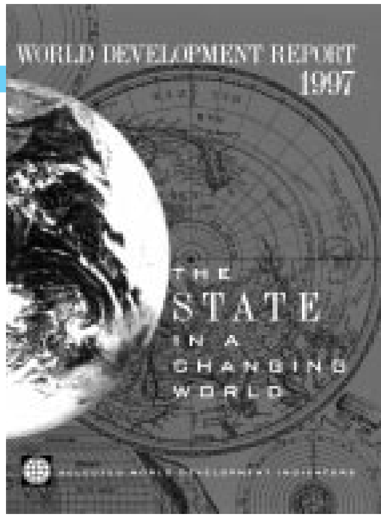


The State in a Changing World

AJAY CHHIBBER

The state has an important role to play in economic and social development as a partner, catalyst, and facilitator. An effective—not a minimalist—state is needed to provide the goods and services—and rules and institutions—that allow markets to flourish and people to lead healthier, happier lives.

THE ROLE of the state is once again in the spotlight. Recent developments—the reforms in command-and-control state systems, fiscal crises of industrial countries, rapid economic growth and poverty reduction in some East Asian countries, and the crisis of collapsed states—have raised questions about what governments can and should do. And, while many governments continue to grapple with the formidable challenges of reducing poverty and fostering sustainable development, new challenges are emerging, such as the rapid diffusion of technology, growing demographic pressures, environmental degradation, the globalization of markets, and a shift to more democratic government.

For many, the lesson of recent years has been that the state could not deliver on its promises: transition economies have had to make a wrenching shift from state-led planning, and many developing countries have had to face up to the failure of state-dominated development strategies. Even the mixed economies of the industrial world, in response to the failures of state intervention, are moving toward greater reliance on market mechanisms.

Many observers feel that the logical conclusion to be drawn from these failures is that the ideal state is the minimalist state. But, as shown in the World Bank's *World Development Report 1997 (WDR)*, this extreme view is at odds with the evidence offered by the world's success stories, recent and past. A minimalist state would do no harm, but neither could it do much good. Development requires an effective state that can play a catalytic role, encouraging and complementing the activities of individuals and private businesses. It is true that state-sponsored development has failed. But the agonies of collapsed states such as Liberia and Somalia demonstrate all too clearly the consequences of statelessness. Good government is not a luxury but a vital necessity, without which there can be no development, economic or social.

A two-part strategy

Given the growing gap between the demands on states and the latter's capabilities, how can states become credible and effective agents for development? The *WDR* points to a two-part strategy:

• ***Matching the state's role to its capabilities.*** Where state capability is weak, how the state intervenes—and where—should be carefully assessed. States that try to do too much with too few resources and too little capability often do more harm than good.

• ***Increasing state capability by reinvigorating public institutions.*** This means designing effective rules and restraints to check arbitrary state actions and combat corruption, subjecting state institutions to greater competition to increase their efficiency, and offering better pay and incentives to public officials to improve performance. And it means making the state more responsive to people's needs.

Matching role to capability

The first job of states is to get the fundamentals right:

• establishing a foundation of law,

• maintaining a nondistortionary policy environment,

• investing in basic social services and infrastructure,

• protecting the vulnerable, and

• protecting the environment.

Although the importance of these fundamentals for development has long been widely accepted, new insights are emerging as to the appropriate mix of market and government activities in achieving them. We now see that markets and governments are complementary: the state is essential for putting in place the appropriate institutional foundations for markets (see "How Can States Foster Markets?" by Brian Levy in this issue).

A survey specially commissioned for the *WDR* of local entrepreneurs in 69 countries

Ajay Chhibber,
an Indian national, was Staff Director of the World Bank's World Development Report 1997.

Box 1

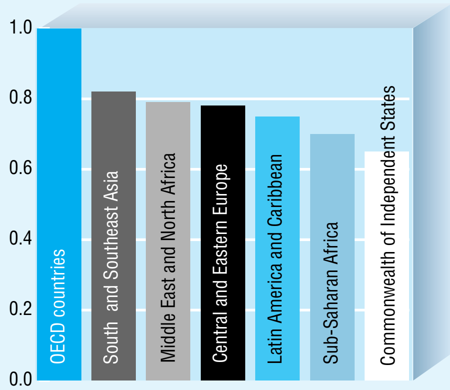
Credibility, investment, and growth

A survey of more than 3,600 local businesses in 69 countries shows that many states are perceived to be performing their core functions poorly: they are failing to ensure law and order, protect property, and apply rules and policies in a predictable manner. Such states do not inspire confidence, and growth and investment suffer as a consequence. Firms were asked to rank each indicator on a scale from 1 (extreme problem) to 6 (no problem). Averaging the answers yields an overall indicator of the reliability of the institutional framework as perceived by private entrepreneurs—what we call the state's credibility (Chart 1). Controlling for policy distortions, as well as for differences in income and education, there is a strong correlation between countries' credibility rating and their record of growth and investment (Chart 2).

Chart 1

Government credibility, as perceived by businesses

(OECD countries = 1)

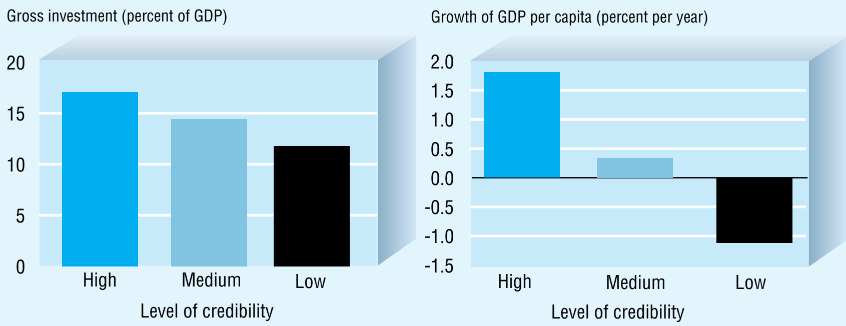


Source: World Bank, *World Development Report 1997* (New York: Oxford University Press for the World Bank).

Note: Using data from a survey of more than 3,600 enterprises in 69 countries, World Bank staff compiled an index of government credibility. Entrepreneurs were asked to evaluate the institutional framework in their country in terms of the following: predictability of changes in laws and policies, government stability, security of property, reliability of the judiciary, and corruption.

Chart 2

Government credibility has an impact on investment and GDP growth



Source: World Bank staff calculations using data in A. Brunetti, G. Kisunko, and B. Weder, 1996, "Credibility of Rules and Economic Growth" (Washington: World Bank), a background paper for the *World Development Report 1997*.

Note: Each bar represents the unweighted average for a group of countries. The graphs are based on regressions for 1984–93 for investment and GDP growth in 33 countries based on a credibility index and controlling for income, education, and policy distortions.

shows that many countries lack the basic institutional foundations for development (Box 1). High levels of crime and violence and an unpredictable judiciary combine to produce uncertainty and raise transaction costs. Lawlessness is often related to a sense of marginalization. Weak and arbitrary state institutions often compound the problem with unpredictable and inconsistent behavior.

To achieve stable and sustainable development, the state has to give a high priority to social and institutional fundamentals. Only then can public policies ensure that growth is shared and that it contributes to reducing poverty and inequality. In too many countries, the affluent have more political clout than other groups; governments may be pressured into adopting policies and programs that benefit the affluent, while resources and services are diverted from those who need them the most.

Reinvigorating institutions

The second task of state reform is to reinvigorate the state's institutional capability by providing incentives for public officials to perform better while keeping arbitrary action in check. Building the institutions for an effective public sector is difficult, however. Certain groups may have a vested interest in maintaining an inequitable and inefficient status quo, while those who lose from this arrangement may be unable to exert effective pressure for change. But the problem is not entirely political. Even when politicians and public officials have strong incentives and a sincere interest in improving public sector performance, managing a public bureaucracy is a complex business that does not lend itself to clear solutions. Three basic mechanisms—rules and restraints, voice and partnerships, and competitive pressures—can be used to overcome these deeper problems (see figure). These mechanisms are discussed in greater detail in Sanjay Pradhan's article, "Improving the State's Institutional Capacity," in this issue.

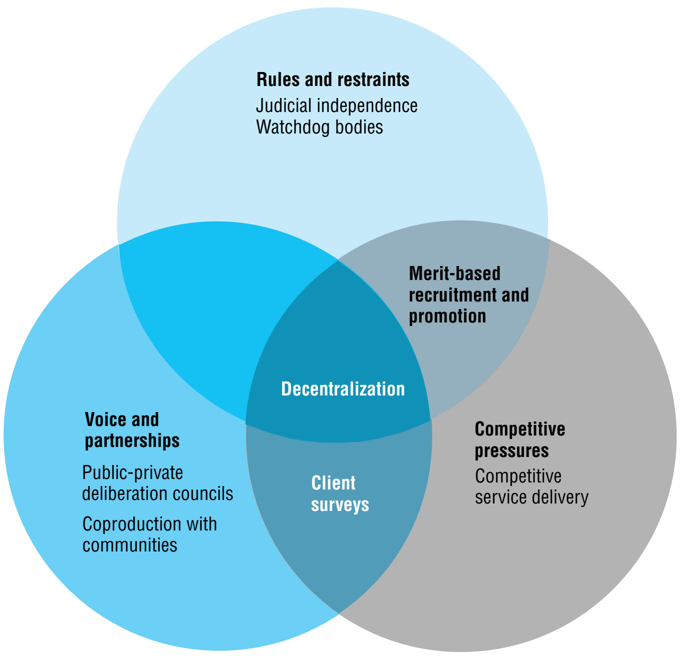
Participation and power

A state that ignores the needs of large segments of its population is not a capable state. And with the best will in the world, a government is unlikely to meet collective needs efficiently if it does not know what those needs are. Reinvigorating public institutions must begin by bringing government closer to people. In certain settings, it may also mean decentralizing government power and resources.

Broadening participation. There is mounting evidence that government programs work better when they seek the participation of potential users and tap the community's social capital. Whereas top-down approaches often fail, local participation ensures smoother implementation, greater sustainability, and better feedback and evaluation. Higher returns from waterborne sanitation systems in Recife, Brazil; housing schemes for the poor in Port Elizabeth, South Africa; management efforts in Gujarat, India; and health care in Khartoum, Sudan: these programs all attest to the power of partnership between local people and government.

The need to inform and respond to citizens leads to improvements in the monitoring of public goods and services and greater transparency in decision making. Governments also enhance the quality of public goods and services by entering into partnerships with businesses and civic organizations. But effective citizen involvement does not come easily. Governments have to improve the institutional environment in which social and human capital is created. And, governments must be conscious not only of the interests represented

A range of mechanisms can enhance state capability



by the groups they work with but also of groups that are not vocal and adequately represented.

Devolving power. Over the past thirty years, there has been a small shift in public spending power in developing countries (with some significant exceptions) from national to local levels, whereas spending power in the industrial economies has tended to move in the opposite direction. Decentralization is bringing many benefits in China, India, much of Latin America, and other parts of the world. It is improving the quality of government and the representation of the interests of local businesses and citizens. And competition among provinces, cities, and localities is spurring the development of more effective policies and programs. But there are three pitfalls to watch out for:

• *Rising inequality.* The gap between regions within a country can widen. This is an issue of considerable concern in Brazil, China, and Russia. Labor mobility is one possible solution, but it is seldom easy, especially in ethnically diverse countries.

• *Macroeconomic instability.* Governments can lose control of macroeconomic policy if local and regional fiscal indiscipline leads to frequent bailouts from the center, as in Brazil.

• *Special interests.* There is a serious danger that local governments will fall under the sway of special interests, leading to the misuse of resources and of the state's power.

Global collective action

Globalization is a threat to weak or capricious states, but for effective, disciplined states, it provides opportunities to foster economic development. Despite all the talk about globalization, however, many developing countries are still economically isolated. The growth of international trade and capital flows since the early 1980s has brought little benefit to countries in which half of the developing world's population lives. Some governments are hesitant about opening up to the world economy because of the risks involved—and it is true that countries can become more vulnerable to external price shocks or to large, destabilizing shifts in capital inflows. But the pitfalls should not be exaggerated, particularly when compared with the risks of being left out of the globalized economy. The state thus has a critical role to play, both in handling such shocks and in helping people and firms seize the opportunities of the global marketplace.

Globalization also sharpens the need for international cooperation in at least five areas:

• ***Managing regional crises.*** Although the threat of nuclear war has receded, smaller conflicts entailing costly problems of refugee relief have mushroomed. No solid international framework exists for managing or avoiding these conflicts. A more integrated assessment of how state policies (and international assistance) can help manage nascent conflict is needed in designing economic and social policy.

• ***Promoting global economic stability.*** There has been growing concern about the potentially destabilizing effects of large and rapid flows of portfolio capital, particularly when a crisis in one country can spill over into others. A variety of international mechanisms have been suggested to guard against such problems, but prudent and responsive domestic economic policies are the best safeguard.

• ***Protecting the environment.*** Urgent global environmental issues include climate change, loss of biodiversity, and protection of international waters. International collective action can help countries achieve better coordination, increase public awareness, transfer technologies with more ease, and adopt better national and local practices.

• ***Fostering basic research and the dissemination of know-how.*** Now being revitalized to meet new challenges in food production, the Consultative Group on International Agricultural Research, which channels international funding to research institutes, has shown how technology can be developed and disseminated through international collective action. Similar consultative mechanisms need to be developed to tackle other pressing problems in the domains of environmental protection and health.

• ***Making international development assistance more effective.*** To become more effective, foreign aid needs to be tied more closely to the policies of recipient countries. Aid agencies should focus on channeling resources to poor countries that have good policies and give a high priority to institutional reinvigoration.

Removing obstacles to reform

Until the last century, Europe, Japan, and North America had many of the same problems that appear to be undermining the effectiveness of the state in the developing world today. But the problems were addressed, and modern states with professional systems have emerged. The experience of these states shows, however, that institutional strengthening takes time and requires immense political commitment. The reforms of the Meiji restoration that launched Japan's development took almost 25 years. But, because such reforms take time, it is important that reform begin urgently, especially in countries with very weak institutional capabilities.

Over the past fifteen years, many governments have responded to internal and

Box 2

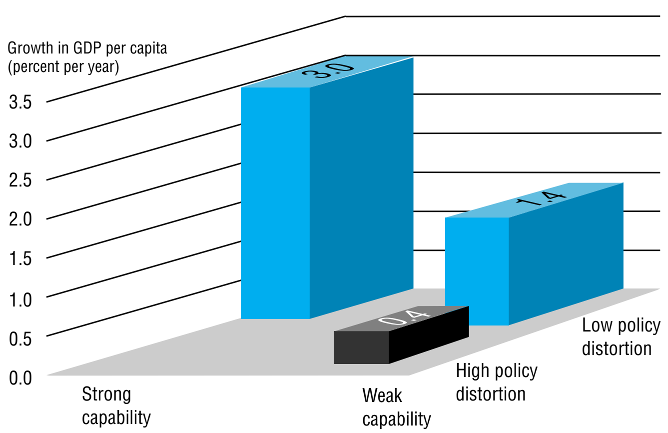
The regional agenda

The key features and challenges of improving the effectiveness of the state in the various developing regions are summarized below. These are of necessity broad generalizations, and each region includes countries whose experiences are different.

- Reforms are beginning to take hold in a few cases but many countries in *Africa* are suffering from a crisis of statehood. They need urgently to overhaul public institutions and to ensure that the rule of law prevails and that there are credible checks on abuse of state power. Improving the delivery of public and collective services will require closer partnerships with the private sector and civil society.
- The capability of the state in most *East Asian* countries is not at issue, but the continued economic success of these countries will very much depend on their ability to undertake necessary regulatory and financial sector reforms and to deal with environmental problems.
- The main issue in *South Asia* is overregulation, which is both a cause and an effect of bloated public employment and the surest route to corruption. Regulatory simplification and public enterprise reform, and the resulting contraction of the role of the state, will be complex and politically difficult.
- The job of reorienting the state toward "steering, not rowing" is far from complete in *Eastern Europe*. But most countries have made progress and are on the way to improving capability and accountability.
- Low state capability in many countries of the *Commonwealth of Independent States* is a serious obstacle to further progress in most areas of economic and social policy. The process of reorienting the state is still at an early stage, and there is a general lack of accountability and transparency.
- In *Latin America*, decentralization of power and spending, coupled with democratization, has dramatically transformed the political landscape. A new model of government is emerging. But greater emphasis is needed on reforming the legal system, the civil service, and social policies.
- Unemployment is by far the greatest economic and social problem in the *Middle East and North Africa*, making government downsizing especially difficult. A promising approach might be to begin decentralizing selected services and focus on reforming state enterprises, while preparing the ground for wider-ranging reforms.

Chart 3

Countries with good policies and strong institutional capabilities grow faster



Source: Derived from S. Commander, H. Davoodi, and U. Lee, 1996, "The Causes and Consequences of Government for Growth and Well-Being" (Washington: World Bank), a background paper for the *World Development Report 1997.*

Note: Growth rates are the unweighted averages for a group of countries. Results are based on a regression using panel data for 94 industrial and developing countries during 1964–93 on growth in per capita GDP on indexes of bureaucratic capability and policy distortion, controlling for education, income, and other variables.

external pressures by launching far-reaching reforms to improve their performance. Typically, the most rapid changes have been made in macroeconomic policy; these changes have political implications but do not require the overhaul of institutions and can be undertaken quickly, often through decree, by a small group of competent technocrats. In contrast, state reforms dealing with regulation, social services, finance, infrastructure, and public works take longer because they involve changing institutional structures designed to accomplish different ends. Government agencies must make radical changes in the way they think and act, and, often, long-established systems of patronage and corruption must be overturned.

Comprehensive institutional reforms will take a great deal of time and effort and will encounter considerable political opposition. What is needed will vary considerably from region to region (Box 2). But the effort is well worth it—in combination, good policies and more capable state institutions to implement them produce much faster economic development (Chart 3). In the short term, reformers can start by strengthening central agencies for strategic policy formulation, introducing more transparency and contestability in decision making, spinning off activities and agencies, and seeking more feedback from the users of public services.

Ineffective states have long suffered the consequences in the form of stagnant economic growth and social development, but the cost of continuing to postpone reforms could be even greater: political and social unrest and, in some cases, disintegration of the state itself. Once the spiral into collapse has occurred, there are no quick fixes. The crucial challenge facing states is to take the steps that set their economies on an upward growth path. If we now have a better sense of the size of the reform challenge, we are also much more aware of the costs of leaving things as they are. F&D

This article is based on the World Bank's World Development Report 1997*:* The State in a Changing World *(New York: Oxford University Press for the World Bank).*