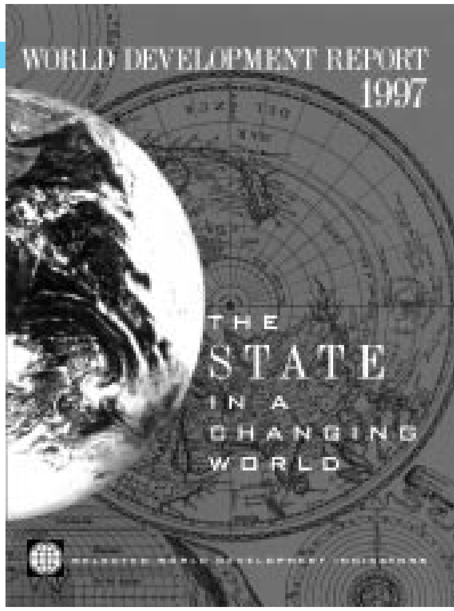

Improving the State's Institutional Capability

SANJAY PRADHAN

An effective government is necessary for economic development. But states may intervene in economic activity in ways that are harmful. What is needed are mechanisms that enable the state to act in the public interest and that check arbitrary and corrupt actions.

THE state's power to intervene in economic activity is a double-edged sword. While the state may use this power to promote the well-being of its citizens, it may also abuse it, to their detriment. Countries therefore need to adopt mechanisms that give state agencies the flexibility and the incentive to act in the public interest while restraining arbitrary action and corruption. Unfortunately, the governments of many developing countries have failed to achieve this balance. As a result, their actions have not been viewed as credible, and investment and growth have suffered.

Three interrelated sets of institutional mechanisms can improve the credibility, accountability, and responsiveness of the state: restraints and rules, voice and partnerships, and competitive pressures.

• *Restraints and rules*. Many countries need to strengthen formal instruments of restraint, such as judicial independence and the separation of powers. Within the executive branch of government, credible rules can create an enabling environment for effective public sector performance.

• *Voice and partnerships*. Mechanisms such as public-private deliberation councils and client surveys, which give businesses and civil society a voice in state activities and foster partnerships between the state and its constituencies, allow external stakeholders to provide input and oversight and exert pressure for change.

• *Competitive pressures*. Competitive pressures from markets and civil society and other state organs check the state's ability to exercise a monopoly in policy-making and service delivery. Competition in civil service recruitment and promotion can help build a motivated, professional bureaucracy.

Formal checks and balances

Sustainable development requires that the state and its officials be held accountable for their actions. The two most important formal instruments for achieving accountability are a strong judiciary and the separation of powers.

For judiciaries to be effective, they must be independent and have adequate resources and instruments for enforcement. Judicial independence and enforcement have repeatedly been compromised in too many countries, however.

Even where judiciaries are capable of enforcing rules, the state's credibility can be limited if the public has little reason to believe that rules will be stable over time. One classic constitutional mechanism for avoiding excessive legislative change is to divide power horizontally (among the judiciary, legislative, and executive branches of government) or vertically (among different levels of government).

The broader the separation of powers, the more difficult it is to change rule-based commitments. The separation of powers thus increases the public's confidence that rules will be sustained or that changes will be made only after considerable negotiation. However, the presence of multiple veto points also has drawbacks: it can make it hard to change harmful laws or lead to gridlock in government. Nonetheless, many developing countries, even those with a formal separation of powers, have few effective checks and balances. In some countries, legislative oversight is weak

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because of poor capacity and inadequate information. In others, the executive branch dominates a compliant legislature.

To some extent, external restraints can substitute for limitations in national institutions. One option is to use extraterritorial adjudication to underpin the domestic judicial system or compensate for its weaknesses. Confidence in the Jamaican judicial system is buttressed by the fact that the United Kingdom's Privy Council serves as Jamaica's appellate court of last resort. Cross-border agreements such as the European Union, the North American Free Trade Agreement, and the West African franc zone are another mechanism for strengthening commitments.

Strengthening policymaking

Instruments of restraint need to be balanced by arrangements that provide the executive branch with sufficient flexibility to formulate and implement policies and respond to changing circumstances. Although the institutional arrangements vary from country to country, the public sectors of the industrial countries and many East Asian countries have generally been characterized by a strong central capacity for macroeconomic and strategic policy formulation; mechanisms to delegate and debate policies among government agencies; and transparent links to external stakeholders. By contrast, policymaking capacity in many developing and transition economies is weak and fragmented, with little institutionalized input or oversight from stakeholders.

Australia provides an example of reforms aimed at creating a more transparent, competitive, and results-oriented policymaking process. Of particular relevance is the emphasis on publishing the medium-term costs of competing policies, facilitating debate and consultation within the government on policy priorities, setting hard budget constraints, and evaluating outcomes.

The United States and some continental European countries have instituted other mechanisms for consultation and oversight in policymaking. US executive agencies, for instance, are governed by the Administrative Procedures Act (APA) of 1946, which imposes procedural requirements—such as public announcements of new policy—that are enforceable in the courts. This approach assures accountability by involving the judiciary and giving citizens the chance to voice their views.

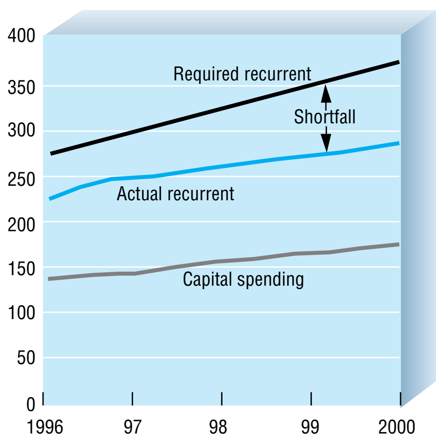
The successful East Asian countries have adopted similar approaches. In Korea, Japan, Malaysia, Singapore, and Thailand, policymaking has been delegated to elite central agencies staffed by professional employees recruited on the basis of merit. Private firms provide input and oversight to the agencies through public-private deliberation councils.

In many developing countries in Africa, Central America, and the Caribbean, the central government's capacity for the formulation of strategic policies is weak.The problem is compounded by poor discipline and an absence of competition. Often, budgets are unrealistic, and decisions are made in an ad hoc manner. In Tanzania, actual recurrent expenditures have been 50 percent higher, on average, than budgeted expenditures in recent years, and, in Uganda, 30 percent higher. There are long lags in the production of financial accounts and audits, and often no system of costing or contesting competing policies.

Chart 1

Guinea's investment projects are unsustainable

(projected costs, millions of Guinea francs [1])



Source: World Bank, 1996, "Republic of Guinea: Public Expenditure Review" (Washington).

[1] In 1996, the Guinea franc–dollar exchange rate averaged 1,004 Guinea francs = $1.

In aid-dependent countries, donors inadvertently exacerbate the problem. Decision making often becomes more fragmented as ministries and donors enter into bilateral deals on several projects without determining whether the cumulative effects are collectively sustainable or mutually consistent. In many countries, public investment programs have become passive repositories of donor-driven projects, and the future recurrent costs of projects have become unsustainable, as in Guinea (Chart 1). Lack of coordination between the ministries of planning and finance further impedes the integration of capital and recurrent expenditures. The result in many developing countries is that newly built roads fall into disrepair; schools find themselves without textbooks; and health centers have no drugs.

Several initiatives have been launched to address these problems. The Africa Capacity Building Initiative seeks to strengthen Africa's policymaking capacity through enhanced external inputs from African universities and civil society. Governments and donors have also launched sectoral investment programs that coordinate donor assistance. Countries like Malawi and Uganda are moving beyond coordinating donor policies within a given sector to developing a systematic process for strategic prioritization across sectors within total spending constraints. A few countries, such as Colombia, are instituting an ex post evaluation system to assess whether policies are achieving intended outcomes.

In the transition countries of Central and Eastern Europe and the former Soviet republics, the problem is not the shortage of administrative expertise but the lack of mechanisms for channeling that competence into coherent policy. When the communist regimes in these countries collapsed, so did the centralized decision making apparatus that coordinated the activities of ministries and departments. As a result, these countries developed confused, overlapping responsibilities and multiple, rather than collective, accountability—a surefire formula for disastrous policy formulation. The situation is improving in some countries, however; Georgia has already removed overlapping and conflicting positions, and Hungary and Poland have introduced reforms to streamline multiple and conflicting responsibilities and speed decision making.

Improving delivery

Even well-designed policies can experience major implementation problems. In many developing countries, services are simply not delivered or delivery is marred by poor quality, high cost, waste, fraud, and corruption. Politicians often intervene in the day-to-day operations of public agencies, and managers have limited flexibility. There is limited accountability for the use of inputs and virtually no accountability for outcomes. And, in many countries, the public sector has a monopoly on delivery of service. To improve delivery, governments are experimenting with a range of institutional mechanisms.

The so-called new public management reforms in the industrial countries have sought to improve delivery primarily using market mechanisms and formal contracting. In New Zealand, for example, commercial activities have been spun off, corporatized, and often privatized. All remaining conglomerate ministries have been broken up into focused business units headed by chief executive officers given fixed-term, output-based contracts and considerable managerial autonomy, including the right to hire and fire.

What is feasible in New Zealand may not be in many developing countries, however. It takes considerable capacity and commitment to write and enforce contracts, especially for outputs that are difficult to specify, as is the case with social services. Indeed, the most appropriate method for improving performance should be determined by the characteristics of the service in question and the ability of the state to enforce contracts.

For contestable services (that is, those with scope for actual or potential competition), such as commercial products, telecommunications, and power generation, market mechanisms can generate strong competitive pressures. Deregulation of telecommunications and power generation has led to significantly lower unit costs and a rapid expansion of service in many countries. But the use of market mechanisms requires a well-developed regulatory capacity.

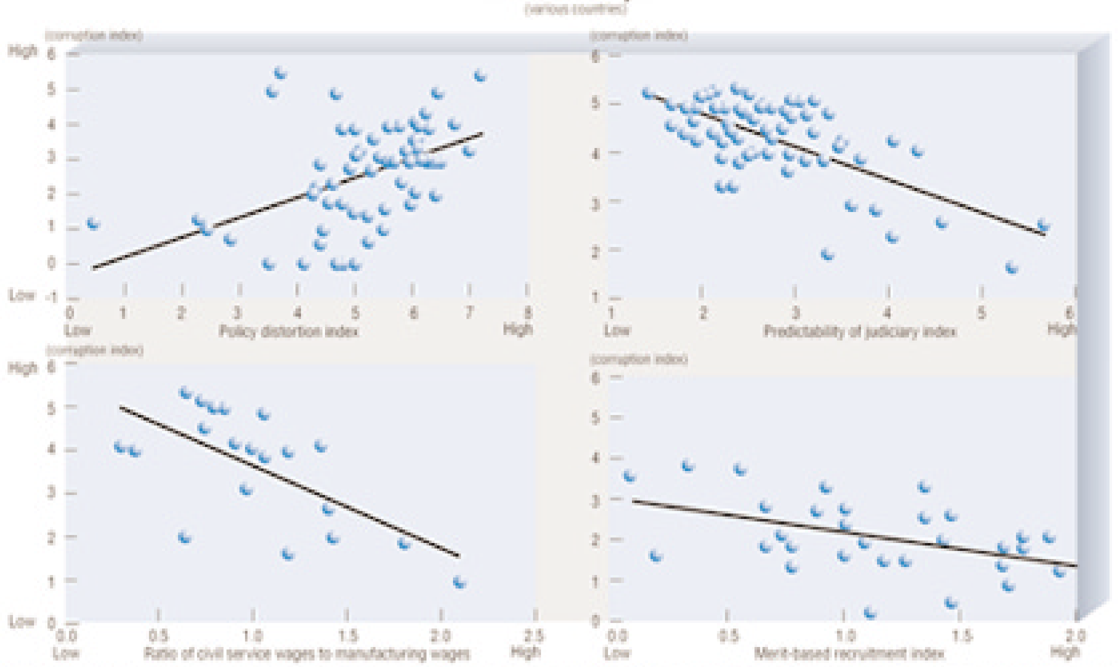
For services whose outputs the state can specify and enforce at low cost, contracting out to private firms and NGOs is an attractive option. In industrial countries, the contracting out of services to the private sector is now common. In Australia's Victoria State, for example, each local council is required to contract out at least half of its annual budget through competitive tender. In developing countries, contracting out easily specified services competitively can lead to efficiency gains. For instance, Brazil reduced the costs of road maintenance 25 percent by contracting it out to private companies.

Some governments are contracting out the delivery of services that are difficult to specify, such as social services. Bolivia and Uganda have subcontracted such services to NGOs that are committed to high quality or that are better able to serve certain groups because of their religious or ideological orientation. In general, however, the costs of contracting out complex or nonroutinized activities are high.

For activities that remain in the public sector, industrial countries undertaking public management reforms are setting up performance-based agencies and drawing up formal contracts even for complex activities such as defense, education, and health care. But countries with scarce capacity and weak bureaucratic controls need to proceed with caution. Industrial countries that have been able to relax detailed control over inputs have been developing credible restraints over a long period of time. Developing countries have often not been successful in enforcing contracts with public enterprises producing easily specified outputs.

Many developing countries need first to strengthen rule-based compliance and financial accountability, provide clearer descriptions of desired outcomes, and introduce ways to evaluate performance. A number of countries—such as Argentina and Bolivia—are now undertaking reforms to improve the quality and credibility of their financial accounting and auditing systems. As input controls are strengthened, countries such as Colombia, Mexico, and

Chart 2
Causes of corruption
(various countries)



Sources: Top two panels—World Bank staff calculations. Bottom left panel—C. Van Rijckeghem and B. Weder, 1997, "Corruption and the Rate of Temptation: Do Low Wages in the Civil Service Cause Corruption?" IMF Working Paper No. 97/73 (Washington: IMF). Bottom right panel—P. Evans and J. Rauch, 1996, "Bureaucratic Structure and Economic Growth" (unpublished; Berkeley, California: University of California).

Note: The index of corruption is based on surveys of investors.

Uganda are introducing performance measurement.

Also needed are mechanisms to enhance the loyalty, motivation, and competence of the civil service. This requires recruitment and promotion based on merit, long-term career rewards, adequate pay, and mechanisms to instill esprit de corps.

Where internal monitoring and enforcement capacity are weak, pressures from clients can improve performance. Feedback mechanisms such as client surveys have been shown to increase transparency and accountability in India, Nicaragua, and Tanzania. Malaysia and the United Kingdom have set minimum service standards through citizen charters, which are being made public. With clear and specific standards, clients and staff know what is expected.

Corruption as a symptom

Even if bureaucracies are flexible and subject to oversight and competition, the risk remains that individual officials will engage in self-seeking behavior, which can degenerate into corruption. Corruption, the abuse of public power for private gain, is symptomatic of the more general problem of perverse underlying incentives. Corruption flourishes where distortions in the policy and regulatory regimes provide scope for it and where institutions for restraint are weak.

Countries with highly distorted policies, as measured by variables such as the black market premium, provide more control rights to politicians and bureaucrats, and are more corrupt (Chart 2). Another cause of general corruption is a corrupt judiciary—lawbreakers see little risk of getting caught and punished. Finally, the punishment for corruption may not be severe enough to outweigh the rewards. Corruption often occurs in countries with large public-private pay differentials, or what is sometimes called the "rate of temptation." But simply raising civil service salaries may not reduce corruption; mechanisms that curb political patronage and create a more impartial public service may also be needed.

The battle against corruption requires a multipronged strategy. First, countries need to build a professional, rule-based bureaucracy with a pay structure that rewards honest effort, a merit-based system to shield the civil service from political patronage, and credible financial controls to prevent the arbitrary use of public resources. Second, the discretionary authority of individual officials needs to be reduced and competition increased. Third, accountability can be increased by improving transparency and strengthening the mechanisms for monitoring the civil service and punishing wrongdoers—relying not only on criminal law but also on oversight by formal institutions (such as statutory watchdogs in Hong Kong, China) and ordinary citizens.

Institutions and reforms

In some developing countries, reform-minded leaders cannot translate their goals into reality because the machinery linking policy statements to action has ceased to function. As a result, a vast gap has opened up between what the state says and what it does. The first step toward building a more effective public sector must be to close these gaps—to reestablish the credibility of the government's policies and the rules it claims to live by. This requires setting hard budget limits, making the flow of resources predictable, ensuring accountability for the use of financial resources, and making the civil service a meritocracy.

Building a professional, rules-based bureaucracy takes time. However, in the interim, measures can be taken that will yield early payoffs. Well-functioning policymaking mechanisms can make the costs of competing policies transparent and encourage debate and consultation. Using the market to deliver contestable services can lower costs and improve quality. Contracting out easily specified activities can reduce the burden on the state and improve efficiency. While the state builds internal mechanisms for monitoring and enforcement, the public can be encouraged to voice its opinions on performance, generating external pressure for improvement. These measures will also help fight corruption. 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).*