11 Development Policymaking and the Roles of Market, State, and Civil Society

My research showed that one needed to find a balance between markets, government, and other institutions, including not-for-profits and cooperatives, and that the successful countries were those that had found that balance.

—*Joseph Stiglitz, Nobel laureate in economics, 2009*

A core goal of public policy should be to facilitate the development of institutions that bring out the best in humans.

—*Elinor Ostrom, Nobel laureate in economics, "Beyond Markets and States," 2010*

11.1 A Question of Balance

National governments have played an important role in the successful development experiences of the countries in East Asia. In other parts of the world, including some countries in Africa, Latin America, the Caribbean, and the transition countries, government often appears to have been more of a hindrance than a help, stifling the market rather than facilitating its role in growth and development. This chapter examines the balance of and relationships between states and markets in the process of economic development.

Achieving the proper balance between private markets and public policy is a challenge. In early years of development following World War II and decolonization, a perception of the state as a benevolent supporter of development held sway, at least implicitly, but the record of corruption, poor governance, and state capture by vested interests in so many developing countries has made this view untenable. More recently, a negative view of government has predominated, but it too has been based more on theory than fact and has failed to explain the important and constructive role that the state has played in many successful development experiences, particularly in East Asia. Now a middle ground has emerged, recognizing both the strengths and the weaknesses of the public and private roles, providing a more empirically grounded analysis of what goes wrong with governance in development and the conditions under which these flaws can be rectified, and incorporating an appreciation of the role of civil society. More subtle shadings between the sectors are also becoming more appreciated. Not only do the private and public sectors work together constructively surprisingly often, but also the lines between the sectors are not always sharp. Indeed, as pointed out by the late Elinor Ostrom, 2009 Nobel laureate in economics, we must appreciate that some phenomena "do not fit in a dichotomous world of 'the market' and 'the state.'"[1]

In this chapter, we examine the roles and limitations of planning and development policymaking as practiced in developing nations, consider the problems of economic transition to more competitive market economies, and ask fundamental questions as to the proper role of the state and how public and private economic activity can best be made mutually supporting. We start with a brief review of the nature of development planning and a summary of general planning issues. After examining the main arguments for and against the role of planning in developing societies and briefly reviewing different models of planning and project appraisal, we examine the requirements for getting the most social benefits from market economies and evaluate the arguments for and against a relatively broader or narrower role of the state in contemporary developing nations.

In particular, we examine the once dominant "Washington consensus" on development policy and its limitations and discuss ongoing progress toward an emerging new consensus. Then we examine some recent theories of development policy formulation, including studies of the impact of political processes on the quality of policy decisions. We next examine three important trends in governance and reform: tackling the problem of corruption, implementing decentralization, and encouraging broad-based development participation. Finally, we examine the nature of the third sector—the civil society or citizen sector, encompassing NGOs—and its growing role in economic development. The chapter concludes with a comparative case study of two of the largest and most innovative developing country–based development NGOs, both based in Bangladesh but with global reach: BRAC and the Grameen Bank.

11.2 Development Planning: Concepts and Rationale

The Planning Mystique

In the initial decades after World War II and decolonization, the pursuit of economic development was reflected in the almost universal acceptance of development planning as the surest and most direct route to economic progress. Until the 1980s, few people in the developing world would have questioned the advisability or desirability of formulating and implementing a national development plan. Planning had become a way of life in government ministries, and every five years or so, the latest development plan was paraded out with great fanfare.

National planning was widely believed to offer the essential and perhaps the only institutional and organizational mechanism for overcoming the major obstacles to development and for ensuring a sustained high rate of economic growth. To catch up with their former rulers, poor nations were persuaded that they required a comprehensive national plan. The planning record, unfortunately, did not live up to its advance billing. But a comprehensive development policy framework can play an important role in accelerating growth, reducing poverty, and reaching human development goals.

The Nature of Development Planning

Economic planning may be described as a deliberate governmental attempt to coordinate economic decision making over the long run and to influence, direct, and in some cases even control the level and growth of a nation's principal economic variables (income, consumption, employment, investment, saving, exports, imports, etc.) to achieve a predetermined set of development objectives.[2] An **economic plan** is simply a specific set of quantitative economic targets to be reached in a given period of time, with a stated strategy for achieving those targets. Economic plans may be comprehensive or partial. A **comprehensive plan** sets its targets to cover all major aspects of the national economy. A **partial plan** covers only a part of the national economy—industry, agriculture, the public sector, the foreign sector, and so forth. Finally, the **planning process** itself can be described as an exercise in which a government first chooses social objectives, then sets various targets, and finally organizes a framework for implementing, coordinating, and monitoring a development plan.[3]

Economic planning A deliberate and conscious attempt by the state to formulate decisions on how the factors of production will be allocated among different uses or industries, thereby determining how much of total goods and services will be produced in one or more ensuing periods.

Economic plan A written document containing government policy decisions on how resources will be allocated among various uses so as to attain a targeted rate of economic growth or other goals over a certain period of time.

Comprehensive plan An economic plan that sets targets to cover all the major sectors of the national economy.

Partial plan A plan that covers only a part of the national economy (e.g., agriculture, industry, tourism).

Planning process The procedure for drawing up and carrying out a formal economic plan.

Proponents of economic planning for developing countries argue that the uncontrolled market economy can, and often does, subject these nations to economic dualism, unstable markets, low investment in key sectors, and low levels of employment. In particular, they claim that the market economy is not geared to the principal operational task of poor countries: mobilizing limited resources in a way that will bring about the structural change necessary to stimulate a sustained and balanced growth of the entire economy. Planning has come to be accepted, therefore, as an essential and pivotal means of guiding and accelerating economic growth in almost all developing countries.

Planning in Mixed Developing Economies

Most development plans have been formulated and carried out within the framework of the mixed economies of the developing world. These economies are characterized by the existence of an institutional setting in which some of the productive resources are privately owned and operated and some are controlled by the public sector. The actual proportionate division of public and private ownership and control varies from country to country, and neither the private nor the public sector can really be considered in isolation from the other. However, mixed economies are often distinguished by a substantial amount of government ownership and control. The private sector in developing countries typically comprises four traditional forms of private ownership and a more recent emerging one:

1. The subsistence sector, consisting of small-scale private farms and handicraft shops selling a part of their production to local markets
2. Small-scale individual or family-owned commercial business and service activities in the formal and informal urban sectors

3. Medium-size commercial enterprises in agriculture, industry, trade, and transport owned and operated by local entrepreneurs
4. Large jointly owned or completely foreign-owned manufacturing enterprises, mining companies, and plantations, catering primarily to foreign markets but sometimes with substantial local sales (the capital for such enterprises usually comes from abroad, and a good proportion of the profits tends to be transferred overseas)
5. A growing number of relatively large, domestic-based firms, primarily locally managed and largely locally owned, often listed on national stock markets in countries such as Brazil, Russia, India, and China but much more common in middle-income than low-income countries and rare in the least developed countries

In the context of such an institutional setting, we can identify two principal components of development planning in mixed economies:

1. The government's deliberate use of domestic saving and foreign finance to carry out public investment projects and to mobilize and channel scarce resources into areas that can be expected to make the greatest contribution toward the realization of long-term economic objectives (e.g., the construction of railways, schools, hydroelectric projects, and other components of **economic infrastructure**, as well as the creation of import-substituting industries or projected future export sectors)
2. Governmental economic policy (e.g., taxation, industrial licensing, the setting of tariffs, and the manipulation of quotas, wages, interest rates, and prices) to stimulate, direct, and in some cases even control private economic activity so as to ensure a harmonious relationship between the desires of private business operators and the social objectives of the central government

Economic infrastructure The capital embodied in roads, railways, waterways, airways, and other forms of transportation and communication plus water supplies, electricity, and public services such as health and education.

Thus, even when development planning is quite active, there is almost always a balance between the extremes of market inducement and central control, as is readily evident from our simplified characterization of planning in mixed market economies.

The Rationale for Development Planning

The early widespread acceptance of planning as a development tool rested on a number of fundamental economic and institutional arguments. Of these we can single out four as the most prominent.

Market Failure Markets in developing economies are permeated by imperfections of structure and operation. Commodity and factor markets are often badly organized, and the existence of distorted prices often means that producers and consumers are responding to economic signals and incentives that are a poor reflection of the real cost to society of these goods, services, and resources. It is therefore argued that governments have an important role to play in integrating markets and modifying prices. Moreover, the failure of the market to price factors of production correctly is further assumed to lead to gross disparities between social and private valuations of alternative investment projects. In the absence of governmental interference, therefore, the market is said to lead to a misallocation of present and future resources or, at least, to an allocation that may not be in the best long-run social interests. This **market failure** argument is perhaps the most often quoted reason for the expanded role of government in less developed countries.[4]

Market failure A phenomenon that results from the existence of market imperfections (e.g., monopoly power, lack of factor mobility, significant externalities, lack of knowledge) that weaken the functioning of a market economy.

Various kinds of market and government failures are examined in several of the earlier chapters, but a brief review is in order here. There are three general forms in which market failure can be observed: The market cannot function properly or no market exists; the market exists but implies an inefficient allocation of resources; the market produces undesirable results as measured by social objectives other than the allocation of resources. Market failures can occur in situations in which social costs or benefits differ from the private costs or benefits of firms or consumers; public goods, externalities, and market power are the best-known examples. With public goods, "free riders" who do not pay for the goods cannot be excluded except at high cost; it is economically inefficient to exclude nonpaying individuals from consuming these goods. With externalities, consumers or firms do not have to pay all the costs of their activities or are unable to receive all the benefits. Coordination failures occur when several agents would be better off if they could cooperate on actions if all or most agents participated but worse off taking the action if too few participated. Moreover, economic development is a process of structural change. The market may be efficient in allocating resources at the margin, allowing certain industries to emerge and others to fail, but may be ineffective in producing large discontinuous changes in the economic structure that may be crucial to the country's long-term development (see Chapter 4).[5] Market power occurs when firms can influence price by restricting quantity, a power most common under increasing returns to scale. Capital markets are particularly prone to failure due to their intrinsic connection to information generation and transmittal; information has public-good properties (see Chapter 15). A more equal distribution of income itself can be considered a public good when it is an agreed social objective. There may be concern for the well-being of future generations, who cannot participate in today's economic or political markets. Merit goods, such as health, education, and basic welfare, can also be considered public goods or social entitlements guaranteed by government. But concerns about distribution and merit goods are often treated as separate rationales for policy because their levels are generally viewed as outside the realm of economic efficiency.

Unfortunately, we cannot jump to the conclusion that if economic theory says policy can fix market failures, it will do so in practice. Government failure may also occur in the many cases in which politicians, bureaucrats, and the individuals or groups who influence them give priority to their own private interests rather than to the public interest. Analysis of incentives for government failure helps guide reforms such as constitution design and civil service rules. Developing countries tend to have both high market failure and government failure.[6] (As noted later in the chapter, the NGO sector can also be subject to what is termed "*voluntary failure*.").

Resource Mobilization and Allocation This argument stresses that developing economies cannot afford to waste their very limited financial and skilled human resources on unproductive ventures. Investment projects must be chosen not solely on the basis of partial productivity analysis dictated by individual industrial capital-output ratios but also in the context of an overall development program that takes account of external economies, indirect repercussions, and long-term objectives. Skilled workers must be employed where their contribution will be most widely felt. Economic planning is assumed to help by recognizing the existence of particular constraints and by choosing and coordinating investment projects so as to channel these scarce factors into their most productive outlets. In contrast, it is argued, competitive markets will tend to generate less investment and to direct that investment into areas of low social priority (e.g., consumption goods for the rich).

Attitudinal or Psychological Impact It is often assumed that a detailed statement of national economic and social objectives in the form of a specific development plan can have an important attitudinal or psychological impact on a diverse and often fragmented population. It may succeed in rallying the people behind the government in a national campaign to eliminate poverty, ignorance, and disease or to boost national prowess. By mobilizing popular support and cutting across class, caste, racial, religious, or tribal factions with the plea to all citizens to work together toward building the nation, it is argued that an enlightened central government, through its economic plan, can best provide the needed incentives to overcome the inhibiting and often divisive forces of sectionalism and traditionalism in a common quest for widespread material and social progress.

Foreign Aid The formulation of detailed development plans has often been a necessary condition for the receipt of bilateral and multilateral foreign aid. With a shopping list of projects, governments are better equipped to solicit foreign assistance and persuade donors that their money will be used as an essential ingredient in a well-conceived and internally consistent plan of action. The requirement that developing countries must put an approved plan in place to receive various forms of assistance remains at least as true in this century as it was in the last.[7]

11.3 The Development Planning Process: Some Basic Models

Three Stages of Planning

Most development plans have traditionally been based initially on some more or less formalized macroeconomic model. Such economy-wide planning models can be divided into two basic categories: (1) aggregate growth models, involving macroeconomic estimates of planned or required changes in principal economic variables, and (2) multisector input-output, social accounting, and computable general equilibrium (CGE) models, which ascertain (among other things) the production, resource, employment, and foreign-exchange implications of a given set of final demand targets within an internally consistent framework of interindustry product flows. Finally, probably the most important component of plan formulation is the detailed selection of specific investment projects within each sector through the technique of project appraisal and social cost-benefit analysis. These three "stages" of planning—aggregate, sectoral, and project—provide the main intellectual tools of the planning authority. All of these tools have been, and still are, extensively used by the World Bank and other development agencies, as well as developing country governments. We now turn to examine each of these stages and their associated models.

Aggregate Growth Models: Projecting Macro Variables

The first and most elementary planning model used in almost every developing country is the **aggregate growth model**. It deals with the entire economy in terms of a limited set of macroeconomic variables deemed most critical to the determination of levels and growth rates of national output: savings, investment, capital stocks, exports, imports, foreign assistance, and so on. Aggregate growth models provide a convenient method for forecasting output (and perhaps also employment) growth over a three- to five-year period. Almost all such models represent some variant of the basic Harrod-Domar (or AK) model described in Chapter 3.

Aggregate growth model A formal economic model describing growth of an economy in one or a few sectors using a limited number of variables.

Given targeted GDP growth rates and a national capital-output ratio, the Harrod-Domar model is used to specify the amount of domestic saving necessary to generate such growth. Typically, this necessary amount of domestic saving is not likely to be realized on the basis of existing savings functions, and so the basic policy problem of how to generate additional domestic savings or foreign assistance comes into play. For planning purposes, the Harrod-Domar model has been typically formulated along the following lines.[8]

We start with the assumption that the ratio of total output to reproducible capital is constant so that

$$K(t) = cY(t) \tag{11.1}$$

where $K(t)$ is capital stock at time t, $Y(t)$ is total output (GDP) at time t, and c is the average (equal to the marginal) capital-output ratio. We assume next that a constant share (s) of output (Y) is always saved (S) so that

$$I(t) = K(t+1) - K(t) + \delta K(t) = sY = S(t) \tag{11.2}$$

where $I(t)$ is gross investment at the time t and δ is the fraction of the capital stock depreciated in each period. Now if g is the targeted rate of growth of output such that

$$g = \frac{Y(t+1) - Y(t)}{Y(t)} = \frac{\Delta Y(t)}{Y(t)} \tag{11.3}$$

then capital must be growing at the same rate, because from Equation 11.1 we know that

$$\frac{\Delta K}{K} = \frac{c\Delta Y}{K} = \frac{(K/Y)\Delta Y}{K} = \frac{\Delta Y}{Y} \tag{11.4}$$

Using Equation 11.2, we therefore arrive once again at the basic Harrod-Domar growth formula (with the capital depreciation parameter):

$$g = \frac{sY - \delta K}{K} = \frac{s}{c} - \delta \tag{11.5}$$

Finally, because output growth can also be expressed as the sum of labor force growth (n) and the rate of growth of labor productivity (p), Equation 11.5 can be rewritten for planning purposes as

$$n + p = \frac{s}{c} - \delta \tag{11.6}$$

Of course, much development policymaking does not take productivity as exogenous but is actively focused on raising it. But given an expected rate of labor force and productivity growth (labor force growth can be calculated from readily available demographic information, and productivity growth estimates are usually based either on extrapolations of past trends or on an assumed constant rate of increase), Equation 11.6 can then be used to estimate whether domestic savings will be sufficient to provide an adequate number of new employment opportunities to a growing labor force. One way of doing this is to disaggregate the overall savings function ($S = sY$) into at least two component sources of saving, normally, the propensity to save out of wage income, W, and profit income, π. Thus, we define

$$W + \pi = Y \tag{11.7}$$

and

$$s_\pi \pi + s_W W = I \tag{11.8}$$

where $s\pi$ and s_W are the savings propensities from π and W, respectively. By manipulating Equation 11.5 and substituting Equations 11.7 and 11.8 into it, we arrive at a modified Harrod-Domar growth equation:

$$c(g + \delta) = (s_\pi - s_W)\left(\frac{\pi}{Y}\right) + s_W \tag{11.9}$$

which can then serve as a formula for ascertaining the adequacy of current saving out of profit and wage income. For example, if a 4% growth rate is desired and if $\delta = 0.03$, $c = 3.0$, and $\pi/Y = 0.5$, Equation 11.9 reduces to $0.42 = s_\pi + s_W$.[9] If savings out of capital income amount to 25%, wage earners must save at a 17% rate to achieve the targeted rate of growth. In the absence of such a savings rate out of labor income, the government could pursue a variety of policies to raise domestic saving or seek foreign assistance.

In countries where inadequate foreign-exchange reserves are believed to be the principal constraint on economic growth, the aggregate growth model typically employed is some variant of the two-gap model, which will be described, along with their limits, in Chapter 14. (Two-gap models are simply Harrod-Domar models generalized to take foreign-trade problems into account.) In either case, aggregate growth models can provide only a rough first approximation of the general directions an economy might take. Thus, they rarely constitute the operational development plan. Perhaps more important, the simplicity and relatively low data collection cost of using aggregate growth models can often blind us to their very real limitations, especially when carried out in too mechanical a fashion. Average capital-output ratios are notoriously difficult to estimate and may bear little relation to marginal capital-output ratios, which are the relevant ratios for forecasting purposes, and savings rates can be highly unstable. The operational plan requires a more disaggregated multisector model of economic activity like the well-known input-output approach.

Multisector Models and Sectoral Projections

A much more sophisticated approach to development planning is to use some variant of the **interindustry** or **input-output model**, in which the activities of the major industrial sectors of the economy are interrelated by means of a set of simultaneous algebraic equations expressing the specific production processes or technologies of each industry. All industries are viewed both as producers of outputs and users of inputs from other industries. For example, the agricultural sector is both a producer of output (e.g., wheat) and a user of inputs from, say, the manufacturing sector (e.g., machinery, fertilizer). Thus, direct and indirect repercussions of planned changes in the demand for the products of any one industry on output, employment, and imports of all other industries can be traced throughout the entire economy in an intricate web of economic interdependence. Given the planned output targets for each sector of the economy, the interindustry model can be used to determine intermediate material, import, labor, and capital requirements with the result that a comprehensive economic plan with mutually consistent production levels and resource requirements can, in theory, be constructed.

Input-output model (interindustry model) A formal model dividing the economy into sectors and tracing the flow of interindustry purchases (inputs) and sales (outputs).

Interindustry models range from simple input-output models, usually consisting of 10 to 30 sectors in the developing economies and 30 to 400 sectors in advanced economies, to more complicated linear programming or activity analysis models where checks of feasibility (what is possible given certain resource constraints) and optimality (what is best among different alternatives) are also built into the model. But the distinguishing characteristic of the interindustry or input-output approach is the attempt to formulate an internally consistent, comprehensive development plan for the entire economy.[10]

Input-output analysis is often extended in two ways. First, by including data on factor payments, sources of household income, and the pattern of household goods consumption across various social groups (such as urban and rural households), a social accounting matrix (SAM) is created. This is accomplished by adding data from the system of national accounts, balance of payments, and flow-of-funds databases, often supplemented with household survey data, to the basic input-output table. A SAM therefore provides a comprehensive and detailed quantitative description of the interrelationships in an economy as they exist at a point in time, making it well suited as a tool for evaluating the impact of alternative development policies. SAMs for many countries can be found online. SAMs are often further elaborated with CGE models, which assume that households maximize utility and firms maximize profits. Utility (or demand) and production functions are assumed or estimated from national data. The resulting impact of the policy is then simulated using standard computer programs. The CGE approach is more complicated than a SAM, but its value lies in enabling policymakers to take into account the possible reactions of consumers and firms to the alternative policies being considered rather than assume that they will behave the way they did before the new policies were implemented.[11]

Project Appraisal and Social Cost-Benefit Analysis

Project appraisal The quantitative analysis of the relative desirability (profitability) of investing a given sum of public or private funds in alternative projects.

The vast majority of day-to-day operational decisions with regard to the allocation of limited public investment funds are based on a microeconomic technique of analysis known as **project appraisal**. The intellectual as well as the operational linkage among the three major planning techniques, however, should not be overlooked. Macro growth models set the broad strategy, input-output analysis ensures an internally consistent set of sectoral targets, and project appraisal is designed to ensure the efficient planning of individual projects within each sector.

Cost-benefit analysis A tool of economic analysis in which the actual and potential private and social costs of various economic decisions are weighed against actual and potential private and social benefits.

Basic Concepts and Methodology

The methodology of project appraisal rests on the theory and practice of social **cost-benefit analysis**,[12] which is also used in the United States and other developed countries. The basic idea of cost-benefit analysis is simple: To decide on the worth of projects involving public expenditure (or, indeed, in which public policy can play a crucial role), it is necessary to weigh the advantages (benefits) and the disadvantages (costs) to society as a whole. The need for social cost-benefit analysis arises because the normal yardstick of commercial profitability that guides the investment decisions of private investors may not be an appropriate guide for public-investment decisions. Private investors are interested in maximizing private profits and therefore normally take into account only the variables that affect net profit: receipts and expenditures. Both receipts and expenditures are valued at prevailing market prices for inputs and outputs.

The point of departure for social cost-benefit analysis is that it does not accept that actual receipts are a true measure of social benefits or that actual expenditures are a true measure of social costs. Not only will actual market prices often diverge from their true value, but also private investors do not take into account the external effects of their decisions. These externalities can be sizable and pervasive.[13] In other words, where social costs and benefits diverge from private costs and benefits, investment decisions based entirely on the criterion of commercial profitability may lead to wrong decisions from the point of view of social welfare, which should be the government's primary concern. Although social valuations may differ significantly from private valuations, the practice of cost-benefit analysis is based on the assumption that these divergences can be adjusted for by public policy so that the difference between social benefit and cost will properly reflect social profitability, just as the difference between actual receipts and expenditures measures the private profitability of an investment.

Thus, we can define **social profit** in any period as the difference between social benefits and social costs where these are measured both directly (the real costs of inputs and the real value of outputs) and indirectly (e.g., employment effects, distributional effects). The calculation of the social profitability of an investment is then a three-step process.[14]

Social profit The difference between social benefits and social costs, both direct and indirect.

1. We must first specify the objective function to be maximized—ordinarily, net social benefit—with some measure of how different benefits (e.g., per capita consumption, income distribution) are to be calculated and what the trade-off between them might be.
2. To arrive at calculations of net social benefit, we need social measures of the unit values of all project inputs and outputs. Such social measures are often called **accounting prices** or **shadow prices** of inputs and outputs to distinguish them from actual **market prices**.[15] In general, the greater the divergence is between shadow and market prices, the greater the need for social cost-benefit analysis in arriving at public investment decision rules.
3. Finally, we need some decision criterion to reduce the stream of projected social benefit and cost flows to an index, the value of which can then be used to select or reject a project or to rank it relative to alternative projects.

Shadow prices (or **accounting prices)** Prices that reflect the true opportunity costs of resources.

Market prices Prices established by demand and supply in markets.

Let us briefly examine each of these steps of project appraisal.

Setting Objectives Given the difficulty of attaching numerical values to such objectives as national cohesion, self-reliance, political stability, modernization, and quality of life, economic planners typically measure the social worth of a project in terms of the degree to which it contributes to the net flow of future goods and services in the economy—that is, by its impact on future levels of consumption.

Recently, a second major criterion, the project's impact on income distribution, has received increased attention. If preference is to be given to raising the consumption standards of low-income groups, the social worth of a project must be calculated as a weighted sum of the distribution of its benefits, where additional consumption by low-income groups may receive a disproportionately high weight in the social welfare objective function. (This procedure is analogous to that of constructing a poverty-weighted index of economic growth, discussed in Appendix 5.2.) Beginning in 1991, project analysis at the World Bank also included an environmental impact evaluation as a third criterion, along with future consumption and income distribution.

Computing Shadow Prices and Social Discount Rates The core of social cost-benefit analysis is the calculation or estimation of the prices to be used in determining the true value of benefits and the real magnitude of costs. There are many reasons for believing that in developing countries, market prices of outputs and inputs do not give a true reflection of social benefits and costs. Five such reasons, in particular, are often cited.

Exchange rate Rate at which the domestic currency may be converted into (sold for) a foreign currency such as the U.S. dollar.

1. *Inflation and currency overvaluation.* Many developing countries are still beset by inflation and varying degrees of price controls. Controlled prices do not typically reflect the real opportunity cost to society of producing these goods and services. Moreover, in many countries, the government manages the price of foreign exchange. With inflation and unaltered foreign **exchange rates**, the domestic currency becomes overvalued (see Chapters 12 and 13), with the result that import prices underestimate the real cost to the country of purchasing foreign products and export prices (in local currency) understate the real benefit accruing to the country from a given volume of exports. Bubbles and crises can also lead to larger distortions. Public investment decisions based on this price will therefore tend to be biased against export industries and to favor import substitutions. The reverse holds with systematically undervalued exchange rates.
2. *Wage rates, capital costs, and unemployment.* Almost all developing countries exhibit factor price distortions resulting in modern-sector wage rates exceeding the social opportunity cost (or shadow price) of labor and interest rates understating the social opportunity cost of capital. This leads to widespread unemployment and underemployment and the excessive capital intensity of industrial production technologies. If governments were to use unadjusted market prices for labor and capital in calculating the costs of alternative public investment projects, they would underestimate the real costs of capital-intensive projects and tend to promote these at the expense of the socially less costly labor-intensive projects that would be more favorable to the poor.
3. *Tariffs, quotas, subsidies, and import substitution.* The existence of high tariffs, in combination with import quotas and overvalued exchange rates, discriminates against the agricultural export sector and favors the import-substituting manufacturing sector (see Chapter 12). It also encourages socially wasteful **rent seeking** on the part of competing exporters and importers. They vie with each other (often through bribes and threats as well as direct lobbying efforts) to capture the extra profits that can accrue to traders with import licenses, export subsidies, tariff protection, and industrial preferences.

Rent seeking Efforts by individuals and businesses to capture the economic rent arising from price distortions and physical controls caused by excessive government intervention, such as licenses, quotas, interest rate ceilings, and exchange control.

4. *Savings deficiency.* Given the substantial pressures for providing higher immediate consumption levels to the masses of poor people, the level and rate of domestic savings in most developing countries is often thought to be suboptimal. According to this argument, governments should use a discount rate that is lower than the market rate of interest in order to promote projects that have a longer payoff period and generate a higher stream of investible surpluses in the future.[16]
5. *The social rate of discount.* In our discussion of the shadow price of savings, we mentioned the need for governments to choose appropriate discount rates in calculating the worth of project benefits and costs that occur over time.

The **social rate of discount** (also sometimes referred to as *social time preference*) is essentially a price of time—the rate used to calculate the **net present value** of a time stream of project benefits and costs, where the net present value (NPV) is calculated as

Social rate of discount The rate at which a society discounts potential future social benefits to find out whether such benefits are worth their present social cost.

$$\text{NPV} = \sum_t \frac{B_t - C_t}{(1 + r)^t} \tag{11.10}$$

Net present value The value of a future stream of net benefits discounted to the present by means of an appropriate discount (interest) rate.

where B_t is the expected benefit of the project at time t, C_t is the expected cost (both evaluated using shadow prices), and r is the government's social rate of discount. Social discount rates may differ from market rates of interest (normally used by private investors to calculate the profitability of investments), depending on the subjective evaluation placed on future net benefits: The higher the future benefits and costs are valued in the government's planning program—for example, if government also represents future, unborn citizens—the lower the social rate of discount will be.

In view of these five forces leading to considerable product, factor, and money price distortions, as well as considerations of external economies and diseconomies of production and consumption (by definition, factors not taken into account in private-investment decisions), it has been widely argued and generally agreed that a strong case can be made for concluding that a project's actual anticipated receipts and expenditures often do *not* provide an accurate measure of its social worth. It is primarily for this reason that the tools of social cost-benefit analysis for project appraisal are essential to an efficient process of project selection in developing countries.

Choosing Projects: Some Decision Criteria Having computed relevant shadow prices, projected a time stream of expected benefits and costs (including indirect or external effects), and selected an appropriate social discount rate, planners are in a position to choose from a set of alternative investment projects those thought to be most desirable. They therefore need to adopt a decision criterion to be followed. Normally, economists advocate using the NPV rule in choosing investment projects; that is, projects should be accepted or rejected according to whether their NPV is positive or negative. As noted, however, NPV calculations are very sensitive to the choice of a social discount rate. An alternative approach is to calculate the discount rate that gives the project an NPV of zero; compare this **internal rate of return** with either a predetermined social discount rate or, with less justification, an estimate of either the marginal product of capital in the economy or the market rate of interest; and choose projects whose internal rates exceed the predetermined or market rate. This approach is widely used in evaluating educational investments.

Internal rate of return The discount rate that causes a project to have a net present value of zero, used to rank projects in comparison with market rates of interest.

Because most developing countries face substantial capital constraints, the choice of investment projects will normally also involve a ranking of all projects that meet the NPV rule. Projects are ranked by descending net present value (more precisely, by their benefit-cost ratios, which are arrived at by dividing NPV by the constraint on total capital cost, K—that is, an NPV/K ratio is calculated for each project). The project or set of projects (some investments should be considered as a package of projects) with the highest NPV/K ratio is chosen first, then the next highest, and so on down the line until all available capital investment funds have been exhausted.[17]

Conclusions: Planning Models and Plan Consistency The process of formulating a comprehensive, detailed development plan is obviously a more complicated process than that described by our three-stage approach. It involves a constant dialogue and feedback mechanism between national leaders who set priorities and planners, statisticians, research workers, and departmental or ministry officials. Internal rivalries and conflicting objectives (not to mention political pressure from powerful vested-interest groups) are always to be reckoned with. Nevertheless, our presentation should at least serve to provide a feel for the mechanics of planning and to demonstrate the ways in which aggregate, input-output, and project planning models have been used to attempt to formulate an internally consistent and comprehensive development plan.

11.4 Government Failure and Preferences for Markets Over Planning

Problems of Plan Implementation and Plan Failure

The results of development planning have been generally disappointing.[18] The widespread rejection of comprehensive development planning based on poor performance has had a number of practical outcomes, the most important of which is the adoption in a majority of developing countries of a more market-oriented economic system.

What went wrong? Why has the early euphoria about planning gradually been transformed into disillusionment and dejection? We can identify two interrelated sets of answers—one dealing with the gap between the theoretical economic benefits and the practical results of development planning, and the other associated with more fundamental defects in the planning process, especially as they relate to administrative capacities, political will, and plan implementation.

Theory versus Practice The principal economic arguments for planning briefly outlined earlier in this chapter—market failure, divergences between private and social valuations, resource mobilization, investment coordination, and the like—have often turned out to be weakly supported by the actual planning experience. Commenting on this planning failure, Tony Killick has noted that

> it is doubtful whether plans have generated more useful signals for the future than would otherwise have been forthcoming; governments have rarely, in practice, reconciled private and social valuations except in a piecemeal manner; because they have seldom become operational documents, plans have probably had only limited impact in mobilizing resources and in coordinating economic policies.[19]

Government failure A situation in which government intervention in an economy worsens outcomes.

To take the specific case of the market failure argument and the presumed role of governments in reconciling the divergence between private and social valuations of benefits and costs, the experience of government policy in many developing countries has been one of often *exacerbating* rather than reconciling these divergences—**government failure** rather than market failure. Government policy often tends to increase rather than reduce the divergences between private and social valuations. For example, public policies have raised the level of wages above labor's shadow price or scarcity value by various devices such as minimum-wage legislation, tying wages to educational attainment, and structuring rates of remuneration at higher levels on the basis of international salary scales. Similarly, investment depreciation and tax allowances, overvalued exchange rates, low effective rates of protection, quotas, and credit rationing at low interest rates all serve to drop the private cost of capital far below its scarcity or social cost. The net effect of these factor price distortions has been to encourage private and public enterprises to adopt more capital-intensive production methods than would exist if public policy attempted to correct the prices.

As another example, we noted in Chapter 8 that economic signals and incentives in many developing countries have served to exaggerate the private valuations of the returns to education at the secondary and tertiary levels to a point where the private demand for ever more years of schooling greatly exceeds the social payoff. The tendency to ration scarce high-paying employment opportunities by level of completed education and the policy of most governments in the developing world to subsidize the private costs of education at the higher levels together have led to a situation in which the social returns to investment in further quantitative educational expansion seem hardly justified in comparison with alternative investment opportunities.

In view of the forgoing examples, we may conclude that the gap between the theoretical economic benefits of planning and its practical results in most developing countries has been quite large. The gap between public rhetoric and economic reality has been even greater. While supposedly concerned with eliminating poverty, reducing inequality, and lowering unemployment, many planning policies in developing countries have in fact unwittingly contributed to their perpetuation. Some of the major explanations for this have to do with failures of the planning process itself; these failures in turn arise out of certain specific problems.[20]

Deficiencies in Plans and Their Implementation Plans are often overambitious. They try to accomplish too many objectives at once without consideration that some of the objectives are competing or even conflicting. They are often grandiose in design but vague on specific policies for achieving stated objectives. In this they have much in common with the excessive lists of 60 to 100 or more issue areas in conditionality agreements set out by the World Bank and the International Monetary Fund (IMF). Finally, the gap between plan formulation and implementation is often enormous (many plans, for reasons to be discussed, are never implemented).

Insufficient and Unreliable Data The economic value of a development plan depends to a great extent on the quality and reliability of the statistical data on which it is based. When these data are weak, unreliable, or nonexistent, as in many poor countries, the accuracy and internal consistency of economy-wide quantitative plans are greatly diminished. And when unreliable data are compounded by an inadequate supply of qualified economists, statisticians, and other planning personnel (as is also the situation in most poor nations), the attempt to formulate and carry out a comprehensive and detailed development plan is likely to be frustrated at all levels.

Unanticipated Economic Disturbances, External and Internal Because most developing countries have open economies that are dependent on the vicissitudes of international trade, aid, "hot" speculative capital inflows, and private foreign investment, it becomes exceedingly difficult for them to engage in even short-term forecasting, let alone long-range planning. The oil price increases of the 1970s caused havoc in most development plans. But the energy crisis was only an extreme case of a general tendency for economic factors over which most governments in the developing world had little control to determine the success or failure of their development policies.

Institutional Weaknesses The institutional weaknesses of the planning processes of most developing countries include the separation of the planning agency from the day-to-day decision-making machinery of government; the failure of planners, administrators, and political leaders to engage in continuous dialogue and internal communication about goals and strategies; and the international transfer of institutional planning practices and organizational arrangements that may be inappropriate to local conditions. In addition, there has been much concern about incompetent and unqualified civil servants; cumbersome bureaucratic procedures; excessive caution and resistance to innovation and change; interministerial personal and departmental rivalries (e.g., finance ministries and planning agencies are often conflicting rather than cooperative forces in governments); lack of commitment to national goals as opposed to regional, departmental, or simply private objectives on the part of political leaders and government bureaucrats; and in accordance with this lack of national as opposed to personal interest, the political and bureaucratic corruption that is pervasive in many governments.[21]

Lack of Political Will Poor plan performance and the wide gap between plan formulation and plan implementation are also attributable to a lack of commitment and **political will** on the part of many developing-country leaders and high-level decision makers.[22] Political will entails much more than high-minded purposes and noble rhetoric. It requires an unusual ability and a great deal of political courage to challenge powerful elites and vested-interest groups and to persuade them that development is in the long-run interests of *all* citizens even though some of them may suffer short-term losses. In the absence of their support, be it freely offered or coerced, a will to develop on the part of politicians is likely to meet with staunch resistance, frustration, and internal conflict.

Political will A determined effort by persons in political authority to achieve certain economic objectives through various reforms.

Conflict, Postconflict, and Fragile States In extreme cases, violent conflict or the large-scale failure of a state to otherwise function meaningfully has resulted in catastrophic failure of even the most basic development objectives. In these cases, development assistance is usually essential. This topic will be examined in Chapter 14, section 14.6.

The 1980s Policy Shift toward Free Markets

As a result of the disenchantment with planning and the perceived failure of government intervention, many economists, some finance ministers in developing countries, and the heads of the major international development organizations advocated increased use of the market mechanism as a key instrument for promoting greater efficiency and more rapid economic growth. U.S. President Ronald Reagan made a famous reference to the "magic of the marketplace" in a 1981 speech at Cancun, Mexico. If the decade of the 1970s could be described as a period of increased public-sector activity in the pursuit of more equitable development, the 1980s and 1990s witnessed the reemergence of free-market economics.

As part of their domestic-market liberalization programs, a majority of developing countries, with differing degrees of seriousness of purpose, generally sought to reduce the role of the public sector, encourage greater private-sector activity, and eliminate distortions in interest rates, wages, and the prices of consumer goods. The intent of such changes was to lubricate the wheels of the market mechanism, thereby achieving a more productive allocation of investments. In addition, these "liberalizing" developing countries sought to improve their comparative advantage in the international economy by lowering exchange rates, promoting exports, and eliminating trade barriers.

Among the international organizations preaching the virtues of the free market were the IMF and the World Bank, in addition to several bilateral donors such as U.S. Agency for International Development (USAID). The IMF required substantial market liberalization programs and policies to improve comparative advantage and promote macroeconomic stabilization as conditions for access to its higher credit windows. The World Bank carefully scrutinized its project lending to ensure that the projects proposed could not otherwise be undertaken by the private sector.

Government Failure

Just as markets are permeated by imperfections, so too is government subject to a variety of failures.[23] Thus, while in theory government can correct a market failure, sometimes in practice it fails to do so despite costly expenditure—and in some cases might only make matters worse. Thus, government regulations may improve industry efficiency, such as by breaking monopoly power; and it may otherwise improve social welfare, such as by limiting pollution (as we saw in Chapter 10). But poorly designed regulations could stifle emerging industries or even facilitate corruption. And once established, special interest groups may spring up, which find ways to benefit from regulations through rent seeking. Such groups may resist modifications in regulations even long after conditions that led to them have changed; this problem is examined in more detail below in Section 11.7.

There is a general presumption that when markets are functioning well, government should not intervene—on efficiency grounds there is generally no case for doing so. Instead, often there are great benefits to allowing decisions to be made on a decentralized basis. In general, individuals and families know more about their preferences and conditions than government can know.

As government failures are sometimes serious even regarding rather specific interventions, with overall development planning the scope for failure is larger. As we saw in Chapter 4, government can help by pushing an economy toward a better equilibrium, which the unaided market cannot attain; but government could potentially make things that much worse by pushing the economy into a bad equilibrium. Similarly, government programs can reduce social risks; but it has been observed that development planning could increase risks because of problems of correcting mistakes: Markets may make serious mistakes; but through its decentralized decision making mechanisms, often markets can more easily self-correct. And while markets generally cannot overcome coordination failures (see Chapter 4), coordination across government departments—or national and regional levels of government—cannot always be readily achieved.

More generally, development planning, which sometimes relies on seeking broad consensus, may be more rigid than markets, which can have a more agile response to unexpected shocks such as changes in global markets. In other cases, rather than resulting from consensus, development planning may be heavily influenced by powerful interest groups. The result may be the augmentation of the power of elites, rather than achievement of more egalitarian development goals. Development planning also faces the broad problem of *incentive compatibility*, meaning that the goals and mechanisms of the plan may be inconsistent with the self-interest of many of the key actors in the economy. Even when workers are employed directly for government, their incentives for hard or creative work may be less than for private sector workers.

But just as market failure does not always justify public intervention (because governments, as noted, can often make things worse), so too government failure is not necessarily an argument for private markets. For example, in South Korea, the Pohang Steel Company was publicly operated and highly efficient until its privatization in 2000, whereas the Steel Authority in India, also publicly owned and operated, has been a model of inefficiency. Subsidized interest rates exist in both East Asia, where growth accelerated, and in Latin America, where it stagnated. Unproductive rent-seeking activities can just as easily be found in poorly functioning private markets as in inefficient state operations. Simple judgments about the relative merits of public versus private economic activities cannot therefore be made outside the context of specific countries and concrete situations. But for developing countries intent on extending market reforms, either because of their dissatisfaction with the performance of their public sectors or because of IMF or World Bank pressure, a number of sociocultural preconditions and economic practices must be met.

11.5 The Market Economy

Sociocultural Preconditions and Economic Requirements

Markets accomplish many positive things, not least of which is delivering goods that consumers want, where and when they want them, and providing incentives for innovation. Amartya Sen has pointed out that to be generically against markets is almost as strange as to be generically against conversations.[24] As he says, some conversations do harm, even to those doing the conversing, but this is not a reason to be against conversations in general. To underpin a well-functioning market system requires special social, institutional, legal, and cultural conditions that are often very limited, if not absent, in developing nations. Fraud, corruption, monopoly, and other market failures do not disappear with the wave of a magic neoclassical wand.

A well-functioning market system depends on at least the following 12 market-facilitating legal and economic practices:[25]

1. Property rights clearly established and demarcated; procedures for establishing property rights and transferring them
2. Commercial laws and an independent judiciary to enforce them, especially contract and bankruptcy laws
3. Freedom to establish businesses in all sectors except those with significant externalities, without excessive licensing requirements; analogous freedom to enter trades and professions and to attain government offices (equal economic opportunity)
4. A stable currency and banking system, including a reliable and efficient system for making transfers
5. Public supervision or operation of natural monopolies (industries with increasing returns to scale) as occurs in industries where technological efficiency requires that a firm be large enough to supply a substantial fraction of the national market
6. Provision of adequate information in every market about the characteristics of the products offered and the state of supply and demand, to both buyers and sellers
7. Autonomous tastes—protection of consumers' preferences from influence by producers and purveyors
8. Public management of externalities (both harmful and beneficial) and provision of public goods
9. Instruments for executing stabilizing monetary and fiscal policies (see Chapter 15)
10. Safety nets—provisions for maintaining adequate consumption for individuals affected by certain economic misfortunes, especially involuntary unemployment, industrial injuries, and work disabilities
11. Encouragement of innovation, in particular, issuance and enforcement of patents and copyrights
12. Security from violence, the most basic of all social foundations

It is clear that market reforms involve much more than merely eliminating price distortions, privatizing public enterprises, and declaring markets free. The setbacks to market reforms in many transition economies is in no small measure attributable to the absence of some (or many) of the institutional preconditions and market practices. Thus, governments have important limits, and so do markets, as the earlier review of market failures makes clear.[26] Again, the question is one of balance. This is reflected in the move away from the once dominant "Washington Consensus."

11.6 The Washington Consensus on the Role of the State in Development and Its Subsequent Evolution

For much of the 1980s and into the 1990s, the so-called Washington Consensus on development policy held sway. This consensus, encapsulated by John Williamson, reflected the free-market approach to development followed in those years by the IMF, World Bank, and key U.S. government agencies, along with some other developed countries at the time. It contained 10 points, summarized in column 1 of Box 11.1.

The 10 points of the Washington Consensus are striking at least as much for what they do not contain as for what they do. There is no mention of shared growth, of the central need to focus on eliminating absolute poverty to achieve development in any meaningful sense, or of reducing inequality, as central ends in themselves as well as instruments of economic growth.[27] Driving the several components of the consensus was the conviction that government was more likely to make things worse than better. Prevalent also was the view that poverty would be taken care of by growth and was not a major obstacle in itself to growth and development; but this view, as noted in Chapter 5, is no longer considered adequate by most development specialists.

The Washington Consensus list is also striking in its free-market approach, even in fields in which market failure is prevalent, such as the financial sector

BOX 11.1 The Washington Consensus and East Asia

Elements of the Washington Consensus	South Korea	Taiwan
1. Fiscal discipline	Yes, generally	Yes
2. Redirection of public expenditure priorities toward health, education, and infrastructure	Yes	Yes
3. Tax reform, including the broadening of the tax base and cutting marginal tax rates	Yes, generally	Yes
4. Unified and competitive exchange rates	Yes (except for limited time periods)	Yes
5. Secure property rights	President Park starts his rule in 1961 by imprisoning leading businessmen and threatening confiscation of their assets	Yes
6. Deregulation	Limited	Limited
7. Trade liberalization	Limited until the 1980s	Limited until the 1980s
8. Privatization	No. Government established many public enterprises during 1950s and 1960s.	No. Government established many public enterprises during 1950s and 1960s.
9. Elimination of barriers to direct foreign investment (DFI)	DFI heavily restricted	DFI subject to government control
10. Financial liberalization	Limited until the 1980s	Limited until the 1980s

Source: From "Understanding economic policy reform," by Dani Rodrik. *Journal of Economic Literature* 34 (1996): 17. Reprinted with permission from the American Economic Association and courtesy of Dani Rodrik.

(examined in Chapter 15). Moreover, the list is striking in its limited applicability to two of the most successful cases in the history of economic development, South Korea and Taiwan. These cases not only represent among the highest rates of economic growth over the past half-century but also have often been cited as examples of shared growth, in which absolute poverty was eliminated early on, and the lower-income groups have continued to benefit from the development process, despite an upturn in inequality since the late 1990s. The historical record of high growth in China reflects the combination of various incentives for entrepreneurship and an extremely active industrial policy and other government activity. Indeed, as Dani Rodrik summarizes in Box 11.1, for about half of its elements, the Washington Consensus is at best of limited applicability to South Korea and Taiwan. It can be concluded that the state has had a broader role in the most successful development experiences than encapsulated by the Washington Consensus.

Toward a New Consensus

In recent years, major changes in the Washington Consensus worldview have occurred in Washington D.C and elsewhere. In the Americas, the new views were sometimes referred to as the *New Consensus*, which began to take shape at the April 1998 Summit of the Americas in Santiago, Chile. Other important contributions to attempts to describe an expanded and more balanced consensus—albeit with a focus solely on growth rather than broader human development—include the Commission on Growth and Development's 2008 *Growth Report: Strategies for Sustained Growth and Inclusive Development* (commonly referred to as the *Spence Report*) and the broader scope suggested by Dani Rodrik. A final example including infrastructure and industrialization was articulated in the 2010 Seoul G20 communique.[28] Note that the scholarly tradition in Europe and Japan, as well as in many parts of the developing world, such as India, has remained more positive toward the role of the state throughout the period but has to a large degree also converged toward the New Consensus. The broad elements of the New Consensus are summarized in Box 11.2.

Given that developing-country governments are highly constrained in their available resources, some of these New Consensus objectives will have to receive less emphasis than others. An important dimension of the New Consensus is the emphasis on government's responsibility to focus on poverty alleviation. This is in part a return to the focus of the 1970s; one reason for this renewed focus is that free-market policies of the 1980s and early 1990s were viewed as inadequately helping the poor. The New Consensus also appears to reflect a growing sentiment that the goal of poverty eradication is finally achievable, especially given recent progress in health, education, and other areas. But the New Consensus on the role of government in development borrows some important lessons from the Washington Consensus period. In particular, the stress on market-based development and limiting government's role in direct production continues to be the consensus view. And the new elements are not based on an assumption that government is a benevolent provider of social welfare. A sober view continues but emphasizes the importance of building state capacity and responsiveness by reacting to government failure with judiciously designed reforms, seeking feasible improvements in economic institutions, and encouraging a deepened civil society role.

BOX 11.2 The New Consensus

1. Development must be market-based, but there are large market failures that cannot be ignored.
2. Government should not be in the business of direct production, as a general rule.
3. Nevertheless, there is a broad, eclectic role for government in the following areas:
   - Providing a stable macro environment
   - Infrastructure, though in fewer sectors than thought necessary in the past
   - Public health
   - Education and training
   - Technology transfer (and for advanced developing economies, the beginnings of original R&D)
   - Ensuring environmentally sustainable development and ecological protection
   - Providing export incentives
   - Helping the private sector overcome coordination failures
   - Ensuring "shared growth" by acting to reduce poverty and inequality and to ensure that as the economy grows, the poor share substantially in the benefits
   - Prudential supervision and regulation of the financial sector
   - Provision of fundamental public goods, including institutions such as protection of property rights and broad access to opportunity

The New Consensus also does not include some features that many commentators have considered significant to East Asian success, such as an active or at least a highly targeted industrial policy—picking winners—to overcome coordination failures, because these remain controversial. There are doubts about the replicability of industrial policy experiences—specifically in encouraging particular industrial activities—of these countries, and the most widely held perspective is that industrial policy is generally ineffective when government is less capable or more constrained (though some specialists conclude from this problem that it should be a priority to raise government capabilities in these fields in other countries).

The New Consensus view represents in part a renewed recognition that markets do fail; that at times these failures cannot be addressed without a significant and ongoing role for government—that market failure can be significantly worse than government failure after all; and that when governance is poor, it can often be improved. Indeed, a key part of government's role is to help secure the foundations for economic development by ensuring that the requirements for an effective market-based economy are met.

11.7 Development Political Economy: Theories of Policy Formulation and Reform

Until recently, two extreme views seem often to have dominated the discussions of the role of government in economic development. The first view has been that effective government was not only necessary due to market failure but possibly even sufficient to achieve economic development. At least implicit in this view is the argument that if a particular regime could not be counted on to perform competently and honestly in this process, either the regime would eventually be forced to do so as a result of building political pressures or else it would lose power, through elections if available or through other means if not.

The second view, associated with the neoclassical counterrevolution or new orthodoxy school, which has its roots in Nobel laureate Friedrich von Hayek, was developed in the ideas of Nobel laureate James Buchanan and was applied to development policy by Anne Krueger, Deepak Lal, and others. In this view, participants in government, such as politicians and bureaucrats, were as selfish and self-interested as owners of companies but lacked the market to restrain them. Even when the economy was locked in a poverty trap, government itself played a key role in that bad equilibrium. While these points might enjoy broad agreement under some circumstances, this approach drew the strong conclusion that as a rule, at least beyond a minimum role, governments could only make things worse.[29]

It is easy to see how such extreme views became popular: At least they offered a guiding framework. Development specialists with a more nuanced view of government's role seemed to lack a clear theory. At the same time, most countries seemed to follow a particular "model" of development year after year, decade after decade, many reacting to colonial experiences: Governments in newly independent countries often either continued colonial policies or seemed to choose policies in angry reaction to those of the colonial period by emulating either Soviet policies or more moderate versions of them, as in India. In short, there was all too little on which to base a meaningful theory of development policy formulation.

The questions are insistent ones. Why did some developing countries reform quickly and effectively and others remain stuck year after year in an obviously counterproductive set of policies? Why did some adopt a course of aggrandizement for the rulers and others focus successfully on shared growth? Why did some reform programs become bogged down in squabbling among interest groups and others reach compromises that allowed for relatively efficient and equitable outcomes? Why were apparently good policy reforms abandoned in some countries after their adoption and stuck to diligently and unswervingly in others? Moreover, why did some governments that seemed to be following good advice on reform end up with an unequal and slow-growth outcome when they led to better outcomes elsewhere? Why were some countries such as Chile able to make a transition to a centrist, shared-growth regime after being stuck first in a stagnant import substitution mode and then in a dictatorship for which reducing poverty and inequality was not a priority? What makes for the dynamism of a Mauritius rather than the stagnation of a Guinea-Bissau, the recent progress of a Mozambique rather than the impasse of an Angola, a South Korea rather than a Philippines, a Thailand rather than a Myanmar? There are better questions than answers, but a start has been made.

A foundation is to focus on the quality of incentives provided by the underlying economic institutions as examined in detail in Chapter 2. Beyond this, the general framework of political economy analysis is that people may be assumed to oppose policy changes if they think they are likely to personally lose by them. Obviously, people do at times support policies that they believe are morally right, even if they will prove materially costly to them. As a rule of thumb, however, most work in this field begins with the assumption of material self-interest, the so-called *self-interest standard of rationality*. For example, an economic reform that benefits most people may not be adopted if the losers are relatively few in number but have a lot to lose and so have a great incentive to take actions—ranging from lobbying to bribery—to block the reform, while the many gainers each stand individually to benefit relatively little, so they do not have much of an incentive to take comparable political action in support of the reform.

As a simple numerical example, suppose that nine people each gain \$100 from a reform, and one person loses rents worth \$300, for a net gain of \$600. It sounds like a winner—but in some contexts, political participation can require time, effort, and money. Suppose that the opportunity cost of political engagement to influence the decision is \$200, so the nine gainers do not politically engage. But the last person retains a net gain (or put differently, avoids a loss) of $\$300 - \$200 = \$100$, and so determines the decision—not to reform. This pattern of diffuse gainers and concentrated losers has been identified repeatedly in postmortems of reform failure.[30]

Understanding Voting Patterns on Policy Reform

Sometimes reform is designed to maximize the benefits of the few. It is natural that the majority would oppose this, if they have the power to do so. Or they may think it likely that they will lose in the process of reform and, perhaps reflecting their previous experience, not believe that they will be adequately compensated through redistribution. But sometimes a majority of the public opposes policies that the majority would likely gain from. This may in part be due to lack of understanding of the nature of economic policy choices among the general public. It may be due to uncertainty over who will likely gain or lose from the policy. It is easy to understand that if voters are risk-averse, they may oppose a policy if they see a risk that they may turn out to be among those who will lose from it.

Raquel Fernandez and Dani Rodrik, however, demonstrated why even risk-neutral voters may rationally vote against a policy from which a majority will benefit. The basic idea is that if a significant number, but still a minority, of voters know with certainty that they will gain from a policy, they will vote for the policy. But what of the majority who do not know? For example, most may be unsure what skills they will need in order to be successful in the still obscure postreform environment and therefore how competitive they can be. Suppose that these remaining voters can only estimate their chances of gaining. Even if the percentage of gainers is fully known—say, 55% will gain—in many cases, if the uncertain voters estimate their chances of gaining as equal to that of the other uncertain voters, it will be rational to vote no.[31] A simple numerical example of this "status quo bias" will illustrate.

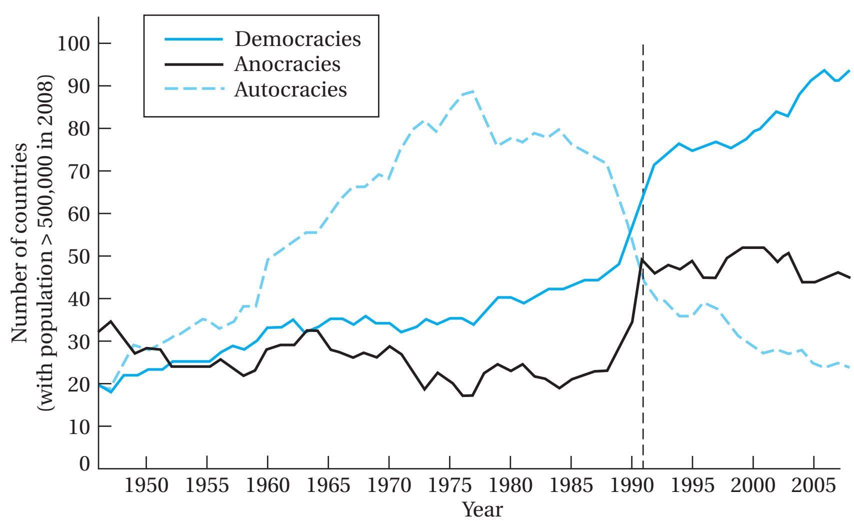
Suppose that 60% of the people will gain \$100 each from the proposed reform, while 40% will lose \$80 each. The expected gain for this population is given by $0.6(100) - 0.4(80) = 28$. If no one knows who any of the gainers are, this reform passes (because people are not averse to risk). But if a fraction

x are known beforehand with certainty to be among the gainers, a majority of risk-neutral voters (who still do not know if they are one of the remaining winners) may have an incentive to vote no. In this case, if 40% of the people know that they will be winners, this leaves 60% who do not know; when they recalculate with this greater chance of being one of the losers, they find it in their interests to vote no.[32]

Although this is a specific case, the result is quite general. Students can verify that in many cases, a large majority of 60% or more can gain from a policy, but when a sufficient number are already known with certainty to gain, this leaves a majority of voters with an expected loss, and they then block the policy.

In contrast to our relatively clearer understanding of the obstacles to constructive reform, we still understand too little about why constructive change takes place at all. If progress were rare, this would not be much of an empirical problem, because there would be little to explain. It would, of course, remain an important development problem because it would leave an important sphere of policy unaddressed. Fortunately, progress appears to be much more common than political economy theory would suggest. Democratization has been sweeping the developing world, as reflected in governance indices such as those in Figure 11.1. In more countries, attention to shared growth and development participation has been strengthening. Reforms that benefit the majority are sometimes implemented even over the strenuous resistance of powerful social and economic forces that stand to lose. This is what we need to understand better if successful development policy reform is to spread further in the developing world.[33]

FIGURE 11.1 Global Trends in Governance, 1946–2008



Source: Monty G. Marshall and Benjamin R. Cole, *Global Report 2009: Conflict, Governance, and State Fragility* (Vienna, Va.: Center for Systemic Peace) 2009, p. 11. Reprinted with permission from the Center for Systemic Peace.

Note: An anocracy is a mixed, or incoherent, authority regime.

A widely favored approach to understanding policy formation has been to examine the trade-off between short-term costs of reform and its long-term benefits, to both politicians and the economy. Politicians in particular are viewed as having a very short time horizon because of their limited time in office. Only when crises become sufficiently serious do discounted net benefits of reform become sufficiently large to induce change. The limitation of this literature is that the short-term costs of reform are rarely quantified, and the precise causes of increased growth remain difficult to identify.

It has been noted that reforms are often instituted after a crisis, and so the literature has considered whether "crisis can cause reform." Only when conditions are very serious, one view has it, will risk-averse politicians and voters be willing to try a different strategy. The debt crisis in Latin America is viewed as the catalyst to the adoption of more market-friendly policies, moving away from what had been, in most Latin American countries, failed experiments in import substitution. However, left unexplained is why even more severe debt crises in Africa did not promote analogous reforms. One part of the answer may be that greater outside pressure and resources were brought to bear on Latin America because of the greater threat its insolvency represented to major banks. But as Rodrik notes, "What we surely need to understand is why South Korea's politicians are ready to change course at the slightest hint of a crisis, while Brazil's will bring their economy to the brink of hyperinflation several times before they tackle the problem."[34] The political-economy literature recognizes this issue but is largely silent on it.

Institutions and Path Dependency

The framework suggested by Nobel laureate Douglass North is useful for understanding qualitative differences in policy formulation across countries. North distinguishes between institutions and organizations. Institutions are "formal and informal rules of the economic game." These are humanly devised constraints, such as contract enforcement, that define incentives for savings, investment, production, and trade. These, in turn, affect benefits and costs, and economic behavior that may lead to development or decline. Following from this, organizations spring up around the property rights, designed to help those who control the organization prosper under these existing property rights. Organizations emerge that are in large part defined and shaped by the incentives that emerge from these rules. In a widely cited quote, North says, "If the institutional matrix rewards piracy, then [only] piratical organizations will come into existence."[35]

Once these inefficient rights are in place, there are generally no incentives for the people in power to change them, especially when these rights can provide leaders with greater private gains than an alternative regime that may be better for society as a whole. Thus, inefficient institutions continue at the expense of overall welfare or of growth; the market cannot guarantee the evolution of efficient institutions. This trap is an example of **path dependency**, a condition in which the past condition of an individual or economy affects future conditions. Several examples of path dependency were examined in Chapters 2 (colonial origins of comparative development), 4 (poverty and low productivity traps), 6 (Malthusian traps), and 8 (child labor traps). Specifically,

Path dependency A condition in which the past condition of an individual or economy, measured by the level of one or more variables, affects future conditions.

North argues that the "inability of societies to develop effective low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment."[36]

The individuals who control the state have the incentive to use it for private gain rather than for the public interest. But North argues that historically, on occasion, the interests of those with high bargaining power have coincided with the public interest; when this occurs, effective institutions emerge, which prove very difficult to roll back once established.

In addition, although there is no way to ensure that this will happen, it appears that the more examples of successful institutions in neighboring countries, the greater the pressure on governments to adopt similar institutions. Clearly, the adoption of certain institutions, including human rights, property rights protection, and democracy, has spread over the objections of dictators because of their popular appeal. An example of the outward spread of democracy to neighbors can be seen in Europe from core advanced countries toward less developed areas—first to Spain, Portugal, and Greece and then to eastern Europe from the fall of the Berlin Wall to some of the "color revolutions" and recent "Arab Spring" revolts. Other examples are the spread of democracy across Latin America from the 1980s, from Japan outward to other East Asian countries after their middle classes reached a certain size, and in a cascade of freer elections in Africa. A final approach argues that democratization can emerge as a commitment device, that is, a reform accepted by elites who need to prevent revolution but can do so only by guaranteeing in this way that they will not renege on their concessions. Of course, democracies make serious policy errors too, but the chance that very bad policies will be implemented and go unchecked are much reduced. Unfortunately, even after democracy emerges, societies sometimes revert to autocracy, as long-standing political forces reassert themselves—the process can be more like the proverbial "two steps forward, one step backward."

An improved understanding of the political economy of successful policy reform and implementation will probably require continued and extensive interactions between political scientists, sociologists, and economists, each of whom have valuable insights to contribute from their research. In the process, more will have to be done to base theory on the experiences of the governments of developing countries, which in many cases will be struggling with the early stages of democratization and expanding avenues for development participation, with higher levels of conflict and in some cases an ongoing threat of return to military government or other autocratic rule. As Merilee Grindle has noted, further progress in this field will require moving beyond political-economy models that were developed primarily to study political processes in advanced economies with stable democratic traditions.[37]

Democracy versus Autocracy: Which Facilitates Faster Growth?

The comparative merits of democratic or autocratic regimes for development performance (especially economic growth) have been much debated. These debates have presented some of the trade-offs starkly. Under democracy, politicians seeking reelection have an incentive to reflect the will and interests of a majority of the people. On the other hand, a looming election gives an incentive to pursue short-term accomplishments that can be pointed to during a campaign, rather than what is necessarily good for long-term development. Worse, the corrupt politician who knows he or she will soon be voted out of office has an interest to steal as much as possible in the meantime. Under autocracy, there are fewer constraints on what can be stolen and for how long. But the politician who is reasonably confident of remaining in power for a long time can pursue long-term development strategies (at the very least, to have more to steal from).

Some high-growth but autocratic countries such as Singapore, along with South Korea and Taiwan prior to their transitions to democracy, appear to have enjoyed some of the potential benefits of autocracy for development. In these cases, corruption was present but to no greater extent than in most other developing countries and probably somewhat less than average. The positive effect of autocracy on growth-enhancing policies seems to have worked best when a regime sees that its greatest chance of remaining in power lies in achieving a maximum rate of growth; this is the case with South Korea, which has historically viewed economic development as a bulwark against the aggressive designs of North Korea, or of Taiwan, with its concern over possible invasion from the People's Republic of China. For that matter, China's current rulers have staked their political legitimacy and dreams of political recognition as a world power on a drive to modernization, so far with success. But autocrats also have the power to use the state for strictly private gains, as Mobutu did in the Democratic Republic of Congo (which he had named Zaire), following the example of the ruthless Belgian colonial rule of that unfortunate country. And those who fear overthrow will have an incentive both to "steal fast" and to focus resources on fortifying their own power and crushing opponents rather than using state resources to develop institutions and make investments that foster development.

Some dictatorships have been explained as "necessary" phases in the economic development of countries, as in the "Lee thesis," named after longtime Singapore prime minister Lee Kuan Yew. Amartya Sen would disagree, arguing that market freedoms and political freedoms are both valuable development outcomes in their own right and also are complements in encouraging economic development. For every example of a development star under dictatorship, other examples of development disasters under dictatorship can be provided. And many democracies have prospered; Botswana is a democracy, and over the long run has been the fastest-growing country in Africa. Sen also argues for a *constructive* role of political and other human rights in achieving pro-poor development: that people only become aware of important information (such as the plight of poverty of an ethnic minority) or understand the importance of some fundamental values (such as the right to a basic education) in the *process* of free public debate. Moreover, people only frame their own preferences in the context of *dialogue*. Although decision making may be slower, the best choices—including in the evolution of institutions—are likely to be made under conditions of freedom, Sen argues. For example, famines are unlikely when there is a free press to report on them. The greater capacity for the poor to organize their communities under democracy may give rise to many benefits in addressing local problems of poverty. Corruption is more likely to be rooted out more quickly. And fertility declined more in Kerala, with its emphasis on political dialogue, than in China, with its administrative mandates.[38]

In the face of such nuanced problems, it is no wonder that the empirical results are closely divided. It seems that about a third of studies find a positive effect for democracy, a third a neutral effect, and the remaining third a negative effect. Ahmed Mobarak has proposed that democratic regimes will be less volatile than autocratic ones. As a result, because more volatile economies are known to grow more slowly than more stable economies, the positive effect of democracy on growth may operate through this channel. But these benefits may be canceled by negative direct effects of democracy on growth.[39]

Jakob de Haan and Clemens Siermann point out that despite the arguments and also some evidence in the literature of a negative relationship between growth and democracy, such studies report that a *lack* of civil and political liberties is also negatively correlated with growth. They propose using better measures of democracy, including how deeply rooted it has become in the society, suggesting a measure based on the number of years that a country can be regarded as a democracy. They then offer various statistical tests of direct and indirect effects of "democratic liberties." Their main conclusion may speak for the literature in general: "The relationship between democracy and economic growth is not robust."[40] However, a widespread view is that democracy is good for broader development objectives, such as equity, education, health, and famine prevention.

11.8 Development Roles of NGOs and the Broader Citizen Sector

It is increasingly recognized that development success depends not only on a vibrant private sector and an efficient public sector but on a vigorous citizen sector as well. Relying on the former sectors alone has been compared to trying to sit on a two-legged stool. Organizations of the citizen sector are usually termed **nongovernmental organizations (NGOs)** in the development context but are also referred to as *nonprofit, voluntary, independent, civil society,* or *citizen organizations.*

Nongovernmental organizations (NGOs) Nonprofit organizations often involved in providing financial and technical assistance in developing countries.

A wide range of organizations fall under the NGO banner. The United Nations Development Programme defines an NGO as

> any non-profit, voluntary citizens' group which is organized on a local, national or international level. Task-oriented and driven by people with a common interest, NGOs perform a variety of services and humanitarian functions, bring citizens' concerns to governments, monitor policies and encourage political participation at the community level. They provide analysis and expertise, serve as early warning mechanisms and help monitor and implement international agreements. Some are organized around specific issues, such as human rights, the environment or health.[41]

Whereas governments rely on authority to achieve outcomes, and private-sector firms rely on market mechanisms to provide incentives for mutually beneficial exchange, civil society actors, working through NGOs, rely on independent *voluntary* efforts and influence to promote their values and to further social and economic development.

Cooperatives also play significant and important roles in economic development in many developing countries; but the experience has been mixed. In some countries and regions co-ops have assisted farmers with getting more reliable and lower-cost inputs, better access to credit, and higher prices and better marketing channels for their output. In other regions, co-ops have been subject to manipulation by the state, paving the way for corruption as well as inefficiency. Richard Simmons and Johnston Birchall concluded that in many cases, cooperatives in developing countries historically "failed to live up to expectations; having been created by governments they remained controlled by the interests of government, party and civil service"; however, "some new, more genuine co-operative sectors are now emerging."[42]

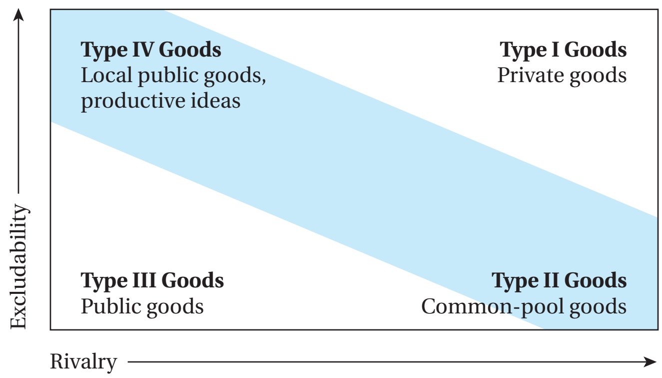
The emergence of civil-society actors such as NGOs as key players in global affairs is recognized by Nobel Peace Prizes given to the Campaign to Ban Landmines in 1997, Doctors Without Borders in 1999, and the Grameen Bank in 2006 (see the case study at the end of this chapter), as well as individual Nobel laureates who have played key roles in establishing NGOs and other citizen organizations.[43] A good example is the late 2004 Nobel laureate, Wangari Maathai, who launched the Kenyan and now Africa-wide Green Belt Movement.

Some 3,051 NGOs had consultative status with the United Nations as of 2010; the number of international NGOs grew by 20% in the 1990s and grew 20-fold from 1964 to 1998.[44] The potential impact of NGOs is also seen in their wide scope in activities and issues and their size as measured by number of employees as well as their large and growing budgets.

In contrast to private goods, public goods are nonexcludable (it is impossible to prevent individuals from consuming them except at excessive cost) and nonrival (consumption by individuals does not reduce the amount of the good available for consumption by others). Activities in which NGOs have comparative advantage typically lie between conventional private and public goods in these dimensions. In particular, they tend to be partially rival, partially excludable, rival but not excludable, or excludable but not rival. Figure 11.2 reflects this range of activities in these two dimensions. The result is a typology that includes "private goods" (high excludability, high rivalry) in the upper right-hand corner, referred to here as Type I goods, and "public goods" (low excludability, low rivalry) in the lower left-hand corner, referred to here as Type III goods. The production and distribution of these Type I and Type III goods are generally assigned to the market and the public sector, respectively. The other two corners represent goods that are hybrids of the other two.[45]

In the lower right-hand corner are found common-pool (or common-property) resources, characterized by low excludability but high rivalry. Examples of such Type II goods are natural resources such as fisheries, pastures, and forests, with open access. As explained in Chapter 10, unless well-managed (see Box 10.3, page 516), these resources often tend to be overused (and underinvested).[46] Common-property resources can be allocated through institutions in both public and private sectors, but NGOs play an important and growing role. Historically, common-property resources were allocated by traditional (e.g., tribal) mechanisms, but these often broke down under colonialism and postcolonial government control in many developing countries.[47] Increasingly,

FIGURE 11.2 Typology of Goods



The shaded diagonal indicates the area of primary NGO comparative advantage in dimensions of rivalry and excludability. When, based on local conditions (such as government failure), NGOs are in a position to supply public or private goods at a lower price or higher quality, they may be found expanding into these nonshaded areas as well (Type I and Type III goods).

NGOs are helping community-based organizations (CBOs) reclaim this role in common-property resource allocation. Because they are organizations based on trust rather than coercion (government) or individual self-interest (market), NGOs may be able to arrive at efficient and socially acceptable allocations of common-property resources at relatively low transaction costs.

Finally, in the upper left-hand corner are found another hybrid, Type IV goods. For example, productive ideas can be used by all without their becoming used up or degraded and so are nonrival, but they can often be effectively kept secret, so they are excludable.[48] A related example is technology transfer to developing countries. Technical knowledge is not a rival good once it is transferred and absorbed into the local economy, as ideas may often spread rather freely across firms within a locality, but it is excludable in that without active intervention, productive ideas often do not cross national boundaries (especially between developed and developing countries). One reason is the free-rider problem: One firm might pay to learn a new technology, but its local rivals could likely find a way to absorb their knowledge (such as hiring away employees) without sharing the cost. Type IV goods exhibit high excludability but low rivalry and are typically assigned to government-regulated private-sector or civil-society actors.[49] For example, productive but basic and general ideas are often developed by nonprofit universities and other research centers, and technology transfer in areas such as public health is often undertaken by specialized NGOs or nonprofit industry associations or consortia.

A special form of public good that operates at the local level or in a specialized subgroup of a wider society is known as a *local public good*. Under some conditions, a decentralized solution to allocation problems for such goods may be found.[50] Local public goods are excludable from those outside the area but generally not for those in the local area. One can find all three sectors active in producing and allocating local public goods. For example, local amenities may be provided by for-profit developers, local government, or local NGOs.

There are at least seven partially overlapping and mutually reinforcing types of organizational comparative advantage for international or national NGOs or local organizations such as federations of community-based organizations; these are illustrated with examples from the field of poverty alleviation.

1. *Innovation.* NGOs can play a key role in the design and implementation of programs focused on poverty reduction and other development goals. For example, NGOs that work directly with the poor may design new and more effective programs that reach the poor, facilitated by this close working relationship. Individual profit-making firms may lack incentives for poverty innovation, especially when the innovations that would be effective are so difficult to anticipate that no request for proposal could be written to draw them out. In many cases, government has an advantage in scaling up established programs. But government has been relatively less successful at significant program innovation, compared to (or at least without a prod from) the NGO sector. Often government programs have not reached the poorest families. More broadly, government tends to offer uniform services, whereas the poor may have special needs that are different from mainstream populations. Some of the most important innovations in poverty programs (such as microfinance) have been conceptualized and initially developed by domestic and international NGOs. In the sphere of education, for example, NGOs have played the pioneering role in such areas as nonformal education, community literacy campaigns, educational village theater, use of computer technology in urban slums, and subtitling of community center music videos for educational purposes.[51] A key question is whether the government or private sector is then capable of scaling up NGO innovations, once they have become established as working models, as effectively as or better than the innovating NGO. In any case, if governments or private-sector firms are unable or unwilling, the experience of BRAC (see the case study at the end of this chapter) shows that NGOs may do this scaling up to a substantial degree, at least until the government is finally ready to step in. Such innovations are nonrival but are potentially excludable, particularly if detailed information is not transmitted easily.

2. *Program flexibility.* An NGO can address development issues that are viewed as important for the communities in which it works. In principle, an NGO is not constrained by the limits of public policy or other agendas such as those of donor-country, foreign-assistance priorities or by domestic national or local governmental programs. Indeed, national NGOs (such as BRAC, in this chapter's case study) are in principle also unconstrained by the preferences of the international NGOs (and vice versa). Moreover, once a potential solution to a development problem has been identified, NGOs may have greater flexibility in altering their program structure accordingly than would be the case for a government program. Flexibility can be interpreted as localized innovations or minor adaptations of program

innovations to suit particular needs. NGOs may be better able to make use of participation mechanisms, unconstrained by limits placed on individual rights or prerogatives for elites that prevail in the public sphere. However, there are limits to this flexibility, as NGOs may have a tendency to tailor their programs to fit the available funding, a phenomenon known as *donor capture*.

3. *Specialized technical knowledge.* National and international NGOs may be greater repositories of technical expertise and specialized knowledge than local governments (or businesses). In particular, international NGOs can draw on the experiences of many countries that may offer possible models for problems of poverty faced by any one country, as well as possible solutions. Of course, this forms part of the basis for credibility. These technical skills may be used for developing effective responses to locally binding poverty traps and coordination problems. Specialized knowledge is acquired in the process of doing specialized work with local citizen groups, including those of the poor. Consider the Grameen phone lady model, in which microcredit and training are provided to village women to purchase and operate a cell phone available to community members on a fee basis (see the case study on the Grameen Bank). This program reflects innovations coupled with local NGO advantages in technical knowledge. Knowledge, understood as an economic good, is also excludable but nonrival.

4. *Targeted local public goods.* Goods and services that are rival but excludable, including those targeted to socially excluded populations, may be best designed and provided by NGOs that know and work with these groups. Possible examples include local public health facilities, nonformal education, provision of specialized village telecommunications and computing facilities, codification and integration of traditional legal and governance practices, creating local markets, community mapping and property registration, and community negotiations with governments. Some examples of these goods may lie along the shaded diagonal of Figure 11.2, but local public goods are generally locally nonrival but excludable from those outside the local area.

5. *Common-property resource management design and implementation.* NGOs, including federations of local CBOs, can play an important role in common-property management and targeted local public-good provision. Throughout the developing world, both governments and the private sector have a poor track record in ensuring sustainability of forests, lakes, coastal fishing areas, pasturelands, and other common-property resources, also known as "commons." But a large fraction of the world's people still rely on local natural resources for most of their income and consumption. Targeted NGO and CBO programs, including training, assistance with organizational development, efforts to change noncooperative cultural characteristics, and initiating measures such as community and common-property policing, can help address common-property mismanagement and related problems. Common-property resources are rival but nonexcludable.

6. *Trust and credibility.* In practice, NGOs may have other advantages over government in gaining the trust of, and providing effective services to,

groups with special needs, notably those in extreme poverty. NGOs' local presence and relationships, frequent interaction and communication, and greater avenues for participation may generate greater trust among the poor and other citizens. Although in a decentralized and socially inclusive democratic setting, an elected government might be at least as trusted as "unelected" NGOs, government in many developing countries may be democratic in name only. But even majority rule can be of little benefit to the socially excluded, particularly when the majority population or its representatives actively marginalize the poor. When government resources are limited, trade-offs between benefits for established or excluded groups can take on added significance. Democracy may also provide little benefit to the socially excluded when they experience benign neglect and a lack of established communication channels with the government. Once such a history is established, it may be difficult for even a new and well-meaning government to overcome this legacy. NGOs, in contrast, may enjoy greater trust in assumed competence, benevolence, reliability, responsiveness, established personal contacts, and perception of consistent behavior in various settings that may not be possible to monitor. To the degree that NGOs follow explicit bylaws requiring democratic practice, accountability, and responsiveness, credibility is enhanced over time. Partly as a result, NGOs may also be more trusted by local government than less responsive or less accessible official donors. At the same time, if governments are perceived as corrupt or incompetent, foundations and certain other donors may trust only NGOs to address poverty, environment, local health and education delivery, and other services. Thus, NGOs help mobilize resources that would otherwise not be available for local residents, including those in structural poverty. Finally, the private sector may prefer to partner with NGOs than with governments or other official actors to gain credibility in socially responsible investment activities.[52] In sum, NGOs may enjoy higher trust than other organizations among all the major parties concerned, including the poor, developing-country local and national governments, and donors. Trust is related to the capability for effective advocacy.

7. *Representation and advocacy.* NGOs may hold advantages in understanding the needs of the poor, who otherwise are often excluded from political processes and even local community deliberations. NGOs may play a role in the aggregation of preferences and hence of representation of community needs. To the degree that NGOs have a better understanding of locally binding poverty traps, they should be in a position to represent the needs of the poor more effectively. This responsibility reflects the advocacy role of NGOs, including federations of CBOs, in advocating for the needs of poor and socially excluded peoples. Minorities may need special protections in majority-rule representative democracies, and existing constitutional protections are not always sufficient. It is not a comparative advantage of either the private or the public sector to advocate for the poor or the excluded. The private sector is less likely to hold the trust of those whose interests are to be advocated. Individual donors, foundations, agencies, or other funders of advocacy will want to ensure that the

advocates they sponsor are working with a broad understanding of the mission. Finally, if it is government that needs to be lobbied or influenced, it is unlikely to be in the comparative advantage of government to fulfill this function—particularly to the degree that trust is at issue—although an ombudsman or citizen protection office can play a valuable role. Advocacy for a given group is partly nonrival and nonexcludable.

Sometimes exceptional failures of either government or the private sector create situations under which NGOs can, and perhaps should, temporarily step in to fill the void through "sector extension." For example, BRAC is involved with producing private goods such as chalk, shoes, and seeds, under conditions of a dysfunctional private sector, at least in rural areas (see the case study at the end of this chapter). In Africa, in the face of government neglect, the international NGO Africare is involved in what are normally government responsibilities such as road building. But in such cases, NGOs may eventually turn these functions over to local CBOs, to the private sector, or to government (through a transfer agreement) when conditions warrant. For example, Africare helps government and CBOs take over responsibility for road maintenance after construction of a road has been completed.

As noted, in the developing countries, both government and markets can be weak, and strengthening their capacity is essential. But unfortunately, the citizen sector is often even weaker in these countries, in part because people have less money and time to donate, because skills are lacking, and because sometimes the citizen sector is actively undermined by the government and business sectors. Short of embezzlement or other outright lawbreaking, NGOs are also vulnerable to weaknesses, termed **voluntary failure**. Instead of realizing their potential, NGOs may be insignificant (owing to limited resources or small scale and reach), selective and exclusionary, elitist, and or ineffective.[53] One potential pitfall is the lack of adequate incentives to ensure effectiveness, which requires careful organizational design. Another is the ever-present danger of capture by the goals of funders rather than intended beneficiaries. This can reach the point where NGOs change their priorities from one year to the next.[54] NGOs can fail to live up to their organizational potential when means—such as fund-raising—become ends in themselves or when means are given too little attention, as when poor fund-raising keeps NGOs from realizing the scale they need to have a real impact. There are sometimes inadequate checks and balances to prevent these flaws. NGOs may not receive the immediate feedback from the market that private firms receive or that elected governments receive at the polls. This lack of rapid feedback can encourage these weaknesses or at least let them go on for some time before being corrected. Such problems must be addressed if NGOs are to achieve their potential for facilitating development and poverty alleviation. Research findings on tactics to improve NGO performance are found in Box 11.3. In this case, the program focused on an NGO-run school system whose leaders were motivated to improve performance, but this could become an example of innovations in the NGO sector that can spill over to the public sector.

Voluntary failure The inability of nongovernmental organizations and the citizen sector more broadly to efficiently achieve social objectives in their areas of supposed comparative advantage.

In addition to the rapid rise to prominence of NGOs as key players in the development drama, three other major trends in governance have emerged: tackling corruption, fostering decentralization, and facilitating development participation in both the government and NGO sectors.

BOX 11.3 FINDINGS Reducing Teacher Absenteeism in an NGO School

Teacher "truancy" (absenteeism) helps explain why effective literacy skills have remained so poor in South Asia despite increases in enrollments. Esther Duflo, Rema Hanna, and Stephen Ryan studied one-teacher nonformal primary schools run by the NGO Seva Mandir in rural Udaipur, in the Indian state of Rajasthan. In half the schools, which were randomly selected, teachers were told to have a student photograph them with the rest of the class at the beginning and end of each school day. A tamperproof time stamp showed which days the school was open and at what times the classes began and ended. The teachers' salaries directly depended on their attendance for at least a five-hour day. Thus, the study examined the combined effect of direct monitoring with financial incentives. The impact was strong, with teacher absenteeism rates dropping by half, from 42% to 21%. The teachers' measured effort while at the school did not decline, so students benefited from about 30% more instruction time. These students had somewhat higher exam scores (by 0.17 standard deviations after one year) and were more able to gain admittance to formal government schools. This simple technological monitoring proved cost-effective for monitoring teacher attendance, because staff visits could be reduced from daily to periodically. Duflo, Hanna, and Ryan used economic analysis to conclude that the financial incentives alone could explain the difference of monitored teachers, and they argued that the incentives, rather than being monitored per se, caused the improvements. The researchers used the information to estimate cost-effective compensation policies. NGO schools might be different, for example, by providing better training, but the study team argued that such a program should also be workable in government schools; in any event, the team noted, the results supported hiring more "parateachers" such as those studied.

Source: Based on Esther Duflo, Rema Hanna, and Stephen P. Ryan, "Incentives work: Getting teachers to come to school," *American Economic Review*, 102(4): 1241–78, June 2012.

11.9 Trends In Governance and Reform

Tackling the Problem of Corruption

Corruption The appropriation of public resources for private profit and other private purposes through the use and abuse of official power or influence.

Corruption is the abuse of public trust for private gain; it is a form of stealing. Indexes of corruption regularly rate the incidence of corruption far higher in developing countries than in developed countries. This is understood to reflect both cause and effect. An absence of corruption encourages investment and efforts to expand the pie rather than merely fight over its distribution, and thus encourages growth; to this extent, improvements in governance, in general, and reduction of corruption, in particular, could be means to accelerate the process of development. In addition, as societies grow wealthier, good governance becomes more widely demanded by the population. This latter effect makes simple correlations between income and good governance difficult to interpret: Which causes which? Poor governance practices, such as bribery, controls over the press, and limits on civil liberties, are often found together and are clearly mutually reinforcing. As pointed out in Chapter 2, there is clear evidence that good institutions such as rule of law and constraints on elites lead to higher growth and incomes. But reform can also beget reform. For example, when Taiwan's press obtained substantial freedoms, many public scandals became publicized, which in turn helped generate public pressures for reform; the introduction of elections provided a mechanism to enforce this popular will.

The elimination of corruption is important for development for several reasons. First of all, as just noted, honest government may promote growth and sustainably high incomes. In addition, the association of eliminating corruption with public empowerment suggests that it is a direct objective of development (see Chapter 1). Finally, the effects of corruption fall disproportionately on the poor and are a major restraint on their ability to escape from poverty.[55]

The elimination of corruption and improvement of governance, in general, can thus also be viewed as part of an antipoverty strategy. While the rich may pay large bribes under corrupt regimes, the poor generally pay much larger fractions of their incomes in bribes and other forms of extortion. In other words, corruption may be viewed as a regressive tax on the absolutely poor. In addition, government for sale means government for the highest bidder. The poor find fewer services in their communities, including poor education and health facilities, when corruption is rife. This makes it more difficult to accumulate the means to escape from poverty traps. In addition, microenterprises of the poor pay a much higher fraction of their sales in bribes than larger firms do, and low-income households pay a much larger percentage of their incomes in bribes than higher-income households, as Figure 11.3 illustrates for the case of Ecuador.

Countries that have avoided or successfully tackled corruption have tended, on average, to promote competition and entry in the economy, avoiding too much power in the hands of large monopolies such as those in the energy sector in many countries, and have ensured that privatized firms faced competition; promoted civil service professionalism, with improved pay and incentives for public servants; made public expenditures more transparent, with clearer rules of procurement and budgeting; reduced immunity from prosecution of executive, legislative, and judicial figures; provided judicial independence; established and enforced meritocratic, transparent promotion policies; and eliminated inefficient regulations and made needed ones more transparent.[56]

With many forms of corruption and differences across nations and localities, there is no single best way to fight it. Basic public monitoring even by itself may matter, in procurement, or in local government public funds receipts and disbursements.[57]

Recent experience also suggests that even in broadly corrupt environments, real progress in overcoming government shortcomings is achievable, at least in some contexts, through focused reform efforts at the local level. This may threaten some local interests but need not threaten (or may even benefit) more national-level interests. For example, on net urban elites probably do not benefit from village power abuses, or from rural teacher and health worker truancy, and may back reforms that address such problems. A potential example of locally based popular reforms is the community monitoring of local health facilities in Uganda as examined in Box 4.2. Such examples also raise the broader tantalizing prospect that higher-level institutions eventually can be reformed from the bottom up.

FIGURE 11.3 Corruption as a Regressive Tax: The Case of Ecuador

Source: World Development Report, 2000–2001: Attacking Poverty, by World Bank, p. 102, fig. 6.2.

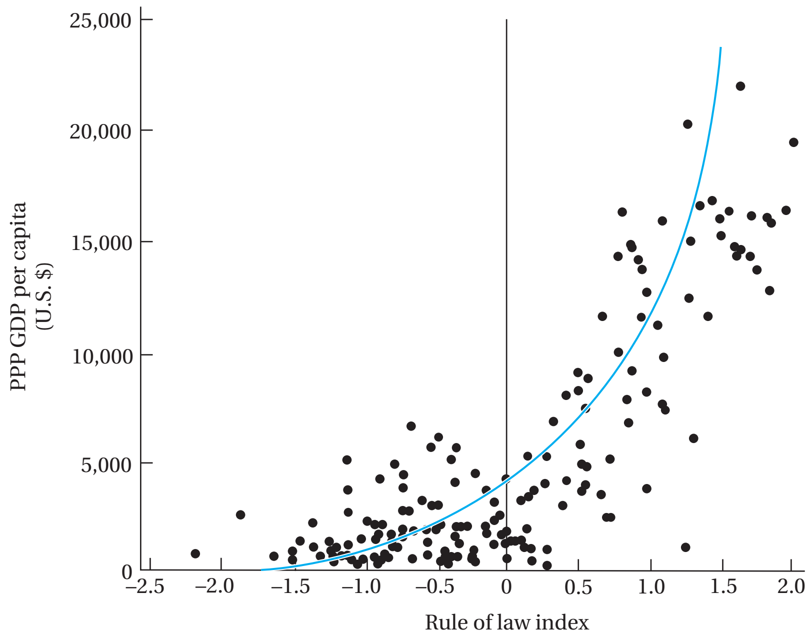
The relationship between the rule of law and per capita GDP is shown in Figure 11.4.

Decentralization

Decentralization has been a long-term trend in developed countries. The United States, Canada, and Germany have had significant powers at the state and local level enshrined in their constitutions. The European Union has been proceeding—officially, at least—on the principle of "subsidiarity," meaning that feasible decisions are made at the most local level. The United Kingdom has decentralized authority to Scotland and Wales and also to local authorities in England. In Italy, power has been transferred to the 20 regions and their provinces. Local governments are closer to the urban and rural problems they must address.

Recently, trends toward decentralization and greater urban self-government have been growing in the developing world as democracy has spread in Latin America and elsewhere, and the political process has allowed for providing greater autonomy, notably more fiscal autonomy, for regional and local levels of

FIGURE 11.4 The Association between Rule of Law and Per Capita Income



Source: World Development Report, 2000–2001: Attacking Poverty, by World Bank, p. 103, fig. 6.3. Copyright © 2000 by World Bank. Reproduced with permission.

government. The constitutional reform that has frequently accompanied democratization has in many cases provided an opportunity to codify greater local autonomy. A major motivation of the central government has often been to share fiscal burdens with regions and cities, but decentralization has sometimes taken on a life of its own that has been difficult to contain.

Decentralization in Brazil to its 26 states and some 5,000 municipalities dates at least to the 1891 constitution, but the recent period of devolution of authority started with the constitutional reform of 1989, which gave new authority and responsibilities to the states and developed fiscal federalism, increasing the local share of government resources. The fiscal decentralization occurred in the wake of the debt crisis of the 1980s and the perceived need to carry out structural adjustment by lowering the federal budget deficit and spread some of the adjustment burden to the regions. However, many observers consider the resources available to states and cities too small in relation to responsibilities, with still more burden than opportunity.

A wave of decentralization in Mexico also began in the late 1980s in the wake of the debt crisis, alongside programs of privatization, liberalization, and deregulation. Constitutional reforms transferred additional power—and responsibilities—to the states and municipalities. But as in Brazil, local governments complain that they have insufficient resources to carry out their added mandates. (The debt crisis is examined in Chapter 13.)

A third Latin American example is the Bolivia decentralization of 1994, which recognized local forms of organization and citizen participation; indigenous and peasant organizations have sought an active role under the new system, although conflict has continued. The decentralization resulted from a combination of pressures from local government and popular organizations and from international agencies.

The experience of Senegal is a well-known example of decentralization in Africa. In 1996, presidents of rural councils were made more accountable to their constituencies, and regional governments were established to develop and carry out regional development policy. However, the fiscal limitations of local government in Latin America are small compared to those faced in Senegal, and thoroughgoing fiscal reform remains a top priority. There were high hopes for the democratically elected government that came to power in 2013, and the experience will be watched closely.

In Asia, decentralization has proceeded apace with democratization, while long-standing democracies such as India have also provided greater local control, notably under India's 74th Constitutional Amendment. In China, decentralization has occurred to some extent.

Development Participation

If the goal of economic growth is human development, then without participation, we could have economic growth without development. Indeed, participation—a say in development policies by the people most affected by them—is arguably in itself a chief end of development. Participation is also a means to further human capabilities and other goals of development, as defined in Chapter 1. Moreover, economic growth is greatly facilitated by human development and impossible to sustain without it. Development participation has been shown to make projects work better. With genuine and full participation by beneficiaries on what projects are chosen and in the way that development assistance gets used more generally, we should expect less corruption and greater development results per dollar of aid spent.

Development participation has been discussed for decades. The United Nations has been promoting it since the 1970s; it was an academic fad in the early 1980s; and in the late 1990s, the World Bank came out vocally for development participation. Critics have complained that when the World Bank uses the term *participation*, it often seems meant as a strategy to reduce project costs or to deflect criticism. But the World Bank has clearly discovered the merits of getting governments and civil society to take ownership of development projects and reforms. Only then are reforms undertaken in a serious and sustainable way.

What are the potential objections to the principle of genuine participation? First, the poorest countries need to make some policy decisions and get some relief operations up and running immediately. The highly indebted poor countries that need immediate debt relief feel pressure to prepare plans quickly and provide little more than nominal time for civil-society participation. Even if the mechanisms of participation are already in place, it takes time to operate them, to make sure there is sufficient voice, to aggregate the preferences voiced, and to work out a means of implementation. But in most cases, mechanisms of genuine participation are not in place; doing so may take years, even with the full cooperation of national government and local power brokers.

Second, unhealthy and unskilled people are probably not able to participate effectively in development projects, let alone have a full voice in the decisions that affect them. A third objection is the costs of time: The poor are busy trying to survive. They may receive a low market wage, but that does not mean they have time available for volunteer work. This is especially true of women. They work long hours in both economic activity and at home because they cannot afford alternatives to household production. They may reasonably view expectations that they participate as unremunerated labor. Donors and developing-country governments need to develop ways to reward participation, but a big part of the problem is the superficiality of what passes for participation in the field. These three objections suggest that participation may have limits.

Distinctions between different types of participation are a valuable starting point and have been suggested by a number of authors. For example, John Cohen and Norman Uphoff examine degrees of participation along three dimensions: kinds of participation (in decision making, implementation, benefits, and evaluation), identity of participants (including residents, leaders, government personnel, and foreign personnel), and how participation occurs (the basis, form, extent, and effect of participation).[58] David Deshler and Donald Sock distinguish "genuine participation," which can include either citizen control or cooperation, with delegated power or partnership agreements between citizens and agencies, from "pseudo-participation," which can include placation, consultation, or information without power sharing, as well as "therapy" and manipulation.[59] The deeper problem is that genuine participation is often not in the interests of national or local government officials and other elites.

Many NGOs are committed, at least on paper, to the more complete forms of participation, and aid is often channeled through these organizations. But NGO staff often perceive, rightly or wrongly, that beneficiaries do not have the skills and experience needed to make fundamental decisions or administer projects efficiently. Administrative competence of beneficiaries is a less tangible outcome than, for example, the percentage of farmers who get linked up to irrigation canals; so staff, even with the best of motives, may not view genuine participation as a priority but more as a distraction. It is also obvious that staff owe their livelihoods to development work and do not have a material interest in working themselves out of a job. Thus, voluntary failure may again be present, and staff are motivated to encourage participation as long as it increases the efficiency of the project, but not necessarily beyond that point. Such a level of participation may bring benefits, but not normally the socially transformative benefits of genuine participation.

Sarah White reports on an NGO in the Philippines that was committed to genuine participation in theory and enabled local people to develop and control their own organization. But when this organization wanted to bypass the NGO and interact directly with donors, the NGO would not allow it to do so.[60] Victoria Michener reports on a nonformal education project run by an NGO (Save the Children/FDC in Burkina Faso). Participation itself is one of the six objectives of the project, to "increase community participation in educational decision making, and in the management of educational activities." Participants are expected to play an active role in recruiting teachers and students, determining curriculum, building and maintaining the schoolhouse, and paying costs such as teacher salaries. Overall, the projects would rank very high in participation typologies such as that of Cohen and Uphoff, providing for substantial participation in decision making, implementation, benefits, and evaluation. But at the same time, Michener notes an undertone of "planner-centered participation," especially in the emphasis on the responsibilities of beneficiaries. To fieldworkers, participation comes with an obligation that recipients give something in return—payment, in a sense—for the benefits of a project: financial, in-kind, or at least the donation of time. But participants naturally resent this requirement, at least in a context of paternalism. Typically, villagers cannot afford to repudiate the NGO; they do benefit from the assistance but lack the resources to continue the project on their own.[61]

Genuine public participation at all levels provides a foundation for democratic and responsive government. Participation will not cure all of the ills of government, including the limits of democracy itself, but it will go some distance to alleviating the ills of the politics of development policy reform. Unfortunately, the rhetoric is still well ahead of the reality on the ground.

A Three-legged Stool We may conclude, then, that successful economic development requires improved functioning of the public, private, and citizen sectors. Each has serious weaknesses that must be addressed. Each leg of this "three-legged stool" needs strengthening. At the same time, each plays an essential and complementary role in attaining balanced, shared, and sustainable development.