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## [Combating poverty and inequality] Building state capacity for poverty reduction

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# Building State Capacity for Poverty Reduction

For development strategies to generate the types of structural change and corporate behaviour conducive to equitable growth and poverty reduction described in this report, states must possess certain capacities. They must be able to overcome critical market failures; assist in the acquisition of new technologies; mobilize and channel resources to productive sectors; enforce standards and regulations; establish social pacts; and fund, deliver and regulate services and social programmes. Governments must also be able to reach political settlements with domestic actors in defining public policies and creating developmental and welfare-enhancing bureaucracies. Such settlements may differ in authoritarian and democratic regimes. In the first case, they tend to be top-down, while in the second, they generally require a broader power base and more engagement with citizens.

States that can deliver growth-oriented and welfare-enhancing structural change need to be rule based, not beholden to patronage, knowledgeable about the economy and society, and staffed by adequately paid and trained individuals. They also need to be able to mobilize domestic resources and strengthen capacities to influence and discipline investor behaviour. Current international development policies that emphasize a standard set of market reforms pursued through various types of conditionality limit the policy space in which national actors can pursue alternative development strategies.

From the 1950s to the early 1980s, most developing countries prioritized growth through active state intervention. This period saw the rapid expansion of the public sector, as governments provided incentives to the private sector to invest, while also establishing parastatal organizations to undertake activities in sectors where private entrepreneurs were slow to respond to incentives or had no interest in investing. However, many states were unable to develop

the requisite governance capacities for the effective implementation of their strategies.

A few countries, largely those in East Asia, did break out of poverty in a sustained way and emerged as economic giants during the period, doing so under authoritarian political systems. A number of countries with democratic regimes combined moderate growth with redistribution and achieved spectacular gains in social development. And many middle- and low-income countries initially achieved high growth rates and industrialization, but failed to give the majority of their populations the means to lift themselves out of poverty.

By the 1980s, a large group of countries were experiencing budgetary and balance of payments crises that led to a questioning of state-led development strategies and to a retreat of the state from direct economic activities. In responding to these crises, the adjustment model recommended by the international financial institutions (IFIs) did not initially address governance issues directly. Instead, state institutions were treated as a dependent variable, by assuming that once market prices were set right, the state would be efficient in its task of rule enforcement, protection of property rights and public administration. Market actors would then invest, generate growth and reduce poverty. However, the poor growth record associated with structural adjustment programmes (SAPs) has, in recent years, led to a policy stance that advocates an active role of institutions in promoting development. This approach emphasizes the crafting of institutions to promote the rule of law, protect property rights, lower expropriation risk, reduce levels of corruption and improve regulatory quality – policies that have come to define the good governance agenda.

Closely related to this approach to good governance were a second set of managerial reforms. Called New Public Management, they sought to promote market principles

in the governance of the public sector. They challenged public administration principles in which the purchasing, provisioning and policy dimensions of service provision are concentrated in a unified bureaucracy, driven by the values of public service. Instead, the new reforms advocated decentralized management, performance contracts and the contracting out of services.

A third set of reforms have been concerned with decentralization, which has come to be seen as an aspect of good governance. Proponents of decentralization assume that, by bringing government closer to where services are used, decentralization will reduce rent-seeking behaviour, enable the public to hold government providers to account, and allow market and other non-state actors to participate in service provision that will benefit the poor.

These three types of governance reforms can be described as market enhancing. But while they can contribute to greater efficiency, more accountability and transparency on the part of government, and increased citizen participation, they do not necessarily promote sustained growth or improve state capacity for delivering equitable economic and social outcomes. They also differ from the growth and welfare-enhancing strategies deployed by early industrializers or, more recently, by successful developmental states.

*Market-enhancing reforms can contribute to more efficient, accountable and transparent government, but they do not necessarily promote sustained growth or equitable outcomes*

The analysis in this chapter points to four main conclusions.

- Most states that eventually proved successful in achieving high growth and structural change did not have the necessary capacities to do so at first. Rather, these capacities were built over time through purposeful leadership and the formation of strategic ties with citizens and business.

- Coercion is not sufficient for building effective state capacity even in authoritarian settings and is unsustainable in the long run. Such capacity requires an ability to provide wide-ranging and good quality services and protections to broad sections of the population.
- Governments must improve domestic resource mobilization in order to create more policy space and be able to set agendas, strengthen links with citizens, and influence the strategies of business groups and service providers.
- The capacity to allocate resources effectively and enforce rules regarding their use can be improved through citizen participation in monitoring development agents and service providers. Such participation can also reduce the costs involved in enforcing policies.
- Aspects of market-enhancing reforms, including good governance, managerialism and decentralization are desirable goals for all countries, but they do not necessarily generate and sustain growth or produce socially equitable outcomes.

Section 1 of the chapter examines the institutions, policies and dynamics that have enabled some states to build up developmental and welfare-enhancing capacities. It contrasts the experiences of successful and less successful states by examining three dimensions of state capacity: political capacity, resource mobilization capacity, and allocative and enforcement capacity.

Section 2 discusses the market-enhancing reforms of good governance, managerialism and decentralization. The key questions it seeks to answer are: if states are to play an active role in development, what kinds of institutions and policies are needed to make such states effective? What lessons of state building can be learned from successful developmental states? And how appropriate are current market-enhancing state reforms in sustaining growth and generating social outcomes that are beneficial to the poor?

Section 3 concludes the chapter with implications for policy.

## 1. Dimensions of State Capacity That Promote Development

States that have been effective in promoting growth and structural change that reduce poverty do not generally inherit the right capacities or bureaucracies for development. They build them. A political leadership committed to fast growth and equality must reach a political settlement with domestic actors that allows it to define the direction of public policy and then create a developmental and welfare-enhancing bureaucracy to support it.

*States that have been effective in promoting growth and structural change do not generally inherit the right capacities or bureaucracies for development. They build them*

Three issues are important in gauging the developmental and welfare-promoting capacities of states. The first is political capacity, which addresses the extent to which the necessary coalitions or political settlements can be built that will allow governments to define, adopt and implement policies. The second is resource mobilization capacity – that is, the ability of states to generate resources for investment and social development, which may be an index of state-society relations. The third is the capacity to allocate resources to productive and welfare-enhancing sectors, as well as to ensure that favoured sectors comply with agreed-upon rules. As discussed below, these capacities may take different forms under different types of political regimes.

### Political capacity is fundamental to setting and implementing policy

Governments face constraints in defining, adopting and implementing policies, including the possibility of policy capture by powerful segments of the population, opposition

by organized interest groups, and intractable conflicts based on ethnic or religious cleavages. To overcome such constraints, authoritarian regimes with a developmental orientation often rely on top-down methods of coercion and control, as well as on high growth, employment expansion, and the provision of job security, services and social protection. In democratic regimes, citizens enjoy basic rights and the freedom to contest, frustrate or block state policies, making it difficult to rely on coercion and control to push through policies. Democratic regimes with good development outcomes engage citizens more actively in order to build the necessary consensus and support for state policies. Redistributive policies and respect for the right to contest policies and make claims are therefore central to the strategies of political capacity building in such regimes.

### Building political capacity in authoritarian developmental states

Authoritarian developmental states prioritize growth as the fundamental objective of public policy, concentrate power at the top of the political establishment, and use state power to discipline society and drive development.<sup>1</sup> The historical circumstances associated with the emergence of these relatively effective states are not easily replicated. In all the major cases, the perception of external threats was intense, thus providing strong incentives for concerted policy, cooperation among elites and adoption of a nationalistic ideology (often given economic, political and cultural expression).<sup>2</sup> The coherence of a coalition of domestic elites – either of a dominant actor (such as the military) or in the form of a compromise among elites around a set of rules – has been shaped by shared perceptions of external threats, and radical opposition has often quickly and effectively been neutralized or co-opted. In addition, political, military and ideological power was concentrated in the hands of the state, at least in the formative stage, which was conducive to policy continuity. A combination of these factors enabled these types of regimes to impose a set of developmentally driven rules governing economy and polity in order to protect and promote national interest, if not survival. In short, “their politics were developmentally driven and their development was politically driven because growth was seen as important for national autonomy and defence”.<sup>3</sup> Most developmental

states also enjoyed considerable moral, diplomatic and material (financial and military) support from major Western powers in the context of the cold war. Given the urgency of their goals, developmental states were quick to develop effective bureaucracies with the means to ensure infrastructural power<sup>4</sup> – that is, the capacity to devise, implement and achieve social, economic and policy goals. These bureaucracies were also generally well trained, well paid and highly competitive with respect to recruitment and promotion.<sup>5</sup>

The construction of political capacity for East Asian states to become developmental required the establishment of a tightly knit state structure that was capable of maintaining both distance (autonomy) and collaboration (embeddedness) with private capital, as well as controlling and mobilizing labour for industrialization.<sup>6</sup> In Taiwan Province of China, the ruling regime enjoyed an exceptional, if not absolute, degree of autonomy from all sectors of society, including local elites, residual feudal elements and the emerging working class. To consolidate its rule in the 1950s, the Kuomintang (KMT) broke the power of the Taiwanese ruling class through land reforms. The reforms not only destroyed the powerful landlord class, they also eliminated a significant source of political instability in the countryside.<sup>7</sup> Authoritarian power was supported by strong corporatist-type institutions, such as the 340 farmers associations that had been penetrated by the KMT, the China National Association of Industry and Commerce, the China Federation of Labour and the Youth Corps.

In the Republic of Korea, the military leadership that spearheaded the transformation also monopolized and centralized state power. It relied on trusted military officers to head important ministries and agencies and to redirect the bureaucracy along developmental lines. It benefited from the land reform of the previous regime that eliminated landlord power and used propaganda and campaigns to enhance its legitimacy and achieve its goals.<sup>8</sup>

Authoritarian developmental states did not rely on coercion alone in developing political capacity. State services – such as infrastructure, subsidized fertilizers, improved seedlings, credit, research support, investment in and regulation of

health and education to expand access – and policies of life-long employment and social insurance for workers in key industries helped to build state-citizen relations. And after a certain level of transformation had been achieved, top-down strategies of coercion and control proved unsustainable. In general, the East Asian authoritarian developmental states sought to legitimize their rule by developing economically and ensuring a steadily rising standard of living. As economic growth occurred, there was a proliferation of economic and other social interests and an expanding and demanding middle class, as well as an effective and mobilized trade union movement, acting to strengthen civil society and intensify its demands. These factors helped to shape the transition to democracy in the 1980s and beyond.<sup>9</sup>

*Authoritarian developmental states did not rely on coercion alone in developing political capacity*

The types of state-society relations developed by these East Asian developmental regimes have been rare in the developing world. The vast majority of authoritarian regimes worldwide are non-developmental and unstable, which underscores the limitations of authoritarian strategies for building effective states. Brazil pursued East Asian-type strategies during its period of military rule, especially in the 1960s and 1970s. It prioritized high growth, but its transformation of society did not reach the scale of the East Asian cases. The military was still relatively divided, regional oligarchs still held power in large areas of public life, and high levels of inequality blunted the legitimacy and appeal of the regime.<sup>10</sup> In many authoritarian middle-income countries, the political leadership was often beholden to landholding oligarchs and business elites. Where industrialization was limited and agrarian relations were fairly inequitable, as in many least developed countries, military and single-party dictatorships emerged with no sustained commitment to growth. In some cases, ethnic polarization, civil wars and donor influence in policy making acted as additional checks on political capacity.

### Building political capacity in democratic developmental states

Authoritarian approaches to building political capacity are not only unsustainable, they can also cause the political leadership to perceive societal challenges as systemic threats requiring repressive responses. In addition, such approaches limit the development of a healthy, open and mature relationship between states and citizens and lead to a reversal of social and economic gains when the authoritarian regime collapses. Furthermore, authoritarian developmental regimes are not only difficult to replicate under current conditions, but authoritarian methods of political capacity building have been rendered unacceptable by the democratic norms and values that now inform international development policies. Democracies allow for greater participation by citizens in the construction of capacities and formulation of public policies – especially those important for the well-being of deprived social groups – and can handle open conflicts without experiencing systemic threats. It is true that democracies differ in quality, and many have been unsuccessful in building political capacity for development and poverty reduction. However, as chapter 11 will show, a number of democracies that can be described as developmental have been able to develop effective and cohesive states that have delivered good outcomes.

A central concern for policy makers and investors in all developmental states – whether democratic or authoritarian – is ensuring that wage increases do not outpace productivity gains or spur inflation. Authoritarian regimes may resolve the wage problem by repressing workers, whereas democracies are more likely to develop social pacts with the working population using strong redistributive policies. The participation of subaltern groups is therefore essential in building political capacity and resolving the tension between profits and welfare in developmental democracies.

As chapter 11 will reveal, democracies have been able to regulate distributional conflicts and promote favourable macroeconomic and welfare outcomes when the workforce is highly unionized, collective bargaining agreements cover large sections of the working population, and bargaining

takes place at the national level. In agrarian developmental democracies, such as Costa Rica, the state of Kerala in India, and Mauritius, political capacities for development and welfare promotion were nurtured through active citizenship, the crafting of political parties that were strongly oriented towards equality, the self-organization of subaltern groups and alliances, strong party–social movement ties and electoral competitiveness that gave value to the votes of the poor. The redistributive social policies of such regimes were often part of political settlements that allowed states to pursue effective growth strategies.

*Authoritarian approaches to building political capacity are not only unsustainable, they can also cause the leadership to see societal challenges as systemic threats requiring repressive responses*

The role of popular pressure in building political capacity is vividly illustrated by comparing the performances of states across India, an established democracy. As table 10.1 and box 10.1 show, the southern states and West Bengal outperform India's northern states in poverty reduction, despite the fact that all of them are democratic. In the southern states, however, the power of dominant elites was effectively challenged, allowing middle castes and classes, and, in some instances, even lower classes, to shape state policies. Support from popular classes empowered state officials to overcome strategies of resistance or patronage from dominant classes. In contrast, the main mode of politics in northern states well into the late twentieth century was Congress Party rule, which rested on a narrow political base of upper castes and classes. With patron-client ties at the core of political society, factional and personalistic disputes among politicians were the defining trait of state politics. Such disputes detracted from any type of constructive use of state power, whether in promoting growth or distribution.<sup>11</sup>

**TABLE 10.1: Indian states ranked by poverty reduction, growth rate and growth elasticity of poverty, 1958–2000**

State	Poverty reduction	Growth rate	Growth elasticity of poverty
Kerala	1	7	1
West Bengal	2	11	2
Punjab	3	2	3
Andhra Pradesh	4	5	4
Tamil Nadu	5	3	8
Gujarat	6	6	6
Orissa	7	12	5
Karnataka	8	8	10
Haryana	9	1	9
Uttar Pradesh	10	15	7
Maharashtra	11	4	12
Rajasthan	12	14	11
Madhya Pradesh	13	9	13
Bihar	14	16	15
Jammu and Kashmir	15	13	9
Assam	16	10	14

Source: Kohli 2008, adapted from Besley et al. (2007: figure 3.1).

**BOX 10.1: The power of a broad political base: State capacity for poverty reduction in India**

As table 10.1 shows, all four southern states of India – Andhra Pradesh, Karnataka, Kerala and Tamil Nadu – along with West Bengal, are among the top 50 per cent of states that have made the greatest progress in reducing poverty. In contrast, all of the Hindi-heartland states – Bihar, Uttar Pradesh and Madhya Pradesh – along with Rajasthan, are among the bottom half of states that have made the least progress.

The hypothesis that best explains these patterns is that poverty has been reduced the most in states where effective government power rests on a broad political base. In such cases, rulers have minimized the hold of upper classes on the state, successfully organized the middle and lower strata into an effective power bloc, and then used this power to channel resources to the poor. Poverty, for example, has been reduced sharply in Kerala and West Bengal. Underlying this achievement are complex historical roots, including the political mobilization of lower castes and classes well before independence. This broadened political base then facilitated the rise of a well-organized Communist Party to power. A pro-poor regime interacted with a more effective citizenry, creating what has been called a virtuous cycle.<sup>a</sup> This created both supply and demand for a variety of successful pro-poor public policies, including land reforms, higher investments in and better implementation of education and health policies, along with greater gender equality.<sup>b</sup>

How does one interpret the fact that all of India's southern states, not just Kerala and West Bengal, are above average in their capacity to alleviate poverty? India's southern states share two sets of distinguishing political traits. Narrow domination of the Brahmin caste was more effectively challenged in all the southern states relatively early in the twentieth century.<sup>c</sup> Since independence, the political base of power in these states has generally been middle castes and classes, and in some instances even lower classes.<sup>d</sup> The situation differs from the Hindi heartland states, where Brahmin domination was challenged only relatively recently. The other factor, which has not been well researched, is the generally superior quality of state-level bureaucracy in the south. Among state-level bureaucrats there appears to be a keen sense of professionalism more akin to the Indian Administrative Service than to prevailing practices in the Hindi heartland. Its roots may go back to the traditions of direct rule, when much of southern India was part of the Madras Presidency.<sup>e</sup>

Notes: <sup>a</sup> Drèze and Sen 2002. <sup>b</sup> Shah and Rani 2003. <sup>c</sup> Frankel and Rao 1990. <sup>d</sup> Harris 2003. <sup>e</sup> A province of British India, which included much of southern India, dissolved at independence in 1947. Source: Kohli 2008.

Several governance issues affecting political capacities remain unresolved in a large number of low-income countries. These relate to the protection of civic rights; ensuring that leaders have real mandates to govern; having a fairly representative public sector, especially in contexts of ethnic diversity;<sup>12</sup> and creating effective channels through which citizens can pressure public officials to promote development and deliver public services.

### **The capacity to mobilize resources is key to achieving development goals**

The capacity of states to mobilize resources is a second key measure of the extent to which they can achieve their development objectives. The capacity to mobilize resources improves policy space and the ability to set agendas, and empowers states to influence the orientation and strategies

of civic and business groups. However, resource mobilization is highly political. It generates conflicts over types of resources to be mobilized, who pays, how much should be paid, and how the resources collected should be allocated across sectors, groups and communities. In other words, state commitment to resource mobilization does not guarantee that the desired amount of resources will be generated, let alone allocated to preferred programmes, or that the burden of resource extraction will be distributed fairly among different population groups. Issues of trust, solidarity, consensus and reciprocity in state-society relations define the extent to which governments can succeed in extracting resources from the populace. In short, building state capacity for resource mobilization is an index of the types of relations states develop with society. Redistributive arrangements underpin successful strategies of resource mobilization in both authoritarian and democratic regimes.

Chapter 8 has discussed a variety of revenue sources for the financing of social policies. Table 10.2 shows that while tax revenue as a share of gross domestic product (GDP) in Africa and Latin America was similar to that of East Asia from the mid-1980s to 2000, there were sharp differences in the savings rates among the regions. East Asia's average savings rate, as a percentage of GDP, was more than double that of South Asia and Africa, and two-thirds higher

than that of Latin America. The great divergence in savings rates among regions occurred mainly after 1980.<sup>13</sup> From 1960 to 1974, gross savings relative to GDP in Africa increased from about 18 per cent to 24 per cent and reached a peak of 26 per cent in 1980 before falling dramatically during the period of SAPs. During much of the 1970s, in fact, Africa's savings rate was higher than the average for Latin America.

### Mobilizing savings in authoritarian and democratic developmental states

East Asia's high savings rates were largely a product of incentives and the coercive power of the state, which was deployed to mobilize resources through various forms of forced savings. Among the key elements were restrictions on consumer credit, financial restraint, mandatory pension contributions and the encouragement of postal savings. In the Republic of Korea, a culture of private savings was promoted by the regime of Park Chung-Lee by establishing multiple interest rates – with high interest rates for savers and cheaper rates for borrowers – and a number of campaigns were launched to encourage thrift.<sup>14</sup> The mobilization of savings was also very successful in Taiwan Province of China. Indeed, unlike the Republic of Korea, which combined domestic savings and large loans from Japan to finance its industrialization, Taiwan Province of China financed its industrial investment almost entirely from domestic savings.<sup>15</sup>

**TABLE 10.2: Resource mobilization and growth in developing countries: Regional comparisons**

Regions	Per capita GDP growth <sup>a</sup>	Tax revenues [% of GDP] <sup>b</sup>		Gross savings [% of GDP] <sup>c</sup>		
	1985–2002	1985–1988	1997–2000	1980–1990	1990–2000	1990–2002
Sub-Saharan Africa	-0.4	21.7	16.3	13.9	12.5	12.7
South Asia	3.3	12.8	12.2	13.5	16.7	16.8
East Asia and Pacific	6.1	15.0	15.6	30.8	31.6	31.2
Latin America	0.8	15.2	15.9	21.7	18.9	18.9

Notes: <sup>a</sup> World Bank, World Development Indicators. <sup>b</sup> IMF Government Financial Statistics and calculations done by the author. <sup>c</sup> World Bank 2004b. Source: Di John 2008.

In Singapore, high savings were achieved through a compulsory social security savings plan established in 1955 that originally focused on retirement benefits but was subsequently extended to cover housing and health needs. The Provident Fund mandates every Singaporean wage earner to save a portion of his or her monthly income in an individualized account as social security savings, with a proportional contribution from the employer. The fund is managed as a statutory board of the government, which provides a fixed annual interest. This was only 2 per cent before being raised to 3 per cent in 2008. The savings rate peaked in 1984, with savings of 25 per cent of the monthly wage and an equivalent contribution from the employer. However, the employer's contribution was radically reduced to 10 per cent during the 1997 Asian financial crisis. Since that time, savings rates for both parties have been adjusted and are now graduated according to age. The fund was used to finance infrastructure and other administrative expenditures in the early years of independence and has evolved into an instrument to control wages and to maintain global market competitiveness.<sup>16</sup> Singapore's gross national savings, which reached almost 50 per cent of GDP between 1991 and 2000, is the highest in the world.

The high savings accumulated in authoritarian developmental states raised the capacities of those states to exercise autonomy in policy making, avoid capture by powerful groups, provide leadership in the development process, and nurture and sanction the behaviour of economic and social groups in pursuing development goals. Savings rates have also been high in some democracies that have achieved good welfare outcomes, such as Costa Rica and Mauritius, suggesting that resource mobilization can be achieved if regimes enjoy broad support, the prevailing economic and political environment is favourable, and savings instruments are easily accessible. Costa Rica and Mauritius have highly developed financial sectors that have been instrumental in mobilizing savings. Savings have been generated not only through the banking system, but also through insurance companies and, like Singapore, through social security funds such as pensions. The gross domestic savings rates of Costa Rica and Mauritius averaged above

20 per cent of GDP during the 1990s and compare favourably with other countries in their respective regions.

### **Building state-citizen relations through taxation**

A key feature of developmental states – whether authoritarian or democratic – is the way resource mobilization strategies facilitated the territorial and social reach of the state and the building of effective state-citizen relations. Tax strategies often brought the state into direct contact with citizens, thus allowing the state to influence behaviour and providing benefits for taxes collected. Chapter 8 has shown that East Asia collects more direct taxes than most developing countries. Land and property taxes enhanced the reach of the state. The Japanese colonial all-embracing land-tax policy and post-colonial land reforms reduced landlord power, developed smallholder agriculture, and deepened the state's presence in the countryside. State services – such as infrastructure, subsidized fertilizers and improved seeds – given in return for land taxes, increased the growth of agricultural productivity.<sup>17</sup>

*In developmental states, resource mobilization strategies helped build effective state-citizen relations*

In the case of Mauritius, export taxes on sugar, the main export commodity in the nineteenth and most of the twentieth centuries, had several positive effects on state-society relations and in increasing the productive capacity of the sugar sector.<sup>18</sup> First, the tax was an effective substitute for income taxes, and was generally progressive, since it shifted the burden of taxation and redistributive spending to the upper and middle classes. This contributed to a public sense of fairness and solidarity and thus built up state legitimacy. Second, the tax was used by the state to finance research and development, infrastructure and marketing, which enhanced production and productivity growth in the sugar sector. Third, the tax helped the private sector organize, and it built its capacity to interact with the government

over time. Moreover, it helped both the state and society to solve collective action problems they faced in building skills and in supporting research on sugar. Finally, the export tax helped develop the territorial reach of the state since the tax affected the main employer in the countryside and promoted mutually beneficial rights and obligations between the state and farmers, both large and small. Much of this occurred within a democratic context.

### Expanding state reach through agricultural marketing boards

During the period of state-led development in Africa, part of which was associated with high growth rates, agricultural marketing boards attempted to play a similar role in resource mobilization, expanding the territorial reach of the state and linking rural interest groups to the state. Marketing boards were an important mechanism of resource mobilization, monopolizing the purchase of cash crops below world market prices and selling them abroad at world market prices. The surplus generated was often of similar magnitude to the level of formal tax collection in the 1960s and 1970s. Marketing boards were effective in some countries because the state provided something in return to producer groups, such as services, infrastructure and research. By the 1980s, however, marketing boards were being criticized in the wake of worsening agricultural performance.<sup>19</sup> The idea took hold that the system worsened terms of trade by paying farmers less than the state received for products on the world market. This often created disincentives for farmers to produce, and/or led to smuggling – both of which reduced the resource mobilization capacity of African states. Economic liberalization of agriculture was promoted as the cure for the growth-retarding effects of marketing boards in many contexts.

*The surplus generated by agricultural marketing boards in Africa was often of similar magnitude to the level of formal tax collection in the 1960s and 1970s*

However, in the rush to dismantle marketing boards, there was much less analysis as to why some marketing boards performed better than others or how the operations of the boards were intertwined with other public policy goals and institutions. The historical evidence suggests that the political power of the state and the nature of the political coalitions underpinning the state are significant factors determining the effectiveness of marketing boards.<sup>20</sup> For instance, in Taiwan Province of China, where the power of the landowning class was curtailed in the 1960s, the state was able to tax rice farming in return for financing inputs that improved the productivity of rice production.

In Africa, the Kenyan coffee board in the 1970s and 1980s was more effective than the Tanzanian coffee board because the nature of the coalition in power differed in the two countries. In Kenya, large- and medium-sized coffee farmers were a powerful interest group, whereas in the United Republic of Tanzania, coffee farmers were not powerful in the government's support base. As a result, policies in Kenya were developed in ways that extracted fewer net resources from coffee producers than in the United Republic of Tanzania. The boards were used to target certain public policy goals: to provide foreign exchange for industrialization and economic development; to protect the incomes of farmers against world market fluctuations; and to provide agricultural extension and social services to farmers and the wider public. The failure of adjustment policies to comprehend the interconnectedness of the marketing boards to wider institutions and goals exposed gaps in the institutional setting supporting peasant livelihoods and national development.

### The experience of mineral-rich countries

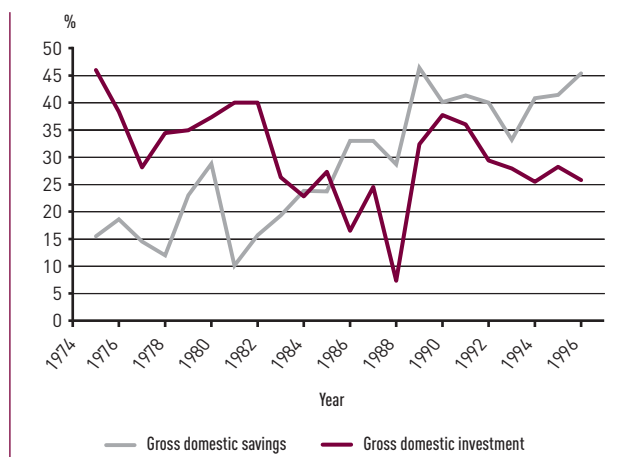
Mineral-rich countries should be expected to do well in resource mobilization, especially when commodity prices are high (see chapter 8). Some countries, such as Botswana, Chile, Indonesia and Malaysia, have been able to extract and manage revenues from the mineral sector fairly well. Democratic Botswana, for instance, has one of the highest savings rates in the world, rising from 16 per cent of GDP in 1975 to 45 per cent in 1995/1996 (see figure 10.1). Until very recently, the major source of such high savings

was the state. While the business sector's contribution to the savings rate has improved substantially since the mid-1990s, household savings are still minuscule, accounting for less than 5 per cent of GDP. The state established several reserve funds to protect the revenue generated by the mining sector: the Domestic Development Fund, which is the key source for funding development projects; the Revenue Stabilization Fund, which helps even out fluctuations in revenue trends; and the Public Debt Service Fund, which became the largest source of loan funds for state enterprises. These reserve funds generate substantial profits in off-shore investments and now constitute a major source of government revenue.<sup>21</sup>

*Saving mineral revenues in reserve funds can generate additional government revenue*

They have allowed the state to manage distributional conflicts as well as build public trust and legitimacy. These savings have also given the state a good deal of autonomy in economic policy making. As a result, Botswana has managed to avoid aid dependence and the neoliberal policy reforms experienced in most African countries in the 1980s and 1990s that further weakened state capacity.

**FIGURE 10.1: Gross domestic savings and investments in Botswana (% of GDP)**



Source: Maipose 2008.

In many countries, the potential to generate revenue from the mineral sector is not being realized even under democratization, since regimes are adopting neoliberal policies to win the confidence of investors, the IFIs and bilateral donors. In Zambia, taxes as a percentage of GDP declined from 18.4 per cent in 1996 to 17 per cent in 2005. One of the main reasons is the extraordinarily low royalty the government set to attract copper mining investment. The economic policy reforms of 1991–2001 under President Frederick Chiluba included privatization of the large parastatal mining company, Zambian Consolidated Copper Mines, attracting large Chinese investments following the surge in copper prices starting in 2004.

The royalty of 0.6 per cent in the privatized mines is one of the lowest in the world, prompting even the International Monetary Fund (IMF) to suggest that the government consider renegotiating a royalty rate of 3 per cent. In 2006, the government received just \$25 million in copper royalties out of a \$2 billion turnover in copper sales. Mozambique, which is also highly aid dependent and pursuing neoliberal economic policies, had a similarly disappointing experience following the failed economic policies of the 1970s and 1980s. Growth has been generated by foreign-owned mega-projects in mining and natural resource-based industrialization. The leading project is Mozal, an aluminium smelter, which accounts for nearly half of total manufacturing output. Mozal was given Free Industrial Zone status, and corporate income taxes are limited to 1 per cent of sales.<sup>22</sup> The low resource base of these countries limits their capacity for autonomous policy making. As box 11.2 in chapter 11 shows, donor intrusion in policy making is pervasive in Mozambique.

*In many mineral-rich countries, potential revenue is not being realized since regimes are adopting neoliberal policies and granting enormous benefits to foreign companies*

## The capacity to put resources to effective use is the core of state power

The ability to channel financial resources to investors, provide public services and enforce rules about resource use is at the core of state power.<sup>23</sup> States that are effective in enforcing rules for generating growth and structural change are often effective in enforcing rules on how public services are delivered. This is because, as we have seen, resource extraction even in authoritarian developmental regimes involves redistribution. States that are effective in mobilizing resources for economic development also provide benefits to taxpayers and savers and, in the process, earn legitimacy. This compels governments to strengthen service delivery institutions leading to good social outcomes, as chapters 5 and 6 have shown. Strengthening public service institutions in democratic developmental states is almost a routine process, given the active role of subaltern groups in governing coalitions. Governments that ignore the development imperative and focus only on welfare may be unsustainable and often fail to craft effective institutions for both accumulation and welfare provision. Those that focus primarily on stabilization and liberalization may empower certain types of institutions, such as central banks and finance ministries, and neglect social service institutions, which are usually the first to be downsized or cut.

*States that are effective in mobilizing resources for economic development also provide benefits to taxpayers and savers and, in the process, earn legitimacy*

### Building allocative and enforcement capacity

Building allocative and enforcement capacity requires that states have some measure of control or influence in the financial system. It also requires bureaucracies that are internally coherent and committed to development goals, have

adequately paid and trained staff, well-developed information systems that facilitate effective monitoring, and political commitment to achieve results. Political commitment can be enhanced and the cost of enforcement reduced when citizens are provided with accurate information about resource allocation and participate in the monitoring of resource use.

*During the early period of transformation the East Asian developmental regimes had state-led financial systems, allowing the state to combine subsidized credit with other policy instruments to influence the general growth trajectory*

Where the financial system is dominated by capital markets, as in the liberal market economies of the United States and the United Kingdom, the capacity of the state to intervene in the economy and influence the flow of financial resources is limited.<sup>24</sup> Where the financial system is credit based, states have more leverage in shaping investment outcomes, especially if they control the key banking institutions. The financial systems of the East Asian developmental regimes were state led. During the early period of transformation, all banks in the Republic of Korea and Taiwan Province of China were state owned. This allowed the state to take a lead role in coordinating investment, although Taiwan Province of China had a flourishing informal credit market for small- and medium-sized enterprises.<sup>25</sup> The East Asian developmental states did not grant banks the kinds of autonomy they enjoyed in the credit-based financial systems of European coordinated economies. Credit control in East Asia allowed the state to select beneficiaries and influence their investment decisions. The state combined subsidized credit with other policy instruments, such as tariff and tax exemptions as well as export subsidies, to influence the behaviour of firms and the general growth trajectory.

Until the 1980s, most developing countries followed growth-enhancing strategies that had many common elements. In all countries, two primary goals of developmental interventions were (i) to accelerate resource allocation to growth sectors, and (ii) to accelerate technology acquisition in these sectors through a combination of incentives and directives. To achieve the first, a variety of policy instruments were used, including licensing of land use, licensing of foreign exchange use, preferential tariffs and taxes, and allocation of bank credit. The state sought to play a lead role in the financial system through the creation of development banks, although the private sector continued to enjoy a good deal of autonomy in the financial system. In some cases, price controls and fiscal transfers were used to accelerate the transfer of resources to particular sectors. To achieve the second goal, incentives for technology acquisition included tax breaks or subsidies; protection of particular sectors for domestic producers in infant industries; licensing of foreign technologies and subcontracting these to domestic producers; and setting up investment zones for high-technology industries and subsidizing infrastructure for them. For both types of policies, growth-enhancing governance required monitoring resource use and withdrawing resources or support from sectors or firms that proved to be making inadequate progress.<sup>26</sup>

Allocative and enforcement capacities are enhanced when the state is knowledgeable about the sectors in which it intervenes. This calls for systematic collection, storage and analysis of economic and social data of value not only to government, but also to business and citizens.<sup>27</sup> The priority areas for business are technological development, quality standards, raw materials and changing market conditions. Having this capacity enables governments to identify new opportunities and constraints, and urge firms to act upon them, upgrade their activities and climb up the value chain. Knowledge is enhanced when the state undertakes research to identify sectors that need upgrading.<sup>28</sup>

**The East Asian developmental states.** The East Asian developmental states invest heavily in industry-based information gathering and research. This activity is often carried out by a lead agency entrusted with directing the

industrial transformation – the Ministry of International Trade and Industry in Japan, the Economic Planning Board in the Republic of Korea and the Council for Economic Planning and Development in Taiwan Province of China. The Republic of Korea mandates all industries to report regularly on export and other types of business performance. In Taiwan Province of China, a network of publicly funded research institutes, such as the Industrial Technology Research Institute, the Electronics Research Service Organization and the Computing and Communications Laboratory, perform the role of knowledge generation.<sup>29</sup>

*The East Asian developmental states invest heavily in industry-based information gathering and research*

These nodal agencies, which are insulated from special interest groups, help to create coherence and direction within the bureaucracy. Such insulation is crucial, since it provides the agencies an encompassing or national character and institutional mission to achieve the state's goals. The nodal agencies decide which industries to support and which to phase out or allow to disappear, based on their understanding of a country's industrial structures and international competitiveness. They also build support in the private sector for the state's plans and facilitate private sector ties with foreign investors and trading companies.<sup>30</sup> Monitoring and enforcement were effective partly because the nodal agencies eschewed comprehensive state planning or wide-ranging discretionary powers of the type that were prevalent in the former Soviet economies. However, there were clearly price distortions and potential for rent seeking,<sup>31</sup> since government planners, who might not have been infallible in deciding what was best for the economy, favoured certain sectors.

With regard to the macroeconomy, prices did not deviate substantially from market-clearing levels, and protections and subsidies tended to be time-bound. The result is that the

bureaucracies for monitoring and enforcement were often not very large, and were staffed by well-paid and trained individuals recruited through highly competitive examinations. The switch to export-oriented industrialization also strengthened the enforcement capacity of the state. Local firms needed state support to attract foreign – especially Japanese – capital, break into the US market and maintain standards. The survival of firms came to depend largely on increasing their efficiency and export performance, since they were now competing in a global market, and the state was reluctant to bail out non-performing companies.<sup>32</sup>

**Poorly performing developing countries.** The difficult part of the allocation process is to enforce decisions about resource withdrawal when performance is poor. Many developing countries have failed abysmally on this score, for a number of reasons.

- The political capacity required to pursue growth-enhancing strategies has been weak.
- Preferential credit and other incentives have tended to be generalized and not directed to any sector or group of firms identified as the growth sectors.
- Countries have lacked a steering agency with the requisite technical expertise to guide and be responsible for economic transformation.
- Bureaucrats have often lacked the economic information needed by business to facilitate a healthy state-business relationship.
- Finally, since most countries have failed to make the transition to export-led growth, the discipline provided by international market competition has not been available. Firms often enjoyed huge rents, but refused to comply with agreed-upon targets. In fact, in many countries, they have succeeded in capturing the bureaucrats who were supposed to track progress.

In India, industrialists actively supported the expansion of subsidies and other protectionist schemes, but resisted efforts to create a strong planning commission that would monitor and enforce targets.<sup>33</sup> The poor development of enforcement capacity for industrial transformation was replicated in the social policy field. Despite the rhetoric of land reform, the retreat of the state was even more

dramatic than in the industrial sector.<sup>34</sup> Land reform was declared the responsibility of individual states, not the central government; and once at the state level, it was allowed to slowly fizzle out as state legislatures were largely dominated by representatives of landed interests. The state thus failed to develop the requisite capacity for land reform and service provision.

*Allocative and enforcement capacity is enhanced by the systematic collection and analysis of economic and social data, for use by government, business and citizens*

#### **Improving allocative capacity through civil society participation**

As explained in chapter 9, allocative and enforcement capacities can be improved by involving citizen groups in regulating development agents and service providers in discussing the conditions under which business can contribute to progressive social outcomes. This requires that governments make available information required by citizens to hold business groups and providers accountable. The involvement of informed citizens and non-state actors in articulating citizen claims and monitoring resource use reduces the cost to government of allocating resources and enforcing policies.

Participatory budgeting – a process involving a range of civil society actors who deliberate with state officials on how government revenues should be spent – along with citizen charters, can help strengthen state-society relations and improve the capacity to enforce rules, especially in democratic contexts. They have been shown to improve allocative and enforcement capacities and redistributive outcomes in situations in which governing elites resolve to change power structures in favour of the poor and marginalized and where there is a dense network of civil society groups that can engage government authorities in policy making (see box 10.2).

**BOX 10.2: Decentralization and participation: Porto Alegre, Kerala and West Bengal**

Decentralization has produced redistributive outcomes in settings where governing elites seek to change local power structures in favour of low-income populations and where there is a dense network of civil society groups that can engage local authorities in policy making. These two conditions inform the experiences of the city of Porto Alegre in Brazil and the states of Kerala and West Bengal in India.

One of the most celebrated cases of decentralization is participatory budgeting at the municipal level in Brazil. The process originated in Porto Alegre in 1989, and has since spread to more than 250 municipalities in Brazil and 40 other countries. This form of local governance arose from the strong ties between civil society organizations and the Partido de Trabalhadores or Workers' Party, which espoused a social democratic agenda. Brazil's decentralization involves real devolution of resources and authority over basic social service provision to local governments. Fifteen per cent to 18 per cent of government spending, or 7 per cent of GDP, is controlled by local governments.<sup>a</sup> Participatory budgeting involves the division of a municipality into regions, each of which elects voluntary delegates. Throughout the year, government-sponsored meetings are held to discuss the budget, and final projects are submitted to a vote by delegates. The plans for the municipality are then included in the budget presented to the municipal legislative chamber.

In Porto Alegre, participatory budgeting has led to considerable increases in the number of households with access to water and sewerage, children in public schools and paved roads; it has also led to the expansion of local government revenues.<sup>b</sup> The main factors contributing to the success of the process include the willingness of mayors to delegate authority to citizens; the extent to which the rules of participation give genuine authority to residents to make decisions; and the ability of civil society organizations to cooperate in the programme through a politics of contestation.<sup>c</sup> In Porto Alegre, participatory budgeting has changed the decision-making process and expanded political rights and accountability to low-income citizens: 78 per cent of participants earned less than \$400 per month, 75 per cent had less than a high school diploma, 71 per cent were women, and 80 per cent were active in civic associations. Since the Workers' Party initially enjoyed only a minority of the popular vote in the cities it governed, mayors saw participatory budgeting as a tool to extend their reach to the electorate, bypass conservative patronage-dispensing elites, and reorder the way the local state was governed. However, in other cities governed by other parties, this has not been the case. In Blumenau, influential groups co-opted the participatory process and the mayor limited the delegation of authority because of party differences with groups that had taken control of the process. Similarly, in São Paulo, factional fights resulted in the mayor centralizing authority, with participants unable to hold the municipality accountable. These contrasting cases show that where participatory budgeting has been implemented from above – rather than as a result of claims made on local governments by well-organized civil society organizations – the outcomes are often less impressive.

Kerala and West Bengal present similar dynamics. In West Bengal, decentralization was introduced by the Communist Party as a tool to undermine the hold of the rival Congress Party and landowning classes on rural politics and to facilitate land redistribution in favour of the poor. About half of local government councils, or *gram panchayats*, are either small farmers, sharecroppers or farm labourers,<sup>d</sup> although the quality of their participation in meetings remains low. In Kerala, decentralization led to the transfer of political, fiscal and administrative powers with the result that 35–40 per cent of all planned expenditures are directly allocated to 1,214 panchayats and municipalities.<sup>e</sup> The communist-led state government supported decentralization because it wanted to maintain its redistributive agenda, despite the state's fiscal problems. It tried to bypass the clientelistic bureaucratic structures by giving greater control to civil society and grassroots movements.<sup>f</sup> It is estimated that more than 1.7 million people have participated in the biannual meetings of the panchayats, including low-caste groups and women, both of whom have traditionally been marginalized.<sup>g</sup> Again, the success of the decentralization programme in Kerala highlights the importance of real accountability of local governments to their citizens.

Notes: <sup>a</sup> Wampler 2007. <sup>b</sup> Wagle and Shah 2003. <sup>c</sup> Wampler 2007. <sup>d</sup> Crook and Sverisson 2001. <sup>e</sup> Heller 2005. <sup>f</sup> Heller 2005; Kohli 2008. <sup>g</sup> Sandbrook et al. 2007.

Citizen charters seek to ensure that citizens are consulted and offered adequate information about the quantity and quality of public services. Service delivery or user surveys are an important source of information and have been promoted in many countries in Africa, Asia and Latin America. With government support, the surveys aim to measure how consumers or citizens feel about a range of services provided by local and central governments. Results are disseminated among civic groups and the print media and given to governments for action. The expectation is that governments will improve their performance based on the survey findings. One of the most advanced applications of this instrument of accountability is the Public Affairs Centre's Report Card, pioneered in the Indian cities of Ahmedabad, Bangalore, Calcutta, Madras and Pune,<sup>35</sup> which solicits citizens' views on services such as telephones, electricity, water, health, the postal system, public transport, the police, public banks and food distribution systems.

Enforcement capacity also requires provision of adequate remuneration to public-sector employees. One of the attributes of developmental states in East Asia is their ability to pay competitive salaries to their employees. In Singapore, for instance, civil servants earn salaries that are superior to

those of employees in the private sector. However, the real incomes of public servants in many low-income countries have fallen sharply over the years. Table 10.3 shows that pay declined somewhat as a proportion of per capita GDP in developing countries as a whole between the early 1980s and early 1990s. The ratio of the average central government wage bill to per capita GDP is estimated to have fallen in Africa from 6.1 per cent in the early 1980s to 4.8 per cent in the early 1990s; in Latin America it fell from 2.7 per cent to 2.3 per cent; and in the Organisation for Economic Co-operation and Development (OECD) countries from 1.7 per cent to 1.6 per cent. The data for Asia show an increase from 2.9 per cent to 3.8 per cent over the same period. The IMF reports that during the 1990s, real wages declined in half of the countries with an Enhanced Structural Adjustment Facility, although a few countries, such as Bolivia and Uganda, showed increases. The complex ways in which many public servants have responded to the pay crisis – diverting time and resources to private ends and sideline activities in the informal economy – have further eroded the administrative capacities of these states.<sup>36</sup> The effects on employees at the service delivery end of the bureaucracy, such as teachers and nurses, have been most telling, provoking mass migration from the public sector or a weakening of the public ethic.

**TABLE 10.3: Changes in central government employment and wages, early 1980s and early 1990s**

Region	Central government employees as % of population		Wage bill as % of GDP		Average government wage: Per capita GDP	
	Early 1980s	Early 1990s	Early 1980s	Early 1990s	Early 1980s	Early 1990s
Sub-Saharan Africa	1.8	1.1	10.8	7.9	6.1	4.8
Asia	2.6	1.1	7.5	4.9	2.9	3.8
Latin America and the Caribbean	2.4	1.5	7.3	4.7	2.9	2.3
OECD countries	2.9	1.9	5.5	4.4	1.7	1.6
<b>Average</b>	<b>2.5</b>	<b>1.5</b>	<b>7.7</b>	<b>5.4</b>	<b>3.5</b>	<b>3.2</b>

Notes: Data for early 1990s are limited to the Heller and Tait sample. In Latin America and the Caribbean, and also to some extent in Asia, reduction in central government employment was offset by growth in local government. Particularly in Africa, total government employment fell relative to both population and in real terms. Source: McCourt 2006, using Schiavo-Campo et al. (1997) and Heller and Tait (1983).

Governments have addressed the pay crisis partly through retrenchment in order to be able to pay living wages to the remaining small number of employees, as well as to offer attractive salaries to senior officials. Often these reforms have not positively affected employees at the lower strata of the public service or those responsible for delivering services – such as health care and education – directly to the poor. They may create some measure of professionalism in the upper echelons of a bureaucracy, while the lower end may remain mired in inefficiencies. Typically, the overall effect is to constrain the capacity of bosses who are well remunerated at the top to translate their policies into real outcomes.

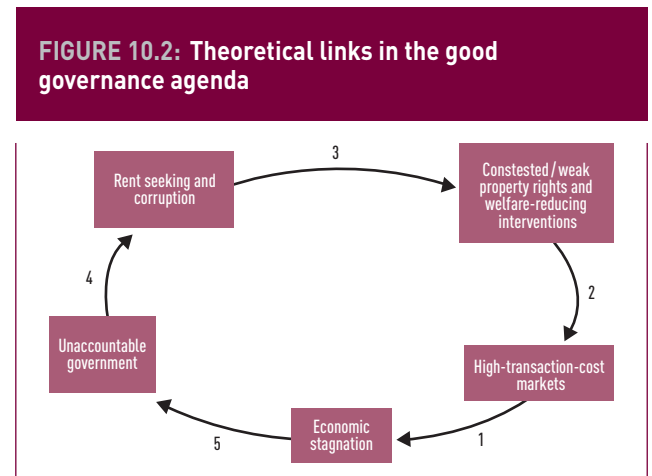
## 2. Market-Enhancing Institutional Reforms

The state's role in promoting development came under sustained attack during the 1980s and 1990s, as some regions experienced crises and turned to the IFIs for help. Under the prescribed SAPs, governments were forced to liberalize their economies, privatize state-owned enterprises and reduce the size and role of the state in the economy. The following sections discuss the potential and limits of three sets of institutional reforms that came to dominate the policy agenda: good governance, managerial reforms (New Public Management) and decentralization.

### The link between good governance and growth is weak

Governance reform now occupies a central position in international development strategies.<sup>37</sup> With the failure of structural adjustment to deliver growth and reduce poverty in the 1980s, a new focus emerged in the 1990s on the types of governance capabilities needed by states to promote efficient market economies. These emphasize enforcement of property rights and the rule of law, as well as a reduction in corruption and a commitment not to appropriate assets.

Figure 10.2 summarizes the major links on which this market-enhancing governance agenda is based.



Notes: Link 1 claims that economic stagnation is ultimately due to high-transaction-cost markets or market failures (North 1990). Link 2 highlights the underlying causes of market failure, which are weak property rights, rule of law and arbitrary interventions (North 1990; Knack and Keefer 1995; Kauffman et al. 1999; Acemoglu et al. 2004). Instead of addressing market failures individually, it focuses on making markets across the board more efficient. The assumption here is that markets are essentially systems of contracts; market failure will follow by definition if the absence of clear expectations and rights prevents contracting. Link 3 states that unstable property rights, poor rule of law and expropriation by states occur because small groups engage in rent seeking and corruption (Krueger 1974; Olson 1982; Mauro 1997). Link 4 asserts that these small groups can profit at the expense of the majority because government accountability is weak or non-existent (North 1990; Olson 2000). Link 5 completes the cycle because economic stagnation can, in turn, prevent the poor from mobilizing and enable autocracy to continue. Source: Khan 2008.

Many of these governance goals are desirable, and civic groups have often pressured public authorities to provide or respect them. The key issue is whether they can form the basis of a poverty reduction and development agenda. While growth is likely to be more rapid if markets mediating resource allocation are efficient, a key question is whether maximizing the efficiency of markets is sufficient to maximize the pace of development. In East Asia and other regions with effective states, governance capacities typically did not focus on the capacities needed for ensuring efficient markets. In fact, in terms of the market-enhancing conditions prioritized by the good governance approach, East Asian states performed poorly. Instead, they had effective institutions that could accelerate growth in conditions of technological backwardness and imperfect markets. Developing countries do not generally satisfy the market-enhancing

governance criteria at early stages of development, even in high-growth cases. This applies also to now-developed countries at the early stages of their development.<sup>38</sup>

*Many governance goals are desirable; the key issue is whether they can form the basis of a poverty reduction and development agenda*

Empirical tests carried out by Khan<sup>39</sup> on each of the good governance indicators – property rights, regulatory quality, corruption, and voice and accountability – demonstrate that the role of market-enhancing governance conditions in explaining differences in growth rates in developing countries is weak. Countries are divided into three groups: advanced, converging and diverging. Advanced countries are members of the OECD; converging countries are those whose per capita GDP growth rate is higher than the median advanced country rate; and diverging countries are

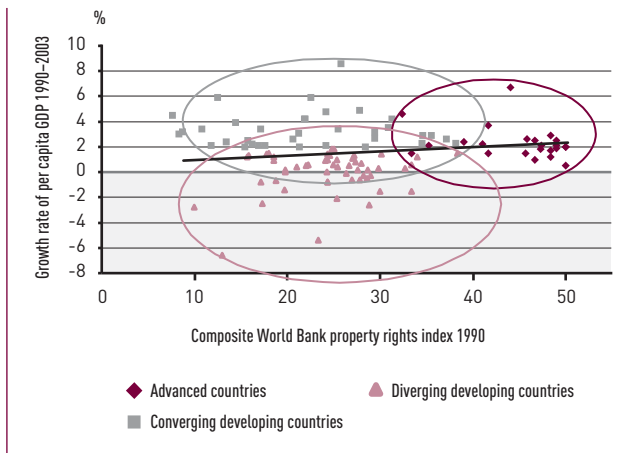
those whose per capita GDP growth rate is lower than the median growth rate of the advanced country group.

Table 10.4 and figure 10.3 report the findings for property rights. They show that there is no significant difference in the median property rights index between converging and diverging developing countries. The absence of any clear separation between these groups of developing countries also applies to the other indicators of good governance not reported here. The very weak, albeit positive, relationship between good governance and growth in many econometric studies depends to a great extent on a large number of advanced countries having high scores on market-enhancing governance (the countries represented by diamonds in figure 10.3) and the majority of developing countries being low-growth and low-scoring on market-enhancing governance (the countries represented by triangles in the same figure). However, market-enhancing governance is likely to improve in countries with high per capita incomes. The critical countries for establishing the direction of causality are the converging developing countries (the countries represented by squares in the same figure). By and large, these countries do not have significantly better market-enhancing governance scores than diverging developing countries.

**TABLE 10.4: Market-enhancing governance: Composite property rights index and economic growth, 1990–2003**

	Advanced countries	Diverging developing countries	Converging developing countries
Number of countries	24	53	35
Median property rights index 1990	47.0	25.0	23.7
Observed range of property rights index	32.3–50.0	10.0–38.3	9.5–40.0
Median per capita GDP growth rate 1990–2003 (%)	2.1	0.4	3.0

Note: The property rights index used here is an aggregate of the corruption, rule of law and bureaucratic quality indices on a 10-point scale, together with the index of repudiation of government contracts and expropriation risk. Source: Khan 2008.

**FIGURE 10.3: Market-enhancing governance and growth, 1990–2003**

Source: Khan 2008.

The policy implications are important.<sup>40</sup> Given the large degree of overlap in the market-enhancing governance scores achieved by converging and diverging developing countries, there is a need to qualify the claim that an improvement in market-enhancing governance quality in diverging countries will lead to a significant improvement in their growth performance. Nevertheless, the significant differences in the growth rates of converging and diverging countries suggest significant differences in the efficiency of resource allocation and use among these countries. And these differences are very likely related to significant differences in other types of governance capabilities ignored by the good governance agenda.

*The good governance agenda overlooks many important governance capabilities*

It is also important to note that most of the indicators of good governance are based on perceptions rather than on direct observation. Nor do they throw much light on how countries differ in terms of political, bureaucratic, resource mobilization and enforcement capacity – all key issues in understanding developmental state capacity.

### Market-enhancing managerial reforms were part of a second wave of reforms

A second set of reforms focus on improving the management of the state.<sup>41</sup> Prior to the 1980s, reform strategies in most developing countries were concerned with strengthening Weberian-style public administration systems. These tended to be characterized by meritocratic systems of recruitment, promotion and performance monitoring. The triumph of neoliberalism led to calls for public management reforms to incorporate private sector techniques in the delivery of basic services. Market-enhancing managerial reforms, known as New Public Management, first emerged in New Zealand and the United Kingdom in the 1980s. Starting in the mid-1980s, governments of low- and middle-income countries around the world began adopting such reforms in response to pressure from the IMF and World Bank, and the influence of some bilateral donors.

*The triumph of neoliberalism led to calls for public management reforms to incorporate private sector techniques in the delivery of basic services*

The argument for the new managerial focus rests on two key ideas derived from public choice and principal-agent theories. According to public choice theory, bureaucrats are exclusively motivated by self-interest (rent seeking), rather than the public good assumed by Weberian principles of public administration. This leads to sets of proposed reforms aimed at overcoming rent-seeking behaviour inside the state apparatus. The first set of reforms involves a change in public sector employment practices – from career tenure towards a preference for limited-term contracts for senior staff, locally determined pay rather than uniform fixed salaries, and the introduction of performance-related pay. The second involves marketizing service provision – through instruments such as contracting out, franchising, developing internal markets, vouchers and user charges or fees – to promote efficiency in service delivery and to give

choice and voice to users of public services. The resulting competition among service providers is intended to promote cost-savings and responsiveness to customers. There is also an emphasis on the quality of service provision, which aims to make public services more demand- rather than supply-driven.

The influence of principal-agent theory is seen in the case made for the reassignment of roles to the different actors involved in the process of service delivery. It involves a split between the purchaser (the central ministry) and the providers (the rest, either in the public or private sector). When service delivery is retained within the public sector, this entails breaking up large bureaucracies by means of disaggregating functions. A distinction is made between the strategic policy core within a ministry (the principal) and the operational arms of ministries that are separated off to form individual executive agencies (the agents). Executive agencies have four major characteristics that distinguish them from a traditional unified bureaucracy: decentralized management and associated financial autonomy, specialization for specific operational tasks, a focus on outputs, and performance-related contracts. Each agency is no longer related to the parent ministry through the traditional departmental hierarchy, but by an arm's-length performance agreement of a contractual nature that has specified performance targets. In cases in which service delivery is transferred to the private sector, this involves a contractual agreement between the central ministry (the principal) and the private service deliverer (the agent).

### **The global spread and impact of New Public Management reforms**

Market-enhancing managerial reforms were a central feature of a second wave of reforms associated with the Washington consensus and structural adjustment. The New Public Management toolbox became a major example of policy transfer in the field of public management. However, the evidence suggests that the global spread of these reforms has been uneven and patchy. They have been more prominent in liberal market-driven policy regimes, such as the Anglo-Saxon societies of Australia, Canada, New Zealand, the United Kingdom and, to a lesser extent,

the United States. By 2007, for instance, 75 per cent of the United Kingdom's civil service was employed in executive agencies. In contrast, the public sectors of societies with coordinated market economies in Continental Europe have been more resistant to the introduction of such reforms.

*The New Public Management toolbox became a major example of policy transfer in the field of public management*

In Latin America, attempts to introduce managerial reforms have proved to be unsustainable, despite a series of initiatives in Brazil, Colombia and Mexico. In Africa, the adoption of managerial reforms reflects countries' relations with principal donors, with less support for these reforms in Francophone countries and more in countries with closer ties to the United Kingdom. In the United Republic of Tanzania, for instance, the 1997 Executive Agencies Act provided the framework for the creation of executive agencies modelled on those of the United Kingdom. Driven from the heart of government by the Civil Service Department, it envisaged the creation of 46 executive agencies by 2004. By 2001, only nine agencies had been created. Ironically, the slow implementation of the programme was attributed to its capture by the bureaucracy, which viewed it primarily as a mechanism to respond to donor pressure, led by the IMF, to downsize the civil service while raising real incomes of senior staff. Between 1992 and 2000, public sector employment in that country fell by 27 per cent – from 355,000 to 260,000. “Agencification” contributed considerably to that decline, with agencies reporting a drop in their staff numbers from 20 per cent to 50 per cent.<sup>42</sup>

In general, the global spread of the complete set of New Public Management-type reforms has been limited. Instead, reforms in most low- and middle-income countries remain primarily focused on establishing the core features of a Weberian bureaucracy. Implementing market-enhancing managerial reforms is especially challenging in countries where markets

for the delivery of services are highly imperfect and where the danger of regulatory capture by powerful groups is likely. For such reforms to succeed, they require good monitoring, inspection and information systems, sound budgetary control systems, development of reliable performance indicators and measurements, and the capacity to regulate the behaviour of private providers, as well as to manage relations among central ministries and a multitude of decentralized agencies.<sup>43</sup> Instead of improving public management performance, New Public Management-type reforms risk increasing the core problems of administrative coordination and corruption. They also tend to undermine the ethic of public service, a problem that is acute in health systems of developing countries that have been commercialized.<sup>44</sup> These problems suggest that Weberian-style “old” public administration must first be created before introducing New Public Management. As box 10.3 shows, some developmental states (Singapore and the

Republic of Korea) have introduced features of New Public Management in their state systems, but they first established effective Weberian bureaucracies.

One study<sup>45</sup> examined the impact of managerial reforms on government in four core sectors (urban water, agricultural marketing, basic health and business development) in four developing countries (Ghana, India, Sri Lanka and Zimbabwe). It identified a number of constraints on governments’ capacities to perform new managerial roles. It concluded that the new managerial approaches – regulating markets, enabling other providers, managing service delivery through decentralized structures, contracting out and charging users – are more complex and taxing on government capacity than previous systems. Often, it was basic administrative failures (record keeping, financial control, enforcement of sanctions and clarity of authority relations) that undermined performance.

### BOX 10.3: Managerial reforms in developmental states: Singapore and the Republic of Korea

**The experience of Singapore provides support for the argument that a functioning Weberian bureaucracy provides the best basis for introducing New Public Management. Although a classic developmental state, Singapore has carried out managerial reforms, known as PS21 (Public Service for the 21<sup>st</sup> Century), since 1989. These reforms were introduced on the basis of an existing public administration system that was already characterized by meritocracy, high status and professional ethics among the senior cadre of the civil service, and an uncompromising attitude towards corruption.<sup>a</sup> Executive agencies now cover the bulk of the civil service, personnel functions such as recruitment and promotion have been delegated to individual ministries, and a culture of service excellence in meeting the needs of the public with high standards of quality and courtesy has been nurtured.<sup>b</sup>**

**Nevertheless, Singapore remains wedded to a state-directed system of governance via a wide range of recently corporatized utilities and other publicly owned bodies. The selective introduction of New Public Management reforms has not sought “to reduce the role and importance of the state as such, but has rather been aimed at maintaining the same strong administrative state by means of refining its role to keep it in step with the latest developments and future challenges”.<sup>c</sup> Clearly, Singapore is experimenting with New Public Management in a manner akin to the neo-Weberian state approach found in Germany.**

**Since the 1997 financial crisis in Asia, the Republic of Korea has also experimented with managerial reforms inspired by the New Public Management paradigm. Under the Kim Dae-jung administration (1998–2003), the Civil Service Commission established an open position system to attract talented candidates from outside government to 20 per cent of the posts in the top three grades of the civil service. It also introduced performance-related pay for senior managers. Most government agencies and public enterprises adopted service charters and introduced a Public Customer Satisfaction Index. By December 2005, there were 23 executive agencies in operation reporting to 16 different ministries. However, there has been widespread informal resistance to the implementation of these reforms, considerably restricting managerial autonomy in executive agencies.<sup>d</sup>**

Notes: <sup>a</sup> Jones 2002. <sup>b</sup> Quah 2003. <sup>c</sup> Cheung and Scott 2003:155. <sup>d</sup> Chang 2006. Source: Nickson 2008.

Resort to user charges without exemptions for those with limited ability to pay also produced undesirable outcomes.

### **The effects of New Public Management reforms on developmental states**

New Public Management reforms may, in fact, be counterproductive to the building of developmental states by thwarting the need for a unified and coherent bureaucracy, high-level strategic planning and trust-based relations with the private sector. The reforms have an innately static quality in promoting development. For example, they rely on competition to improve efficiency, equity and effectiveness, rather than more dynamic means, such as providing incentives for expanding the productive base and technological level of the economy. Concern for these issues is only indirect, based on the view that improvement in the allocation of public sector resources can encourage dynamism by the private sector. This distant relationship between the actions of the state and the wider process of economic transformation is in sharp contrast to the interventionist nature of the developmental state, which has an explicit interest in dynamic change.

This difference between the static New Public Management approach and the dynamic approach of the developmental state comes sharply into focus in education. Here, a notable feature of the developmental state has been the priority it attaches to qualitative change in promoting technical and scientific education, which seeks to transfer and root technological advances from the global economy to the domestic arena. By contrast, the more quantitative approach of New Public Management-type reforms has prioritized the use of blunt and general indicators, such as classroom size, teacher qualification levels, school autonomy and examination results – important issues that have been detached from the larger goal of economic and social transformation. The promotion of high-quality university education is a major feature of the developmental state, and this has had a positive impact on strengthening the professionalism and *esprit de corps* of the core civil service.

Even in the United Kingdom, there has been concern with the negative effect that agencification is having on the

capacity of the state for strategic planning. In the words of one observer, “So many experts have moved into management in the agencies that there are too few civil servants involved in policy making. Core Whitehall departments are in danger of becoming departments of administrators rather than policy makers”.<sup>46</sup> This poses an even greater danger in low- and middle-income countries where the strategic capacity of the state is much weaker.

The managerialist and the developmental state perspectives differ fundamentally in the nature of the relationship between central government and other actors in the development process. Under the New Public Management paradigm, the strategic role of the state is facilitated by distanced principal-agent relationships of a contractual nature with other major actors. Contracting out involves an arm’s-length relationship between the state as purchaser (principal) and the private company as provider (agent). This institutional rearrangement for service delivery is essentially adversarial in nature. It often introduces a semi-autonomous regulatory body to arbitrate over contractual disputes with the regulator acting as a sort of referee. On the other hand, the developmental state advocates a much closer, discretionary and flexible relationship with the private sector, one that is essentially based on a complex web of trust and coercion. In the urban water sector, where New Public Management-type contractual arrangements have been introduced in many low- and middle- income countries, there is a growing recognition of the failure of this adversarial relationship, focused exclusively on the contract, to deal with the multiplicity of conflicts that can arise during the long time period (up to 25 years) of such contracts. In France, there has long been recognition that a legal contract can never incorporate all possible conflicts that may arise in the future; thus, relational or trust-based contracting has become the norm.

### **Progress in decentralization is uneven**

Decentralization features prominently on donor agendas for public management reforms. It is also a feature of good governance. It seeks to reduce rent-seeking behaviour and inefficient resource allocation associated with centralized

power by dispersing such power to lower levels of government, where the poor are likely to exercise influence and a variety of actors may participate in the provision of services. The key services affected by decentralization are public works, education, health, sanitation, waste management and water. However, decentralization also has a political imperative, since it is linked to processes of democratization in which citizens demand more involvement in the way the public space is governed. It can also be used as a tool to resolve conflicts in deeply divided societies.

Decentralization is more entrenched in advanced democracies than in developing countries. In the 1980s, local governments in OECD countries accounted for, on average, 11 per cent of public employment, reaching 25 per cent in some countries. In contrast, local government in developing countries accounted for an average of 4.5 per cent of public employment, ranging from 2.5 per cent in Africa to 8 per cent in Asia. Data from the late 1980s and early 1990s indicate that the local government share of total government spending averaged around 32 per cent in OECD countries, compared to 15 per cent in the developing world. Decentralization expenditure ratios are even higher in countries such as Denmark (45 per cent) and Finland (41 per cent). Current data suggest that the gap is narrowing, but is still substantial.<sup>47</sup>

Democratization in most low- and middle-income countries has been accompanied by some form of decentralization. However, the extent and quality of decentralization is uneven. In many countries, what passes for decentralization is simply deconcentration, that is, the delegation of administrative authority to field units of the same department. Some central authorities have been willing to devolve administrative powers to local authorities but retain fiscal control. In Kenya, the Local Government Act imposes strong constraints on local authorities, which cannot make substantive decisions without approval from the Ministry of Local Government.<sup>48</sup> A comparative study of Côte d'Ivoire, Ethiopia, Ghana, Nigeria and Uganda<sup>49</sup> found greater willingness to transfer responsibilities than financial powers. In general, commercial cities or state capitals enjoy more fiscal capacity than small town and village councils,

which may not function without financial support from the central state. On the other hand, decentralization, including transfer of fiscal responsibilities, has progressed in more established democracies, especially middle-income countries (in Latin America, South Africa and European Union members in Eastern and Central Europe), even if outcomes vary in terms of capacity and service delivery.

### **The potential and limits of decentralization**

Decentralization raises a number of problems for developmental state strategies and equity. It can complicate strategic planning and lead to a reduction in the meritocratic basis for civil service recruitment, especially in countries where the independence of the central public service commission is already limited. An additional problem is interregional redistribution, which cannot be effected in a highly decentralized system with substantial disparities in fiscal capacity across local governments. This can be a serious problem in highly unequal societies. The responsibility for interregional redistribution should always rest with the central government through the pursuit of appropriate national tax, transfer and expenditure policies. Interregional disparities have worsened in some East Asian countries that have decentralized.<sup>50</sup> In addition, many low-income countries are characterized by weak state capacity, which is likely to be particularly accentuated at local levels and in poor regions. Decentralization that is unsupported by capacity-building programmes may simply reproduce or intensify the inefficiencies of the central state at the local level. A lack of administrative capacity may lead to an increase in corruption and elite capture of decentralization.

However, some democracies with decentralized structures have been successful in promoting development and redistribution. As decentralization takes root in low- and middle-income democracies, it may be difficult to reverse it and adopt more centralized arrangements associated with successful developmental states. The challenge is how to improve upon the quality of decentralization and democratization. National compacts and coordination mechanisms may be required in decentralized polities to ensure that growth-oriented and redistributive strategies pursued at the central level of government are supported, or at least not

undermined, across jurisdictions. Box 10.2 discusses three cases of successful decentralization – in the city of Porto Alegre, Brazil, and the Indian states of Kerala and West Bengal. They suggest that the impact of decentralization on poverty outcomes may be positive in contexts where governing elites seek to change local power structures in favour of low-income groups, and where there is a network of civil society groups that can engage local authorities in policy making. In situations where local elites are deeply patriarchal or oligarchic, decentralization may produce undesirable outcomes.

### 3. Building State Capacity for Structural Change and Poverty Reduction: Implications for Policy

Poverty reduction requires effective states that are both developmental and redistributive. Countries that have reduced poverty in relatively short periods of time had purposeful, growth-oriented and welfare-enhancing political systems; they also built and maintained competent bureaucracies. Successful developmental states often lacked the appropriate bureaucracies when they embarked on their development path. They subsequently built them.<sup>51</sup> As this chapter has shown, building state capacity for structural change and poverty reduction requires a focus on three crucial dimensions: the building of political coalitions needed to set and carry out policy; the mobilization of resources with which to implement development objectives; and the ability to allocate resources to productive and welfare-enhancing sectors, and enforce rules governing their use.

Strategies for constructing these three dimensions of state capacity differ in authoritarian and democratic regimes. Authoritarian strategies are top-down, whereas democracies may be forced to engage citizens more actively in the building of capacity. Authoritarian strategies were lauded in much of the development literature in the 1960s as a necessary condition to accelerate the growth process,

achieve modernization, and build nation-states out of complex ethnic cleavages and loyalties that tended to undermine stability and cohesion. Yet authoritarian strategies of state building in most countries turned out to be unstable and non-developmental, and provoked pressures for democratization. A few countries, largely those in East Asia, did succeed in transforming their economies and breaking out of poverty in a sustained way. This chapter has shown that even for these authoritarian developmental states, coercion alone was not sufficient in constructing effective state capacity. Rather, they share with democratic developmental states an ability to provide wide-ranging and good quality services to broad sections of the populace. This suggests that the developmental outcomes that define successful authoritarian regimes can be achieved without recourse to authoritarian practices, which ultimately become unsustainable. Moreover, democracy is now accepted as a core value of the international community, and strategies for developing state capacity should therefore be grounded in democratic principles.

#### Forge political settlements for redistribution

Democratic societies that are committed to structural change and poverty reduction must forge political settlements that allow the political leadership to design public policies and to create the necessary bureaucracies to implement them. Social transfers or redistributions are an indispensable part of such settlements. Both the political base and the organizational effectiveness of governmental power are variables that help explain differences in state capacity and success in poverty reduction strategies. States with a broad power base, well-organized ruling parties, competent bureaucracies and an activist citizenry have effectively implemented redistributive policies.<sup>52</sup> This underscores the importance of redistributing social and political power in favour of subaltern groups in order to build bureaucratic capacities that support both growth and redistribution. The active inclusion of subaltern groups in the political process can empower states to overcome pressures from dominant groups, which often resist policies that are oriented towards redistribution.

### **Improve domestic resource mobilization and encourage citizen involvement in the allocation and monitoring of resources**

This chapter has also shown that high levels of domestic resource mobilization are necessary for state capacity. Governments must aim to improve their domestic revenue base in order to have more policy space and be able to set agendas, strengthen their links with citizens, and influence the orientation and strategies of business groups and service providers. Governments must also be able to enforce decisions about resource use. What distinguishes successful from unsuccessful states in directing development is the latter's failure to generate governance capacities to enforce rules on how the resources allocated are used and construct mutually supportive state-society relations. Allocative and enforcement capacities can be improved through citizen participation in regulating development agents and service providers. But in order for this to happen, governments must provide the necessary information and support that can help citizen groups to hold business agents and providers accountable. The participation of informed citizens and non-state actors in monitoring resource use can reduce the cost involved in enforcing policies.

### **Tackle the three dimensions of state capacity directly rather than rely on good governance reforms to improve delivery of services**

Current approaches to state building have focused largely on market-enhancing governance strategies of good governance, managerialism and decentralization. Aspects of these strategies are desirable goals for all countries. However, they should not be confused with the institutions required for generating and sustaining growth and producing socially equitable outcomes. Governments must focus directly on building political, bureaucratic, resource mobilization and enforcement capacity rather than expect such capacity to emerge from implementation of good governance reforms. As this chapter has shown, the large degree of overlap in the good governance scores of converging and diverging countries suggests that growth is not likely to be sustained in poor countries by simply implementing market-enhancing

reforms. However, the high disparity in growth rates between converging and diverging countries also suggests major differences in the efficiency of resource use, which may be due to significant differences in other types of governance capabilities ignored by the good governance agenda.

### **Create the foundations of a Weberian bureaucracy to improve service delivery for the poor**

Governments must aim to build the foundations of a Weberian bureaucracy before adopting more complex managerial reforms. This is because managerial reforms that improve service delivery to the poor require high levels of regulatory capacity, which can be achieved when countries have succeeded in building modern bureaucracies. Market-enhancing managerial reforms are complex and taxing on government capacity. Bureaucratic capacity can be substantially improved if governments address basic administrative failures, such as record keeping, financial control, enforcement of rules and clarity of authority relations. Bureaucratic performance in poverty reduction can also be improved if public sector employees, especially those at the service delivery end of the bureaucracy – teachers, nurses and extension workers – receive adequate remuneration for their work.

### **Improve the quality of decentralization by involving low-income groups in local decision-making processes**

For decentralization reforms to support effective delivery of services to the poor, governments must commit to changing local power structures in favour of the poor, and allow citizen groups to engage local authorities in policy-making processes. Efforts should also be made to prevent decentralization from creating or reinforcing regional inequalities by entrusting central governments with the responsibility for interregional redistribution through pursuit of appropriate national tax, transfer and expenditure policies. Governments must also support capacity-building programmes to prevent decentralization from simply reproducing or intensifying the inefficiencies of the central state at the local level.

## Notes

- 1 Leftwich 2007; Kohli 2004.
- 2 Leftwich 2007.
- 3 Leftwich 2007:13.
- 4 Mann 1986.
- 5 Evans and Rauch 1999.
- 6 Evans 1995; Wade 2004; Kohli 2004; Huang 2008.
- 7 Huang 2008.
- 8 Kohli 2008.
- 9 Potter 1997; Kang 2002.
- 10 Kohli 2004; Kay 2002.
- 11 Kohli 2008.
- 12 Bangura 2006.
- 13 UNCTAD 2007a; Mkandawire 2001b.
- 14 Kohli 2004.
- 15 Huang 2008.
- 16 Chua 2008.
- 17 Di John 2008.
- 18 Bräutigam 2008; Di John 2008.
- 19 Bates 1981.
- 20 Di John 2008.
- 21 Maipose 2008.
- 22 Di John 2008.
- 23 Woo-Cummings 1999; Skocpol 1985; Weiss 1998.
- 24 Zysman 1983.
- 25 Huang 2008; Wade 2004.
- 26 Khan 2008.
- 27 Weiss 1998.
- 28 Amsden and Chu 2003.
- 29 Weiss 1998.
- 30 Wade 2004.
- 31 Gomez 2002.
- 32 Chibber 2003.
- 33 Chibber 2003, 2008.
- 34 Chibber 2008.
- 35 Paul and Sekhar 1997.
- 36 Olukoshi 1998a; Bangura and Larbi 2006.
- 37 This section draws on Khan (2008).
- 38 Chang 2003b.
- 39 Khan 2008.
- 40 Khan 2008; Meisel and Aoudia 2008.
- 41 This section draws substantially on Nickson (2008).
- 42 Nickson 2008; Therkildsen 2006.
- 43 Nickson 2008; Larbi 2006.
- 44 Mackintosh and Koivusola 2005.
- 45 Batley and Larbi 2006.
- 46 Bogdanor 2002.
- 47 Smoke 2006.
- 48 Oloo 2008.
- 49 Olowu 2006.
- 50 Smoke 2006.
- 51 Kohli 2004; UNCTAD 2009b.
- 52 Kohli 2008.