement at work. Against the backdrop of sound economic policies in large parts of East Asia, these networks have been very successful in generating wealth for their members. Indonesia’s Chinese (non-

pribumi) business community used its extended Southeast Asian network to kickstart exports of garments and furniture. A World Bank survey showed that over 90 percent of the initial export marketing contacts of non-*pribumi* firms were made through private business connections. Indonesia’s non-Chinese exporters relied much more on initial support from public agencies.

Even when parties cannot rely on social enforcement, mechanisms of information sharing can allow quite complex transactions to take place. Box 3.3 shows how in Brazil, for example, sophisticated credit information systems have developed to enable firms to bypass some of the problems created by a predictable, but cumbersome, judicial system.

Focus on the foundations

Taken together, the evidence presented here offers reasons for hope—and a major challenge. The hope comes from the fact that simple institutions can do much to facilitate market-based economic development. The challenge comes from the recognition that so many countries presently lack even the most basic underpinnings of markets. The first priority in such economies must be to lay the initial building blocks of lawfulness: protection of life and property from criminal acts, restraints on arbitrary action by government officials, and a judicial system that is fair and predictable.

Once a foundation of lawfulness is in sight, the focus can turn to the ways in which specific parts of the legal system can buttress property rights. The legal terrain is vast, ranging from land titling and the collateralization of movable property to laws governing securities markets, the protection of intellectual property, and competition law. However, reforms in these areas—especially the more sophisticated ones—will yield fruit only where institutional capabilities are strong. In many countries, more basic challenges remain to be met first.

Sustaining a benign policy environment

Property rights are the foundation for market-led growth and poverty reduction. But much more is needed. Firms need an environment that induces them to allocate resources efficiently, to improve productivity, and to innovate. And unless firms are confident that policies will remain reasonably stable over time, they will fail to invest, and growth will lag.

This section reviews international experience with some key policies that support development. It highlights some institutional reasons why countries find it so difficult to put good policies in place—and the increasing risks, in a more integrated world, of pursuing bad policies. The emphasis throughout is on finding ways in which countries with different institutional capabilities can lock in good policies.

Box 3.3 Contracting and the judicial system in Brazil

The Brazilian judicial system is exceedingly cumbersome from a firm's perspective. A complex maze of laws may apply to an otherwise simple business transaction. In 1981, for example, getting an export license took 1,470 separate legal actions involving thirteen government ministries and fifty agencies. The legal process is also exceedingly slow, primarily because of a complex appeals procedure. Yet surprisingly, when asked to evaluate the relative importance of a diverse array of constraints on doing business, firms assigned a low ranking to problems associated with the legal system.

One reason is that, cumbersome though it is, Brazil's judicial system nonetheless seems to provide a secure backdrop of judicial recourse for business transactions. Most firms report that the judiciary is reasonably fair and predictable, and they do on occasion turn to it: two-thirds of a sample of Brazilian firms have disagreed with a government official and sought to have a ruling changed, 60 percent have taken the government to court, and over 80 percent would do so again. Similarly, one in every 1,000 transactions among produc-

ers and buyers of garments finds its way into court—only one in every 2,600 does so in Chile, and one in every 20,000 in Peru.

A second reason why firms shrug off the slowness of the judicial system is that (as in all private market economies) private institutional arrangements have evolved to restrain opportunism in business dealings, while bypassing court proceedings. We cite three examples. First, Brazilian firms readily provide short-term credit even to new customers with whom they have had no prior dealings; they base their confidence on a well-developed credit information system (backstopped by a juridically sanctioned mechanism for publicizing information on people who fail to pay their debts). Second, although it is difficult to claim pledged property when loans are not repaid, under Brazilian law leased property can be reclaimed much more readily—so Brazilians make liberal use of leasing arrangements. Third, for some simple financial transactions, special judicial mechanisms allow the usual proceedings to be bypassed.

Good policies promote growth

The past few decades have yielded a rich crop of lessons about the kinds of economic policies that support development. The East Asian miracle shows how government and the private sector can cooperate to achieve rapid growth and shared development. The recent recovery of some Latin American economies, breaking out of a long history of inflation and into renewed growth, has further confirmed the power of market liberalization, budget restraint, and credibility-enhancing institutions. Africa, especially south of the Sahara, has been slower in joining this movement, with the exception of a few countries such as Mauritius and Botswana. But several more—Côte d'Ivoire since the devaluation of the CFA franc, Uganda more recently—have embarked on promising new development paths.

Analyses of these and other experiences consistently find a core set of policies that appear to be essential for growth:

- Providing macroeconomic stability
- Avoiding price distortions
- Liberalizing trade and investment.

These policies help position an economy to benefit from competitive market forces. These forces provide the right

signals and incentives for economic agents to accumulate resources, use them efficiently, and innovate. Over time, as we saw in Chapter 2, getting these basics right can have a dramatic effect on living standards.

The relationship between growth and *macroeconomic stability* is well known. Empirical work has shown that high rates of inflation (above single digits) adversely affect growth. High inflation creates uncertainty about the returns on saving and investment, thus creating a disincentive for capital accumulation. Inflation also makes it difficult to maintain a stable but competitive exchange rate, impeding the country's ability to exploit the benefits of openness and creating wage volatility.

As Box 3.4 shows, governments around the world find it difficult to achieve the strong fiscal and monetary discipline required for economic stability. Maintaining such policies is harder still. But reforming governments will not inspire the confidence necessary to generate growth unless people believe the new discipline will be sustained. We discuss below a range of institutional arrangements that can help inspire such confidence.

Limiting price distortions is an essential element of good policies, because price distortions impede growth. They can discourage necessary investment, divert effort into unproductive activity, and encourage inefficient use of re-

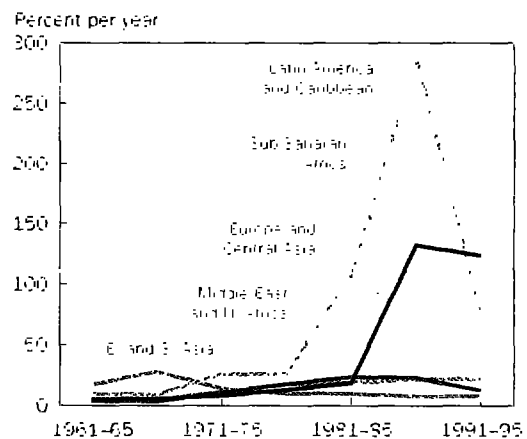
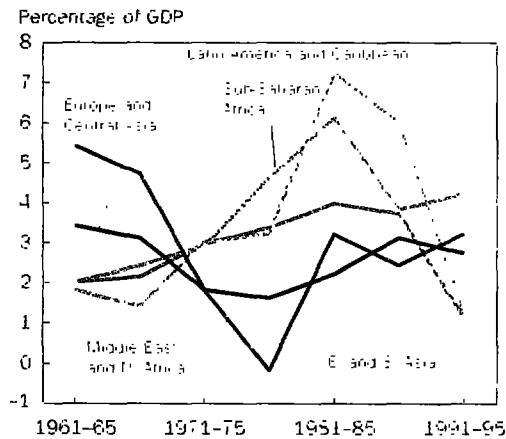
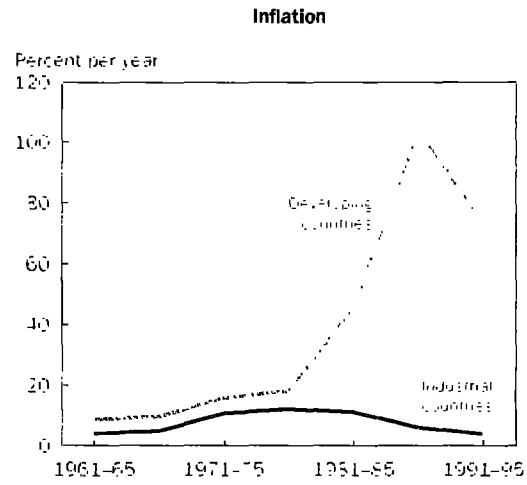
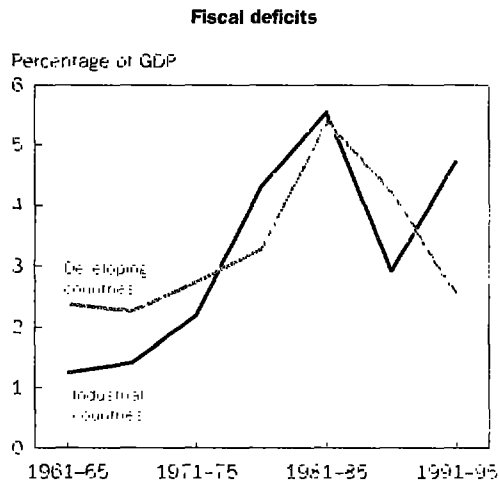
Box 3.4 International track records on fiscal deficits and inflation

As the figure shows, fiscal deficits in the industrial countries as a whole rose progressively for two decades starting in the early 1960s, stabilized briefly in the late 1980s, and then began to grow again. Persistently high deficits have boosted public debt (even before unfunded pension liabilities are included) from about 40 percent of GDP in 1980 to 70 percent in 1995. Developing countries in the aggregate have shown considerable improvement in fiscal discipline, although with substantial variation. Fiscal deficits started falling in the early 1980s, mainly because of expenditure cuts.

However, this aggregate picture reflects mainly successes in Asia and Latin America, where sustained and dramatic deficit reductions have been achieved. By

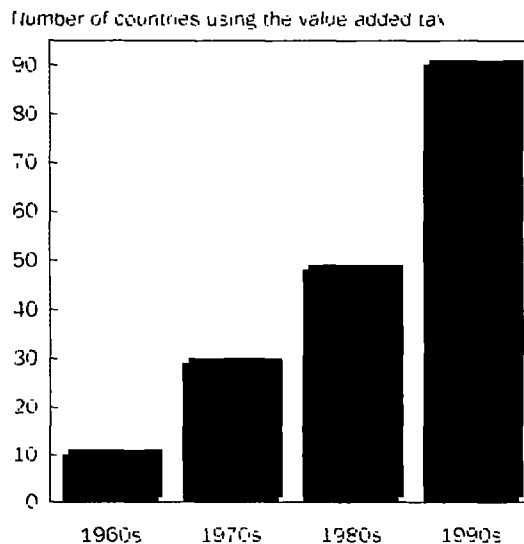
contrast, in the first half of the 1990s neither the African nor the Middle Eastern countries have been able to follow through on deficit reductions achieved in the second half of the 1980s.

Inflation rates have varied across regions even more than have fiscal deficits. The inflationary episode of the 1970s and early 1980s spread quickly around the world. The cooldown of inflation that started in the industrial countries in the early 1980s has begun to take hold, but with a lag. In the developing countries inflation began to moderate in the early 1990s, but not everywhere. In some developing regions, inflation rates are showing signs of convergence toward those of the industrial countries.



Source: IMF, various years (a)

Figure 3.3 Countries are discovering the advantages of the value added tax



Source: Tanzi, 1995b.

sources. Price distortions come in different forms, depending on their historical origins. The most common, however, involve discrimination against agriculture, overvaluation of currencies, unrealistic wages, and hidden taxes or subsidies on the use of capital.

African agriculture illustrates vividly how price distortions can undermine economic development. Agriculture accounts for about 35 percent of Africa's GDP, 40 percent of exports, and 70 percent of employment. Yet historically, African farmers have faced high rates of both explicit and implicit agricultural taxation. Explicit taxes (notably on agricultural exports) were high because administrative weaknesses precluded raising adequate revenue from other sources. Implicit taxes were high because pro-urban and pro-industry policies combined with high levels of import protection resulted in currencies being seriously overvalued in real effective terms. In addition, in some countries public sector monopolies raised border prices well above those at the farm gate, absorbing much of the difference in in-house expenditures. The combination of high explicit taxes and overvalued currencies contributed to alarming declines in Sub-Saharan Africa's agricultural growth rates: from an annual average of 2.2 percent in 1965–73 to 1.0 percent in 1974–80 and 0.6 percent in 1981–85.

Since the mid-1980s many African countries have made great strides in reversing the long-standing bias against agriculture. By the early 1990s two-thirds of a sample of twenty-seven countries had reduced the degree of

distortion by cutting explicit taxes and, often, correcting overvaluations. The 1994 devaluation of the CFA franc (see Box 3.5) significantly reduced the bias against agriculture among virtually all the franc zone countries that had not reformed earlier.

Harder to detect, but also widespread, are price distortions in labor and capital markets. Legal minimum wages, for instance, may be set too high, unintentionally making it more difficult for unskilled and low-wage workers to find jobs in the formal economy. Similarly, the price of capital—the interest rate—is sometimes kept falsely high through heavy taxation of financial transactions or high reserve requirements. When the authorities respond to borrowers' complaints by clamping a lid on lending rates, or by handing out subsidies to investors, yet another layer of distortion is added to the price system.

Maintaining *liberal trade, capital market, and investment regimes* is also essential for growth. As Chapter 8 details, many countries have recently moved toward greater openness. Open markets offer opportunities for citizens and businesses by increasing access to supplies, equipment, technology, and finance. Trade linkages with the world economy also help domestic prices adjust to global market conditions, so that prices reflect the scarcity values of goods and services. And improved incentives and opportunities allow entrepreneurs to use resources more efficiently.

Recent changes in the way developing countries raise tax revenues show how increased global integration can affect domestic policies. Internationalization of business and relentless competition for foreign investment—plus the presence of tax havens and low-tax jurisdictions—imply that countries cannot hope to tax corporate or personal income at rates much higher than global norms and still attract investment. And a growing worldwide consensus for lower national trade barriers has put pressure on the collection of border taxes, historically a major source of tax revenue for developing countries. (As a group, developing countries still derive about 30 percent of their revenue from trade taxes.) With increasing integration, the share of trade taxes in the total revenue of developing countries may be expected to fall further.

With these new constraints on traditional sources of revenue, many countries are turning toward consumption-based taxes such as the value added tax (VAT). Indeed, the combination of its revenue potential and pressures on other sources of revenue has led to dramatic growth in the number of countries using the VAT (Figure 3.3).

A liberal and open trade regime is also a powerful discipline on the other elements of economic policy. More-open economies are more exposed to external risks, making it more costly for governments to pursue inconsistent policies. Consequently, economies in which trade looms

relatively large tend to have lower fiscal deficits than those where it does not. The need to comply with the rules and conventions of international treaties will be another spur to good behavior.

An economy without sound policies is unable to engage fully in international trade and investment. But being part of an integrating world economy also carries new risks. Where markets for goods and capital are open, the state has a hard time suppressing the consequences of monetary indiscipline. If it prints too much money, the foreign exchange market will quickly expect higher inflation, and the local currency will depreciate. This market feedback causes domestic interest rates to rise, and with them the government's financing costs. Good policies are needed to cope with the risks of capital flight, volatile arbitrage activity, and sharp movements in commodity prices. Box 3.4 summarized some differences in how countries have responded to the new global environment.

Foreign capital inflows also impose discipline on policymakers. Inflows tend to make the currency appreciate in real terms, and they can affect competitiveness and domestic saving. They can also be seriously destabilizing because they respond quickly to short-run financial turbulence. Recent experience suggests that this turbulence can be contagious, spilling over to other countries and even other regions in ways not necessarily commensurate with the change in risk. Countries experiencing sizable capital inflows may need to run positive fiscal balances, using these precautionary savings as a hedge against the possibility of sudden capital outflows. Capital inflows also have major implications for exchange rate policy; fixed exchange rates, for example, are unlikely to be a workable option if a country is vulnerable in financial markets. In short, the quality of a government's management of the economy is critical.

The risk of capital flight and financial turmoil is vividly illustrated by Mexico's experience in 1994–95. An important reason for the loss of confidence there was an overvalued peso, maintained despite very large current account deficits. As foreign exchange reserves fell below the domestic monetary base late in 1994, the authorities failed to bring about the necessary monetary contraction. More-consistent policies could have limited the loss of confidence.

An open economy is also exposed to price shocks arising from world markets. Energy and food prices are particularly volatile and can affect a country's external payments and fiscal positions. Exchange rates and interest rates are also volatile. Prudence calls for anticipating adverse shocks (a sharp price increase for importers, a price drop for exporters) by not borrowing excessively and maintaining scope for new borrowing and by holding adequate foreign exchange reserves, and in the medium term by establishing a more diversified economic base.

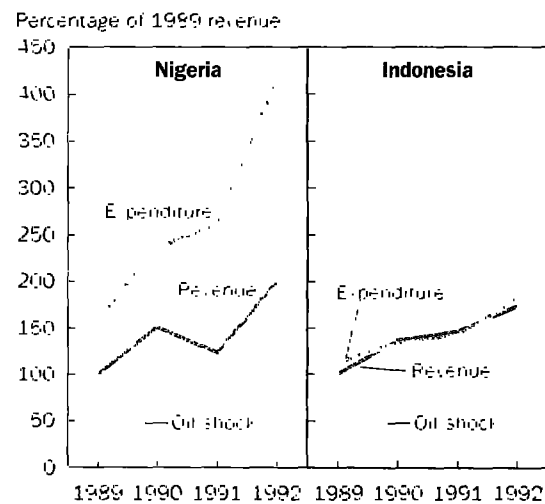
Favorable surprises can cause as much trouble as adverse ones. The prudent response to a positive economic shock is to set aside part of the windfall for future use. When the 1990–91 Gulf War pushed up oil prices, Nigeria used its windfall oil revenue to expand spending (Figure 3.4). So in spite of the large increases in revenue, Nigeria's fiscal deficit actually rose in 1990. When oil prices and revenue fell in 1991, spending remained at the new higher levels. By contrast, Indonesia responded to its oil windfall with fiscal discipline, explicitly budgeting a reserve fund to keep the increase in expenditure below the increase in revenue and maintain budget balance.

Good policies are hard to achieve

Although the recipe for good policies is well known, too many countries still fail to take it to heart, and poor performance persists. This often signals the presence of political and institutional incentives for maintaining "bad" policies.

Policies that are bad from a development perspective are often highly effective at channeling benefits to politically influential groups. Many macroeconomic problems—inflation, exchange rate misalignment—are in fact covert ways of levying unexpected taxes on the private sector or of redistributing economic benefits. Similarly, a broad array of microeconomic restrictions on the operation of markets—import restrictions, local monopoly

Figure 3.4 Unlike Nigeria, Indonesia managed its recent oil windfall prudently



Source: IMF, various years (1991).

privileges, regulatory red tape—serve to shelter powerful incumbent firms or other favored segments of society.

The political system in some countries has a built-in tendency toward chronic budget deficits. Legislators exchange favors, each promising to vote for benefits to the other's constituents, without specifying how these benefits will be paid for. So fiscal deficits rise.

When revenues fall short and politicians have little stomach for cutting spending, governments have to choose either to levy or raise taxes that are desirable from an efficiency standpoint, or impose hidden taxes such as the so-called inflation tax—the tax on real incomes that comes from financing government spending with debased currency. The latter course is often the easier. Increasing formal tax collection requires an efficient and honest tax administration. Achieving that may first require deep structural reform of fiscal administration. A change in the VAT rate might take a vote of parliament, implying delays and political compromise. But an increase in the inflation tax might involve no more than a ministerial order to the central bank.

Even when intentions are good, governments may sometimes be forced to use hidden taxes like the inflation tax—although they recognize that in the long run this brings huge costs and undermines credibility. How does a government with a history of inflationary financing convince potential bondholders that it will not inflate its way out of its obligations this time, or simply default? How can it convince trade union members that it will not cut their real income by raising the cost of living? If it cannot, investors will protect themselves by demanding a higher interest rate on government debt, and workers will protect themselves by demanding bigger raises. Their doubts may then become self-fulfilling: the government could be forced to bring about the inflation that these private agents expect, by loosening monetary policy and allowing real wages or interest rates to rise.

These perverse but powerful institutional incentives can make policy reform very difficult. And even if reforms are initiated, the skepticism of businesses, workers, and consumers may be borne out by events, unless the government can communicate the seriousness of its intent.

Locking in good policies

Once reforms are announced, their lasting success may depend on designing and implementing policies in ways that credibly signal that the government will not renege on its promises. A number of possible lock-in mechanisms are available, all with the same basic logic: to provide checks that restrain any impulse to depart from announced commitments. If institutional capabilities are strong enough to allow some flexibility to adapt rapidly to unexpected events, so much the better. If not, experience

suggests that long-run goals are better served by sticking to self-imposed restraints and living with the rigidities they inflict. The examples here concern fiscal and monetary policy; further examples in the field of regulation are discussed in Chapter 4.

FISCAL POLICY. Many macroeconomic disturbances start life as fiscal imbalances. Recent research suggests that changing the institutional features of the budgeting process can improve fiscal performance significantly.

Increasing the transparency of budgeting is particularly important. Although society as a whole will lose from budgetary ambiguity, it can be a boon for politicians, blurring the cost of favors to special interests, for example, or understating the long-run costs of short-term profligacy. When budgets are not transparent, "creative accounting" practices, such as off-budget spending and overoptimistic revenue and growth projections, become all too easy. Needless to say, all of these gimmicks make it harder to control spending.

How budgets are formulated and approved is also important. The evidence suggests, for example, that it matters whether a country takes a hierarchical approach to budgeting—giving considerable power over departmental spending totals to the finance ministry—or one that is more collegial. In principle, the hierarchical approach ought to foster greater fiscal discipline by enabling more "top-down" control of spending and limiting the scope for legislators to expand the budget piecemeal.

A recent study of twenty Latin American countries suggests that moves toward more transparent, hierarchical budgeting could deliver improved restraint (Figure 3.5). It found that budget deficits tended to be higher among countries that used collegial and nontransparent approaches to budget preparation. Countries with the least transparent and least hierarchical systems ran public deficits averaging 1.8 percent of GDP. The middle third ran an average budget surplus of 1.1 percent, while those with the highest combined hierarchy-transparency scores had budget surpluses, on average, of 1.7 percent. These results highlight that countries looking to improve their aggregate fiscal management need to scrutinize not just their balance sheets, but also the institutional environment that shapes the incentives to spend.

MONETARY POLICY. A well-functioning, independent central bank can effectively reduce the threat of politically motivated monetary expansion while maintaining some flexibility to accommodate unavoidable outside shocks. Many countries seeking credibility for their monetary policy have chosen the model of central bank independence.

In many cases this enthusiasm sprang from evidence that OECD countries with independent central banks generally had lower rates of inflation than others—with no slowdown in growth. But attempts to find a similar

pattern in developing countries have yielded mixed results, depending on how central bank independence is defined. Russia's move to central bank independence in the early 1990s, for example, did not seem to restrain that country's inflation. This more complex story for developing countries suggests that monetary restraint through central bank independence cannot simply be manufactured by fiat. It may require a prior foundation of checks and balances on arbitrary action by public officials.

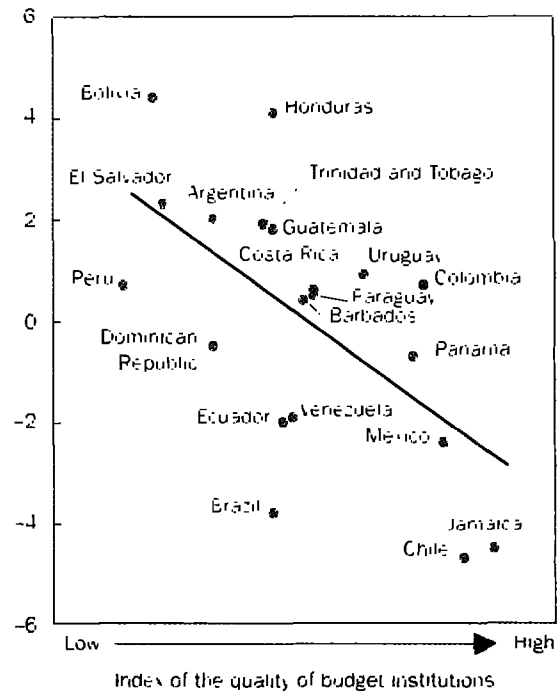
Choosing a conservative central bank governor, one who is more opposed to inflation than society in general, may be one way for developing countries to reap the benefits of central bank independence while containing the risks. Another way is to assign the bank only instrument independence—the day-to-day setting of policy to achieve a certain goal—while leaving the choice of the goal itself to the political authorities. A third option is to establish a contract for the central bank governor that provides for some penalty for deviating from an announced inflation target. This mimics the effect of employing a conservative central banker without relying on subjective judgments about the person holding the position.

The mixed success of independent central banks in restraining inflation raises the possibility that some developing countries may simply be unable to put in place mechanisms that credibly signal monetary restraint and at the same time maintain the capacity to respond flexibly to outside shocks. For these countries the choice may be between commitment through rigid mechanisms and no commitment whatsoever. A variety of inflexible approaches have been tried:

- Argentina, in breaking away from a long tradition of inflation, enacted a currency convertibility law in April 1991 that essentially turns the central bank into a quasi currency board. The money stock must be fully backed by foreign exchange.
- Many Latin American countries switched to a fixed nominal exchange rate to anchor prices and coordinate private sector expectations. A fixed rate precludes the use of devaluation to accommodate short-run external shocks. But as Mexico discovered to its dismay in 1994, a fixed nominal exchange rate can become dangerously destabilizing when capital inflows or domestic policies pull the real exchange rate out of line.
- Most of the francophone countries of Africa affiliated themselves with the CFA franc zone and its supranational central bank. Central bank advances to a member government are limited to 20 percent of tax revenues collected the previous year. This prevents countries from substituting the inflation tax for conventional taxes (Box 3.5). But the same mechanism can also provoke deflation if growth turns negative, as happened in the 1980s.

Figure 3.5 Well-designed budgetary institutions help avoid large deficits

Primary deficit (percentage of GDP)



Note: Budget deficits are averages over the period 1980-92. The index of budgetary institutions is constructed from responses to a survey of country budget directors and has ten components. Source: Alesina, background paper.

These hard-line approaches represent a high-stakes race against time. By raising the cost of policy reversal, such policies contribute to a belief that the government will hold fast. In time, however, some exogenous shock will be strong enough—or, perhaps, political opposition to some side effect of the policy will be strong enough—to demand a reconsideration. At that point, countries that have won the race against time will already have put in place more flexible approaches to monetary restraint, or will have won enough credibility that adapting the strategy will not be interpreted as a reversal.

Investing in people and infrastructure

Well-functioning markets are usually the most efficient means of providing the goods and services an economy needs—but not always. In particular, markets undersupply a range of collective goods—public goods, and private goods that have important spillover benefits for society at large. Generally these are goods that have a significant impact on the quality of life: clean air and safe water, basic literacy and public health, and low-cost transportation

Box 3.5 Commitment versus flexibility in the CFA zone

The CFA franc zone of West and Central Africa is both a currency union and a monetary standard: the CFA franc is convertible to French francs at a fixed nominal exchange rate. France established the zone after World War II to oversee monetary and financial policies in its African colonies, and France continues to play a central role in its operation.

In exchange for France's guarantee of convertibility, member countries surrender the right to print new currency. Policy changes require multilateral negotiations among the member states and France. Short of withdrawing completely from the zone, a single country cannot unilaterally renege on its commitment.

Compared with similarly endowed neighbors, zone members experienced lower average inflation and faster growth throughout the 1970s and early 1980s. By the second half of the 1980s, however, certain costs of zone membership had become apparent. The CFA zone was

hit by a pair of external shocks: a real appreciation of the French franc against the dollar, which led directly to a real appreciation of the CFA franc; and a dramatic drop in the prices of some members' major exports. The fixed exchange rate ruled out adjustment through a nominal devaluation. Inflation remained low in this period, but at the cost of stagnant growth. The very factors that had contributed to the credibility and stability of the CFA zone now made it extremely difficult to devalue the CFA franc. By the early 1990s, however, a consensus was finally reached that a devaluation was necessary.

A 50 percent devaluation was announced in January 1994. Its dramatic size signaled that the devaluation was a once-and-for-all measure. Thus its benefits could be reaped without undermining the future credibility of the fixed exchange rate. Indications to date suggest that the devaluation has proved largely successful on both counts.

and communications. They are also goods whose provision can dramatically affect the welfare and life prospects of the poorest in society.

Public investments in health, education, and infrastructure yield high returns

Access to safe water and the control of infectious disease are public goods and services with large externalities that will be underprovided, or not provided at all, by the private sector. Infectious diseases still account for a large proportion of deaths in developing countries, and the poor suffer the most. Nearly 1 billion people in the developing world lack access to clean water, and 1.7 billion have no sanitation. Water-borne diseases such as cholera, typhoid, and paratyphoid remain a pervasive threat in many developing countries, especially for the poor. Evidence from Malaysia shows that traditional public health interventions, such as immunizations and provision of safe water, can make a significant difference in rates of illness and death, especially in infant mortality.

Returns to education are especially high at the primary level, because universal basic literacy yields large externalities to society. Educating girls, for example, is linked to better health for women and their children and to lower fertility rates. Many attribute a good part of the East Asian countries' economic success to their unwavering commitment to public funding for basic education as the cornerstone of economic development.

As *World Development Report 1994* highlighted, public investment in infrastructure boosts private activity in developing and industrial countries alike. A study of eighty-five districts in thirteen Indian states found that lower transport costs led to considerable agricultural expansion by making it easier for farmers to get their goods to market. More broadly, competing for new export markets requires high-quality infrastructure, to transport goods large distances at lowest cost.

Yet public resources often do not go to these high-return investments

The world over, too few resources are devoted to vital basic services. Governments spend roughly \$1 per capita on public health, against a minimum requirement of \$4 per capita. About 130 million primary-school-age children—60 percent of them girls—were not enrolled in schools in 1990. Half the children in Africa do not go to school. Girls, the rural poor, and children from linguistic and ethnic minorities are less likely to be in school than others.

Part of the problem is misallocation of resources across sectors—among defense, state enterprises, and social services, for example. In many developing countries, state enterprises produce goods that private markets could supply; the funds these enterprises absorb could be better spent on public goods. Turkey's state-owned coal-mining company lost \$3.5 billion between 1990 and 1996. Tan-

zania's central government spent one-and-a-half times what it spent on public health to subsidize money-losing state enterprises. In low-income countries state enterprises' losses averaged 2.3 percent of GDP between 1978 and 1991.

Another part of the problem is the misallocation of resources *within* sectors. Spending on infrastructure and social services tends to be concentrated in areas where markets and private spending can meet most needs—urban hospitals, clinics, universities, and transport—rather than on essential public goods. These expenditures often benefit the rich disproportionately, while the poor receive only a small fraction.

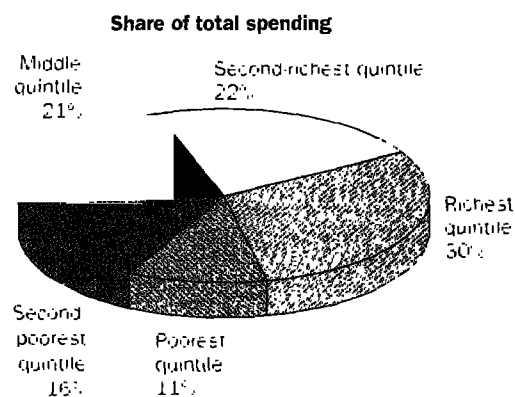
For example, governments often try to finance the entire range of health care services. Yet public health interventions directed at improving the health status of large sections of the population, including the poor, warrant a higher priority. Most curative health care is a (nearly) pure private good—if government does not foot the bill, all but the poorest will find ways to pay for care themselves. This may explain why the public provision of clinical care services had no effect on health status in Malaysia, where people have the option of using private clinical services.

Although some governments are beginning to spend more on primary and secondary education, higher education is still heavily subsidized relative to other tiers. Whereas the Republic of Korea, for example, allocates 84 percent of its education budget to basic schooling, Venezuela allocates just 31 percent. Thirty-five percent of Bolivia's education budget—but only 11 percent of Indonesia's—is allocated to higher education. The tilt toward higher education is most acute in Africa, where public spending is about forty-four times greater per student in higher education than in primary schools. At the extreme—in Tanzania—the ratio was 238 to 1.

This emphasis on clinical health services and higher education entrenches social inequities. Evidence from Vietnam confirms that wealthier groups benefit disproportionately from hospital care: the richest fifth of the population are estimated to enjoy some 30 percent of the benefits of hospital spending, while the poorest fifth get only 11 percent (Figure 3.6).

Government decisions about what kind of services to supply are not the only reason why the benefits of public spending are unequally distributed. Differences in demand, especially those related to gender, are also important. In Côte d'Ivoire, for instance, almost two-thirds of public spending on education goes to boys. In Pakistan, boys benefit from about one-and-a-half times as much public spending on their education as do girls. Often the relative disadvantage of girls is even greater in poorer households, reflecting differences in demand in these households for education for girls and boys.

Figure 3.6 In Vietnam, the benefits of hospital care are skewed toward the better-off



Note: Each slice represents the share of total spending directed toward that quintile in 1993. Source: World Bank, 1995f.

Making better use of public resources

To focus public resources more efficiently on providing collective goods and services, countries will need to reallocate expenditures and learn to use their resources more efficiently. In many countries this will take both political and institutional change. The vital first step in institutional change is a readiness to embrace a pluralistic approach to delivery: to permit private participation while focusing direct public involvement on genuinely collective goods and services (although, as discussed below, governments might also choose to subsidize needy groups' consumption of goods even when the returns are wholly private). Viewed against the common postwar presumption that infrastructure and social services are the exclusive domain of public monopolies, pluralistic approaches might seem radical and untested. In fact, private and community participation in infrastructure and social services has a long historical pedigree (Box 3.6).

Only in the twentieth century did governments, first in Europe and later elsewhere, become important providers of services, in extreme cases excluding the private sector altogether. This transition to a more pervasive government role evolved differently for different services and in different countries, giving rise to wide variation in patterns of financing and delivery within and across income groups. Among low-income countries, for example, the private share of total education expenditure ranges from around 20 percent in Sri Lanka to around 60 percent in Uganda and Vietnam (Figure 3.7). The breakdown of health spending shows similar variation. In Latin America the private share ranges widely: from one-third of total health expenditures in Ecuador to 43 percent in Mexico

Box 3.6 Private provision of social services: A historical perspective

Only in the twentieth century did the state assume an important role in providing social services such as education and health care. The ability of the state to provide these services has varied, however, resulting in different public-private mixes.

Today's modern education systems were founded on private—often religious—initiatives. From the Islamic schools in Indonesia and West Africa to the Hindu gurus in India, the Christian churches in most of Europe, and the village teachers of China, private religious schools have been teaching children for centuries. In general, however, education was a privilege of the elites. Mass public education is a nineteenth-century invention, originating in Europe and North America and spreading to former colonies after independence. Significant public investment led to expanding public sector enrollments, accompanied in several countries by a shrinking role for private schools. In Malawi, for example, enrollment in private primary schools went from 77 percent of the total in 1965 to 10 percent in 1979. Elsewhere the inability of governments to keep up with demand or overcome dissatisfaction with public school quality led to an increase in private school enrollments.

Historically, most medical services were privately provided by midwives, traditional healers, and neigh-

borhood doctors. Not until the first antibiotics were mass-produced after World War II did Western medicine begin to benefit large groups of people. In developing countries, increased urbanization and industrialization led to the formation of labor groups, which organized themselves to provide health insurance through "sickness funds" or pressed for publicly financed social insurance systems. By 1950 sixteen Latin American countries had enacted laws to provide health insurance to selected groups, but only two African and four Asian nations had done so.

The International Conference on Primary Health Care, held in Alma-Ata, Kazakhstan, in 1979, proclaimed health a "basic human right" and urged governments to take "responsibility for the health of their people." Several governments in developing countries created national health systems that purport to provide free medical care to the entire population. These efforts met with mixed success, and the private sector expanded to fill the void. In Malaysia, for example, physicians in private practice rose from 43 percent of the total in 1975 to 90 percent of the total in 1990. But large parts of the population still lack access to basic services, while others rely chiefly on private providers paid out of pocket.

and 57 percent in Brazil. Eighty percent of health expenditures in Thailand are private.

In many settings unbundling the delivery of infrastructure and social services can help achieve a better match between roles and capabilities. In bundled systems of delivery a diverse array of activities—private and collective, subsidized and unsubsidized, competitive and monopolistic—are all undertaken by a single public provider. When services are unbundled, it becomes possible:

- To distinguish between activities that could be financed and delivered entirely through private markets, and those that have important collective elements—and to begin to shed the former
- To distinguish between those collective activities whose delivery should remain in public hands, and those whose financing should be public and their delivery private—with vouchers, contracting, and similar mechanisms providing the bridge between the public and the private sector (Chapter 5 explores these options in more detail)
- To take advantage of new opportunities for competition among the array of goods and services that can now

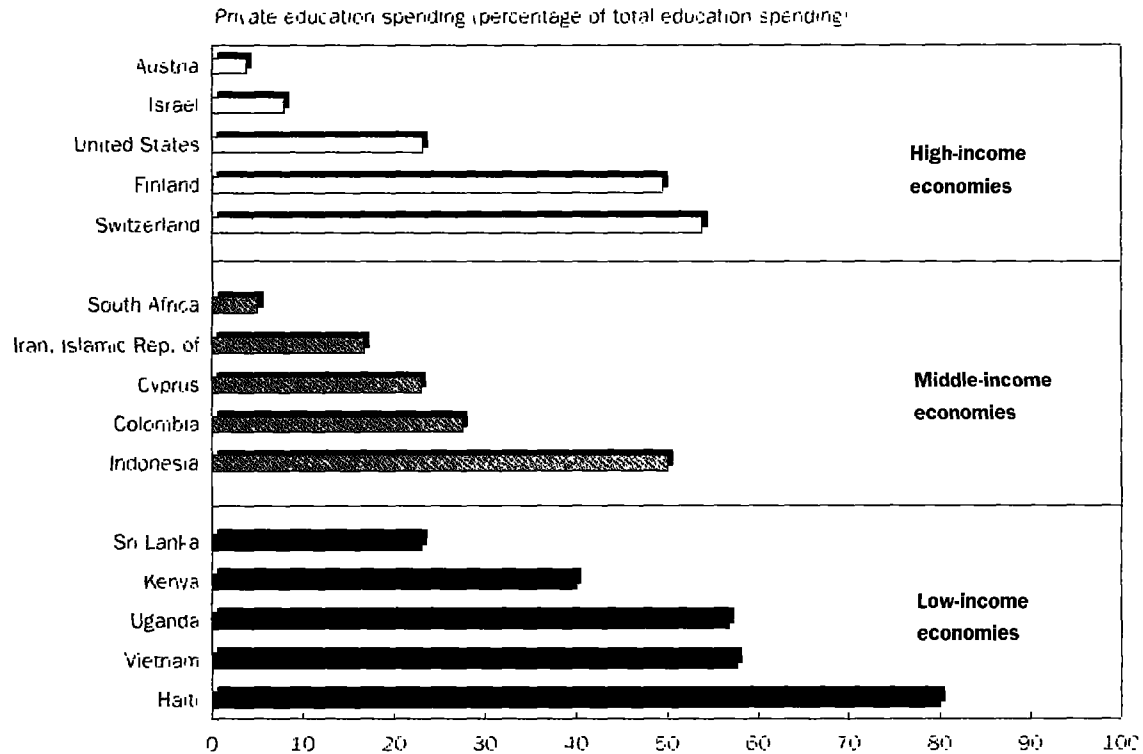
be delivered privately (sometimes, as we see in Chapter 4 for utilities, taking advantage of these new opportunities may require new regulatory arrangements)

- To increase the transparency of the uses to which public money is being put (much harder when many diverse activities are bundled together within a monopoly public provider).

Yet organizational changes will not do it all. Perhaps the most important change in the incentive environment is to empower users themselves with "voice"—not only to work in partnership with providers where localized information is key to efficient delivery, but also to monitor providers' performance and to enforce, through the political process, a commitment to quality. How this can be achieved is the subject of Chapter 7.

Protecting the vulnerable

Over the long term, rapid growth and investment in people will cut poverty dramatically. Yet regardless of a country's income level—and regardless of the gains accruing to the economy as a whole—some citizens will be left behind, and others will suffer temporary hardship. This sec-

Figure 3.7 The balance of private and public education differs enormously worldwide

Note: Data are for various years between 1989 and 1993. Source: Psacharopoulos and Nguyen 1997.

tion examines how states have wrestled with the challenge of protecting the vulnerable.

A wide variety of protective measures

Table 3.1 offers a glimpse of the rich variety of initiatives governments have tried to protect the vulnerable in developing countries. All of these initiatives fall into one of two broad categories:

- Pension, unemployment, and other *social insurance* programs aim to support people who—for reasons of age, the business cycle, or other circumstances—are outside the wage economy for some part of their lives.
- Programs of *social assistance* aim to help the poorest in society, those who are barely able to support themselves.

In industrial countries the universal welfare state, which has influenced welfare programs around the world, has blurred this distinction. Most of the main transfer programs—pensions, unemployment insurance, family assistance—began during the 1930s and 1940s in response to the Great Depression and World War II, and following the realization that the elderly were especially

vulnerable in industrial societies. These three programs, pensions especially, absorb a rapidly increasing share of national income, and rich countries around the world are revisiting some aspects of their welfare programs (Figure 3.8). Even Sweden, where the commitment to the welfare state remains firm, and which has an unrivaled record in eradicating poverty, has embarked on wide-reaching reforms to find a better balance between the social benefits and the heavy—often invisible—economic costs.

In Central and Eastern Europe and the former Soviet Union the state has traditionally provided a wide range of social services. Before their transition to the market these states offered comprehensive benefits, but they differed from those in industrial market economies in four respects. First, because the system was premised on full employment guaranteed by the state, there was no unemployment insurance. Second, social protection focused on those (such as the old and the disabled) who could not work. Third, benefits were decentralized at the firm level. And fourth, in-kind subsidies (housing, energy) played an important role.

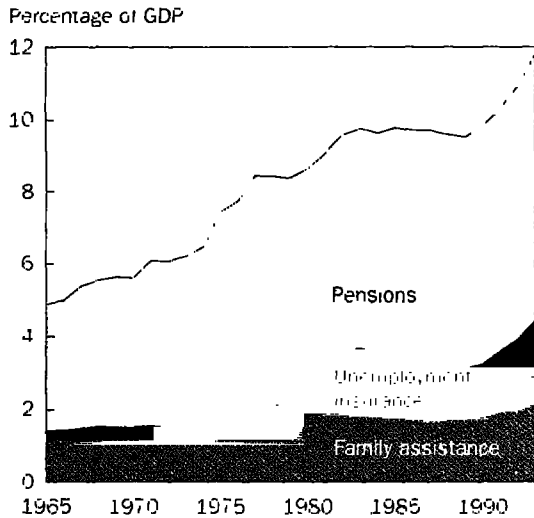
With an unprecedented economic contraction and tight budgets accompanying transition, some countries in Central and Eastern Europe and the former Soviet Union

Table 3.1 Social insurance, social assistance, and poverty-targeted programs in developing countries: Characteristics and lessons

Program type	Coverage and regional patterns	Design issues and lessons	Positive stories
Pensions	Nearly universal in transition countries, very low in Sub-Saharan Africa, medium to high in Latin America. Pay-as-you-go schemes dominate.	Actuarial imbalances, even in some countries with young populations, threaten macroeconomic stability, especially in transition countries, Brazil, and Uruguay. Transition countries need to increase pensionable age. Separate redistribution from insurance.	Innovative schemes in Argentina and Chile
Family assistance	Included in middle- to high-income countries as part of social insurance. It is universal at the enterprise level in transition economies.	Family size correlates highly with poverty in the Central Asian republics but not in Eastern Europe and the rest of the CIS. Poverty incidence determines the degree of progressivity. Where incidence is low, means testing is crucial to containing cost.	
Social assistance (cash)	Limited in transition countries, rare in Asia, nonexistent in Latin America and Africa.	More suitable to countries with relatively low poverty incidence.	Chile's family subsidy and old-age social assistance pension
Food subsidies	General price subsidies dominate in Africa and the Middle East. Quantity rationing is prevalent in South Asia. Food-for-work schemes are used in Latin America. Countries are shifting toward food stamp and targeted programs.	Open-ended price subsidies are fiscally unsustainable, distortionary, and regressive. Leakages can be prevented by innovative targeting. Nutrition programs are more cost-effective than quantity rations or general subsidies. Programs that set work requirements are more cost-effective than rations. Political economy often entails an urban bias.	Tunisia's price subsidy reform, which reduced costs by 2 percent of GDP and improved targeting; 1993 Food for Education Program in Bangladesh
Housing subsidies	Prevalent in transition economies, mostly on-budget; less prevalent in other regions, mostly off-budget.	Often regressive. Urban poor are best protected by increasing and encouraging low-cost housing production. Community organizations and cooperatives have been more successful at targeting. Subsidies in the former Soviet Union complicate functioning of housing and labor markets	Chile's one-time subsidy for housing purchase on the private market
Energy subsidies	Prevalent in transition countries and oil-producing countries, such as Venezuela.	In Asia, Africa, and Latin America gasoline subsidies largely benefit the nonpoor. They are also somewhat regressive in transition countries because of their importance in the consumption basket of the nonpoor. Elimination of subsidies would affect the urban poor.	
Public works	The Maharashtra Employment Guarantee scheme in India and social funds in Africa and Latin America are funded domestically and by international donors.	Provide both insurance and assistance. They are appropriate in areas where poverty is transient and there is scope for unskilled labor-intensive projects. The program wage should not exceed the prevailing market wage. In-kind payments attract more women.	India's Maharashtra scheme; Korea's introduction and cancellation of work program
Credit-based programs	Prevalent everywhere especially in Africa, South Asia, and Latin America.	Main problem is the inability to borrow in the absence of collateral. Programs should subsidize transactions costs but not interest rates, use local groups instead of direct targeting programs, organize beneficiaries, and incorporate incentives to both borrowers and lenders to enforce repayment. Incorporate saving as a necessary component	Grameen Bank in Bangladesh

Source: Adapted from World Bank 1996e.

Figure 3.8 Pensions and other transfers have crept upward in the industrial countries



Note: See the Technical Note for details. Source: ILO, various years; OECD 1996

are beginning to realize that this system of universal coverage is no longer affordable and must be replaced by more-targeted programs. Cash transfers as a percentage of GDP are high. But adapting the welfare system to the new conditions is proving politically difficult. In Poland transfers doubled from 9 percent of GDP in 1988 to 18 percent in 1993.

In contrast to the OECD countries, the vast majority of developing countries have created “oasis” social insurance systems, which grant family benefits and pensions to formal sector workers and civil servants. The size of this oasis increases with income per capita. It covers 6 percent of the labor force in Sub-Saharan Africa, 23 percent in Asia, and 38 percent in Latin America. Formal unemployment insurance is rare, but the use of the public sector as employer of last resort is a form of disguised unemployment insurance.

Developing countries have also experimented with a variety of social assistance measures for meeting the basic needs of the poorest. These have ranged from programs that bundle cash assistance and insurance, to price subsidies (food, housing, energy) and labor-intensive public works (Table 3.1). The design of social assistance programs has often been heavily influenced by international aid. The prevalence of food aid from the United States in the 1950s and 1960s, for example, led to the adoption of many food-for-work programs, particularly in South Asia. The emergence of social funds in the 1980s, especially in

Latin America, reflects the shift to nonfood aid and greater cooperation with nongovernmental organizations (NGOs) and community-based groups in the delivery of targeted assistance. Labor-intensive public works programs have risen in popularity, particularly in South Asia and Africa.

In many countries, social insurance and assistance programs have failed to achieve their objective of protecting the vulnerable. Often they have resulted instead in transfers of resources to elite groups, sometimes with fiscally destabilizing consequences. New approaches are beginning to emerge for both insurance and assistance. We examine each in turn.

Social insurance—options and hazards

The generosity of social insurance programs has sometimes wrought havoc with long-term fiscal policy. As Table 3.2 suggests, in many countries the liabilities implicit in individuals’ accrued pension rights far outweigh any reasonable measure of the government’s tax-raising capacity.

Demographic changes partly explain these ballooning pension liabilities. Aging populations account for more than half of the expansion of pension and other welfare benefits in the OECD countries over a recent thirty-year period. Ukraine and Hungary, too, have older populations, which partly account for their high implicit pension debt. Demographic pressures on pension programs are likely to intensify especially rapidly in some developing countries. China’s over-60 population will double from 9 to 18 percent of the total in thirty years—a transition that took a century in France and Britain.

Table 3.2 Implicit pension debt in selected countries

(percentage of GDP)

Country	Implicit pension debt of governments
Uruguay	296
Hungary	213
Brazil	187
Ukraine	141
Turkey	72
China	63
Cameroon	44
Peru	37
Congo	30
Venezuela	30
Senegal	27
Mali	13
Ghana	9
Burkina Faso	6

Note: Data are for various years between 1990 and 1995 and are net present values calculated at a discount rate of 4 percent.

Source: Kane and Palacios 1996

Box 3.7 The new Chilean unemployment insurance scheme

Chile has a severance pay scheme but no system of unemployment insurance. The government has drafted a law to create one (called PROTAC). The design of this scheme departs from models prevailing in the OECD countries. The proposed scheme tries to circumvent the disincentives to work often associated with unemployment insurance. It would create individual accounts to which workers and employers would jointly contribute 4.4 percent of the worker's salary. These accounts would accumulate up to five months of salary and would be privately managed, possibly by the same institutions that now manage Chile's private pensions. A laid-off worker would receive severance pay of one month of salary per year of service, to a maximum of five years, and could make up to five monthly withdrawals from his or her individual account while unemployed. Workers who became unemployed following a resignation would only be entitled to the monthly withdrawals. The state would regulate these unemployment insurance accounts and guarantee a minimum unemployment benefit. As with pensions, this minimum guarantee would be provided only after funds in the account are exhausted. The individual account would thus act as a deductible.

But at their root the problems go beyond demographics. Civil servants in many countries view their pensions as an entitlement, rather than a form of savings: they make limited contributions to a retirement scheme but receive a full salary as pension after thirty to thirty-five years of service. More generally, influential constituencies successfully lobby for transfers from the budget, which they are unwilling to see scaled back even in the face of a severe fiscal crunch. Or, as in some African countries, public bureaucracies direct toward themselves resources intended for social insurance or for vulnerable groups.

Whatever the cause of these problems, unless social insurance can be put on a sounder financial footing, either the programs will collapse, or countries will be plunged into deep fiscal crisis, or both. An essential first step toward reform is for governments to distinguish between the goals of insurance and those of assistance—especially in developing countries where the gap is often vast between the poorest citizens (generally the targets of assistance programs) and those who participate in the formal

economy (generally the targets of insurance programs). Experience suggests that failure to make this distinction is virtually certain to undermine both the fiscal viability of insurance programs (because the “insured” can lobby for unfunded benefits) and the impact of assistance programs (because nontargeted groups are likely to capture resources intended for the poor).

With insurance clearly distinguished from assistance, states can bring private participation and competition into insurance systems previously dominated by public monopolies. This can be done in several ways:

- The redistributive component of pensions can be unbundled from the saving component through a mandatory multipillar system, with the saving pillar fully funded, privately managed, and publicly regulated. Redistribution can be accomplished through a flat public pension (as in Argentina).
- States can introduce mandatory savings accounts for unemployment insurance, as well as pensions (Box 3.7 describes a Chilean initiative along these lines).
- Companies and individuals can be allowed to choose between public and private providers, as in Japan, Sri Lanka, and the United Kingdom.
- Management of the assets of public insurance programs can be contracted out to the private sector (as in Malaysia).
- States can enlist independent professionals, rather than political appointees, for the boards of trustees of public programs.

Of course, private provision of social insurance is only workable if financial markets are well enough developed so that private intermediaries can readily match these long-term liabilities with long-term assets. Yet even in poor regions such as Sub-Saharan Africa, thin capital markets need not be a bar to the development of private pension funds. Given an appropriate—and enforceable—legal framework for financial sector development, countries could set up regional equity markets. This is a particularly attractive option for countries of the CFA zone, which share a common currency. Already some equity markets in Sub-Saharan Africa compare favorably in terms of market capitalization with those in Latin American countries that have recently privatized their pension systems (such as Peru).

Sustainable approaches to social assistance

Unlike social insurance, which can be self-financing, social assistance requires direct expenditure of public funds. Balancing the objectives of poverty alleviation and fiscal prudence is thus vital to success. (Table 3.1 summarized the wide variety of approaches that have been tried.) In the past

the debate was primarily over the relative merits of broad-based subsidies and means-tested programs. Today, the limitations of both have become more apparent.

Because means-tested programs (in which benefits are set according to the recipient's income) are administratively demanding, they are likely to achieve their goal at reasonable cost only in countries with strong institutional capability. But broad-based subsidies have also lost their appeal: they are expensive and relatively inefficient at reducing poverty. Housing and infrastructure subsidies, for example, turn out to benefit higher-income households disproportionately (Figure 3.9). Food subsidies can be more effective if they are targeted toward items consumed primarily by the poor. Tunisia has effectively moved from a nontargeted to a targeted program by eliminating all subsidies on goods consumed disproportionately by the nonpoor and, for those food products still subsidized, by differentiating product lines through differences in packaging and the use of generic ingredients. These reforms have reduced the cost of food subsidies from 4 percent of GDP in the mid-1980s to 2 percent by 1993, while still maintaining a food safety net for the poor.

With both means-tested and more broad-based assistance programs increasingly in question, attention has shifted to self-targeted approaches. One approach is to focus delivery on those localities, urban and rural, with disproportionate numbers of poor residents. Another is to set the level of benefits low and build in some kind of quid pro quo. Food-for-work programs incorporate these features. So, too, do lending programs for microenterprises in poor communities. Box 3.8 illustrates how Indonesia, which has made huge strides in reducing poverty through broad-based growth, is initiating a variety of self-targeted programs in an effort to eliminate poverty by 2005.

The challenge of sustaining programs of social assistance is political as well as fiscal: since the marginalized poor are politically weak almost everywhere, in times of fiscal belt tightening even prudently designed programs risk losing support. Self-targeted programs—especially those that impose reciprocal obligations on recipients—seem more politically resilient than those targeted more narrowly, but they too are vulnerable. At its root, then, the task—explored in Chapter 7—is to find ways of giving voice to the concerns of the poor, enabling them to become more effective advocates of their own interests.

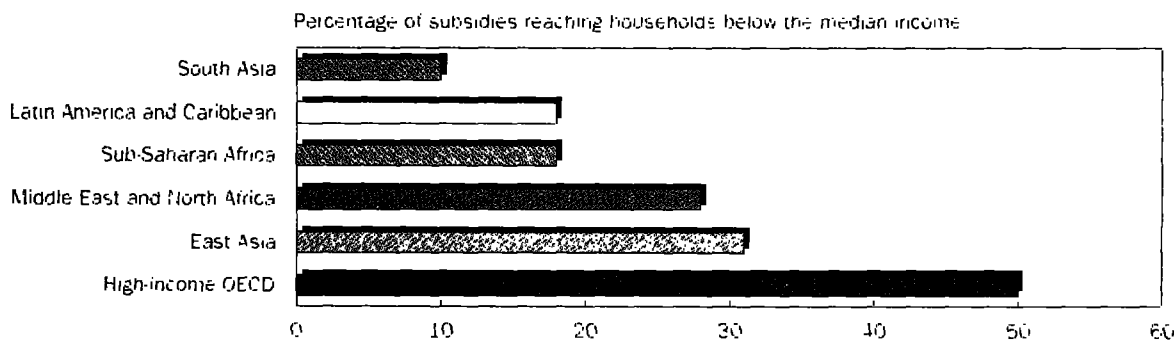
Strategic options: Doing better on the fundamentals

Each of the four sets of economic and social fundamentals poses distinctive challenges, but all have some challenges in common.

First, prioritization is vital. As this chapter shows, in all too many countries the state still does not provide the full complement of core public goods and services: a foundation of lawfulness, a stable macroeconomy, the rudiments of public health, universal primary education, adequate transport infrastructure, and a minimal safety net. At the same time states are overproviding a wide variety of goods and services that private markets could supply in their stead. Especially in countries with weak institutional capabilities, the need is therefore urgent to focus the state's role on the fundamentals.

Second, skillful use of private, competitive markets and voluntary activity can support development while sharply reducing the burden on states with weak institutional capabilities. Market-led growth in a supportive incentive environment is fundamental. Additionally, markets can provide a variety of private goods and services that in many countries have somehow wandered into the domain of public provision, such as higher education, curative

Figure 3.9 Housing subsidies in developing countries mostly fail to reach the needy



Note: Data are for 1991–92. Source: World Bank 1995e

Box 3.8 Reducing poverty in Indonesia—how social assistance complements broad-based growth

Indonesia's rapid and broad-based growth has had a spectacular effect on poverty reduction. Between 1970 and 1990 the proportion of the population living below the official poverty line declined from 56 to 15 percent; other indicators of welfare, such as infant mortality, showed similar improvement. The government has now set itself the ambitious target of eradicating absolute poverty within the next decade. The challenge is that the remaining poor are concentrated in isolated pockets of poverty with poor natural resource endowments, low population densities, and other socioeconomic characteristics that make them difficult to reach. Several targeted interventions have been initiated in recent years, including the following:

- The Inpres Desa Tertinggal (IDT) program, launched in 1994, is directed at villages that the country's development has left behind. The program distributes grants totaling \$200 million per year among

20,000 villages—the poorest one-third of all Indonesian villages—to be used as seed capital for income-generating activities. The program is combined with public works programs.

- The Prosperous Family program, launched in 1996, aims to improve the conditions of families living in non-IDT villages, and whose living standards are below a certain level, through small grants and subsidized credit.
- Under the Transmigration Program about 750,000 families, or over 3.6 million people, have been resettled at government expense from overpopulated Java to less populated outer islands. The program aims to address landlessness as a cause of poverty and provide new settlers with agricultural land and other benefits.
- The Kampung Improvement Program is targeted at improving the provision of social services and infrastructure to densely populated, low-income, urban neighborhoods.

health services, and pensions and other forms of insurance. In a range of other areas—using social funds for poverty alleviation, enhancing the quality of primary education, encouraging participation by NGOs and communities—reform can greatly improve service delivery. Countries with weak public institutions should assign high priority to finding ways to use markets and involve private firms and other nongovernmental providers in service delivery.

Finally, states should seek ways to enhance the credibility of their actions. In the short run, while weak domestic institutions are being reinforced, stronger ties with external actors—for example, through stabilization programs with the IMF—can help governments signal their commitment. In the long run, however, as Part Three explores in depth, the vital challenge is to build homegrown commitment mechanisms, rooted in domestic institutions.