Additional Paper Submitted to Colloquium (2)

SOME ISSUES PERTAINING TO GOVERNMENT FUNCTIONS AND FAILURES IN TRANSITION AND DEVELOPING ECONOMIES

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This paper was submitted as an Economics Directorate contribution to the Colloquium subject. Many of these themes are addressed in much more detail in the World Bank Development Report 1997 "*The State in a Changing World*" from which some of the ideas and the graphics in this paper are taken. Otherwise, this paper reflects the views of its author and does not necessarily reflect the official opinions or policy of NATO member governments or NATO.

Introduction

Most transition economies in Central and Eastern Europe are moving away from command plan economics in which the state controlled prices, production, investment, wages, consumption and trade. By denying firms and households any say in these matters, relative living standards declined rapidly even though several state functions with regard to security, defence and the provision of basic social services were discharged with some success. Several countries in the developing world that escaped the command-plan experiment have also had to face up to the failure of the state in the form of over-ambitious and state-dominated development plans. Even government intervention in OECD states has a mixed record, with many now opting for a state/market mix much more predisposed towards the latter as the costs of all-embracing "welfare states" become unsustainable. But perhaps the biggest indictment of state intervention in the economy can now be found throughout East Asia as the so-called "miracle economies" flounder in financial crises caused in part by continual and covert state direction of bank lending at favourable interest rates to selected, often "family", firms. In Indonesia, the whole state was run as a family business with catastrophic effect.

A logical conclusion of the above might be that the minimalist state is best. Such a state could do little harm, but could it do any good? Although these examples - and in particular the recent declawing of the Asian Tiger economies - suggests that state **dominated** development has failed, **stateless** development has fared even worse, as witnessed by the poverty and destitution in collapsed states such as Liberia, Haiti, Somalia, Afghanistan and Rwanda, with maybe Burma, Algeria, Columbia, Indonesia and North Korea to come. Somewhere between these extremes lies the **effective state**, which in detail may mean different things and have different building blocks in different geographical areas of the world. What comprises an effective state might also differ across countries at different stages of development.

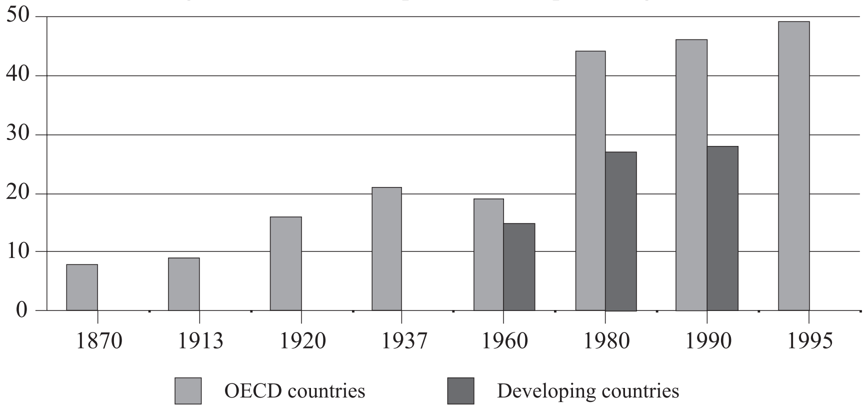
Historically, development and economic growth were seen as largely technical challenges to counter market failures. Accordingly, the state was given a central role in correcting them. But this was too simplistic and led to the emergence of unaccountable and usually corrupt elites with ambitions out of step with reality. Backward states felt that they could bulldozer themselves into the late 20th Century by missing out on all the development stages in between, but failed to build the institutional, educational and legal frameworks to match. A more effective development strategy might be for the state to painstakingly construct these frameworks which would then act as a catalyst; facilitating, encouraging and complementing the activities of business and individuals.

Perhaps the word “state” is wrong here, given its past association with Soviet-style control. “**Good government**” - how to get it and how to maintain it - might be a better description of what this Colloquium is about, and as this short paper will attempt to prove, this **is not a luxury but an absolute necessity** for sustainable development and successful transition. Defining “good government” is not easy. The basic provision should perhaps be that of **external security** and **internal stability**. It then becomes possible to create an underlying institutional and legal environment which, in the words of the World Bank, “...determines how economic and technical inputs into an economy are used.” Perhaps this sounds a little statist. “Applying the rule of law to market transactions” might be better. Moreover, good government should focus on core public activities that are crucial to development such as delivering improvements in education, health and income redistribution. Governments should invigorate public institutions, give public officials incentives to do their jobs well by paying them properly, and put a stop to arbitrary and corrupt behaviour. The key problem is that powerful people will continue to have a vested interest in keeping things as they are, whatever the cost might be for the population at large.

A Global Perspective

The size and scope of governments has risen enormously in the 20th Century, as Figure 1 (from *World Bank Development Report 1997*) below reveals:

Fig. 1 : Government Expenditure as a percentage of GDP



Note: Data for developing countries is central govt. spending. OECD includes central and local govt. spending.

In part, the growth of government and the role of the state in the economy has been a response to the one colossal market failure of the Century - the Great Depression of the 1930s. Post-war governments were determined to avoid the same mistakes. Rapid reconstruction helped to boost global aggregate demand which in turn led to spectacular and sustained periods of economic growth, particularly in Western Europe, North America and Japan. By the late 1950s, this growth was providing governments with the revenue to do much more, and bred confidence in the both the power and ability of governments to continue to do even more. As **Figure 1** shows, state spending now consumes about half of GDP in OECD countries and around 30% of GDP in developing countries. But the debate has now shifted from the **quantitative** - the more a state can spend the better - to the **qualitative** - what is the opportunity cost imposed by the state's relentless appetite for cash and could individuals spend this money more wisely?

This focus on the state's role in the economy has been fuelled by far reaching changes within the global economy - in short, **globalisation** - which has become a threat to weak or poorly governed states. The integration of international economies has narrowed the scope for protectionist, arbitrary or otherwise maverick economic policy. The global market spotlight is focussed on all and none can escape its glare. Policy, especially with regard to taxation, investment and trade, must increasingly correspond to the parameters of the hegemonic, globalised, **market** economy. If states wish to attract footloose international capital, they must conform to this paradigm or otherwise miss out on growth and improved living standards for their people. Effective states have understood this and are opening up to trade, capital and labour, even though this can expose them to external price shocks, capital transfers and speculation. But these can also act as useful control and adjustment mechanisms, rewarding sound government and punishing incompetent and/or venal government. **Globalisation has therefore created new and different roles for states - not as a sole provider but as a facilitator and regulator**.

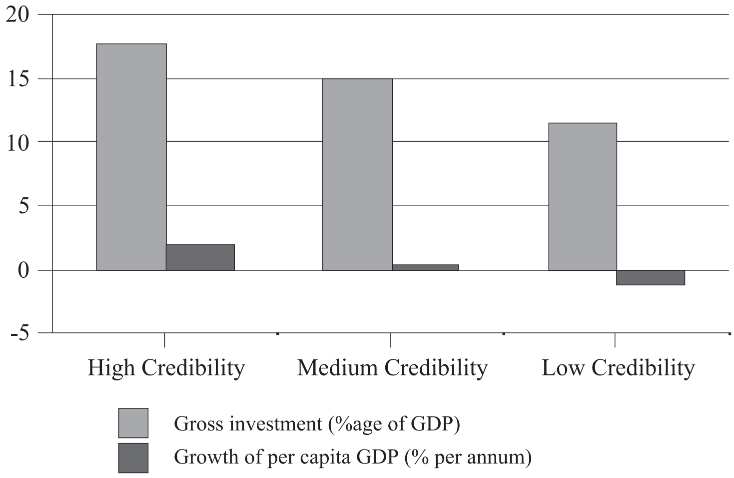
The need for effective government is particularly acute in states that have never experienced it. In many developing countries, the state has failed to provide such fundamental public goods as the rule of law, basic transport infrastructure, basic health and education, property rights, and security from crime or war. Here, a **vicious circle** takes hold as firms and individuals respond to failing public services or diminishing security by refusing to pay taxation, which means that taxes for the few who do pay are increased thereby encouraging more evasion leading to a further deterioration in services and security. Once federal taxation falls below a certain level (which would vary according to the development status of the country concerned), it hardly becomes possible to have a functioning state at all. Some Partner countries are now experiencing severe fiscal problems as barter and shadow economic activity fill the void left by the collapse of one functioning state system (command-plan communism) and its as yet incomplete replacement by another. Into this institutional vacuum step criminal elements who for a substantial fee can enforce contract and “provide” the services that the state no longer can.

Adapting Roles to Abilities

Governments need to be **focused**. Where the fundamental building-blocks of the nation state - a body of non-discriminatory law, maintenance of public order, security from external threat, a non-distortionary policy environment, macro-economic stability, basic social services and infrastructure, protection of the vulnerable, protection of the environment - are either in disrepair or non-existent, this is where the focus should be. For example, in most of the developing world the return on investment in primary education (especially of girls) would vastly exceed that of a similar investment in universities. But governments are unlikely to be able to achieve all of these fundamentals without help from the market. It may be necessary to hive off competitive segments of utility markets from monopoly segments, likewise with social insurance which the market can provide as opposed to state-provided social assistance (or safety-net) for the impoverished minority. The idea that the state must deal with **all** risks to an individual’s economic security is changing. Demographic changes make this an ever more fanciful notion, even in the rich "welfare state" countries of the OECD.

Market and state are therefore complementary. Governments provide the institutional basis for market operation whilst at the same time regulating against the unacceptable face of capitalism by fostering competition, restraining monopoly abuse, protecting consumers and the environment, and of course workers from exploitation. Markets, on the other hand, provide growth and resources for the fundamental services provided by government. But a World Bank survey of over 1,600 firms in 69 countries confirmed that many states have failed to provide an institutional base and are performing their core functions poorly by failing to ensure law and order, protect property, or apply rules predictably. Investors do not consider such states credible. The World Bank survey also revealed a strong correlation between a country's credibility rating and its record of growth and investment. **Figure 2** below refers. As the survey pointed out; "The credibility ratings are based on investors' perceptions. But it is these perceptions that determine investment behaviour." It could have added, "...and subsequent levels of economic growth upon which a state's ultimate security depends."

Fig. 2 : Credibility Levels, Investment and Growth



State Investment in Industry

All states do this to greater or lesser extent, either overtly through direct subsidies or covertly via export credit guarantees, grants to "infant" industries or by indirect support to science, technology or even space projects with potential commercial spin-offs. Basically, state industrial policy and trade promotion are close to zero-sum games in that they tend to be trade-distorting rather than trade-creating. Moreover, they also assume that civil servants can spot commercial "winners" better than private business. Global GDP does not directly increase as a result, but states indulge because other states indulge and distortions might work against them if they do not compete. This is why international economic organisations are needed to level the playing field. Ranged against this argument is the "seed capital" idea whereby the state can get things started and reduce coordination problems when markets are underdeveloped. Many older developed countries also used various means to spur markets in early days. The East Asian miracle economies were prime examples and have (until recently) been paraded as "Exhibit A" evidence in favour of state industrial intervention. Those East Asian states that wean themselves off this particular drug are likely to be those that recover first.

The chief industrial role of the state in transition economies is probably that of divesting itself of poorly performing state enterprises which are a drain on a nation's resources. Some countries, China being the most prominent, have allowed a private sector to grow around the state sector, gradually overtaking it. **Privatisation** has not been a top priority, although the global market paradigm has struck even here and this is now beginning to change. But where the state sector was so pervasive and inefficient to the extent that it impeded overall restructuring and much else, **mass and rapid privatisation** may be the only answer. Ideally, the process should be transparent, should generate broad-based ownership, be acceptable to employees, and must initiate reform of enterprise management. Selling state enterprises can also help to balance state budgets and thereby help with macro-stabilisation, but short-term fiscal considerations should not drive the whole process. In Russia, the now infamous "loans-for-shares" scheme in 1995 got the then government out of a short-term financial hole, but at the cost of allowing a group of favoured banks to diversify into huge industrial holding companies by acquiring, at give-away prices, much of the material and resource wealth of Russia. That this wealth now resides in private rather than state hands could be regarded as positive, but the wider pan-European security benefits that a more prosperous and economically self-confident Russia would bring may not be best served by the fact that the new private hands are so few in number.

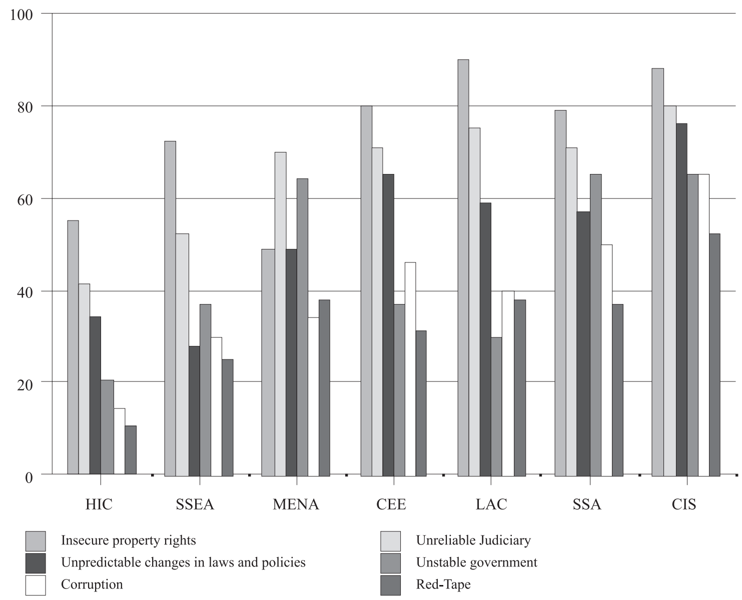
A further issue and concern is the future role of **defence industries** and **military personnel** in transition economies. Much of the technical expertise of the state was invested and still resides within this sector whose product is no longer in large-scale demand. Privatisation is only an option if a buyer can be found. Mass closure is ruled out because of the unemployment and social dislocation it would cause, whilst state-sponsored conversion programmes have a dismal record of success. In a contracting global market, pushing arms exports might preserve production and employment in a few factories, but not in the defence sector overall. Does the state bear any responsibility, moral or otherwise, to intervene in this field, and if so, how?

Reinvigorate State Institutions

The *World Bank Development Report 1997* identifies the key link between policy and action as being a state's **institutional capacity**. Better institutions equals better policy and enforced policy. Corruption thrives when institutions are weak. Building effective institutions is particularly difficult for transition economies where people in government tend to be ill-paid and not organised or properly trained to fulfil new roles. This means changing **attitudes** - a slow and political process involving much more than simply assigning people new responsibilities and paying them a bit more money, although that might help. Unfortunately, powerful interest groups and officials who support and profit from the inefficient status-quo often remain in post, whereas the majority that are ill-served by the status-quo are usually too weak to mobilise for change.

Figure 3 below shows further results from the World Bank survey referred to above. It logs respondents' dissatisfaction with various aspects of the institutional structure and behaviour of government in their respective countries and reveals that, so far as private entrepreneurs and investors are concerned, most governments in most parts of the world lack credibility because they have failed to provide the institutional framework conducive to economic success.

Fig. 3 : Percentage of Survey Respondents Reporting Dissatisfaction With -



Note:
HIC - High income OECD; SSEA - South and south-east Asia; MENA - Middle-East and North Africa; CEE - Central and Eastern Europe; LAC - Latin America and Caribbean; SSA - Sub-Saharan Africa.
"Red-Tape" data is from a separate World Bank survey and records the percentage of firms devoting more than 15% of managers' time to negotiating with officials.

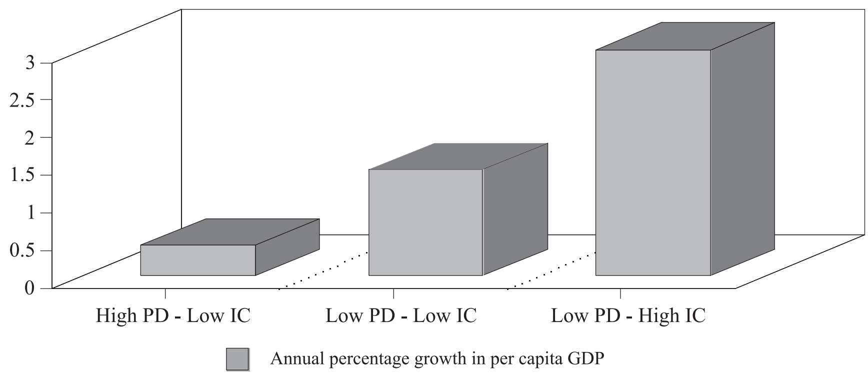
How then can governments improve their performance? Some ideas:

- Good government starts with the **division of power** between the executive, legislative and judicial arms of government. An independent judiciary is especially vital to ensure that the other two arms of state power remain accountable and to interpret and enforce the constitution. Centre, provincial and local levels can also help to devolve power, but unless well-established, multiple levels of decision-making can make it as difficult to change bad laws as to introduce good laws. The problem in transition economies is that legislative and judicial oversight of the executive is weak, thereby creating a chasm between setting policy and the ability to carry it out. The other side of this argument is that without a strong executive, the gap between policy and action grows wider and nothing gets done at all. For an example, witness the slower pace of economic reform in Ukraine compared to Russia over the first half decade of transition.
- A **capable, motivated staff** is the lifeblood of an effective state. Civil servants must be recruited and promoted on merit and well compensated for financially. All established industrial powers used these principles to build modern, professional bureaucracies.
- Telecommunications, transport, energy and power generation are all sectors in which vast efficiency gains have resulted in several industrialised countries following **deregulation** and the introduction of **competition.** Hiving off government supply organisations to the private sector and the introduction of competitive tendering can also bring efficiency gains, even to Ministries of Defence.
- Governments are most effective when they listen to both citizens and business and work in partnership with them. Having good intentions are not enough - officials must know what the needs of their people are. **Democracy** is of course the best established vehicle for collective will to be channelled into government action, although minority concerns can on occasion be steamrollered. In 1974, only 39 states in the World were independent democracies (one in four); today 117 (two in three) use open elections to choose leaders and governments. Democracy at the intermediate (local and/or provincial) level can help to **broaden participation** in government programmes by embedding policy-making in consultative processes. In other words, making the state responsive to its citizens needs.
- An essential adjunct to democracy is of course a **free press**, beholden neither to the state nor powerful interest groups. The key, indeed only, role of the state in the media is to ensure a diversity of ownership and prevent monopoly abuse.

Conclusion

Modern, developed states with professional systems did not emerge overnight. In North America, Europe and Japan, key administrative reforms in response to the same kind of problems that developing countries face today were enacted perhaps 100 years ago and took decades to take root and show positive results. But at least this process proved that **capable states can be built**, even though the process can be lengthy and at times traumatic. Reforms that do not need the overhaul of institutions have tended to come first because they are easier to implement - reforms to further macro-stabilisation and to manage the exchange rate and so on. A dozen good people with political support in key jobs inside the Central Bank and the Finance Ministry may be all that is required. Other reforms of state institutions, the legal system, public services, the military, infrastructure and of industry involve fundamental changes to the way people and institutions behave. If such structural reform is to be successful, it must also involve an end to what may be well established systems of patronage and graft. But changes here are as essential as reforms to achieve macro-stabilisation. Neither can work well or even survive for long without progress with the other. As **Figure 4** - again taken from the *World Bank Development Report 1997*- reveals, sound policy combined with capable institutions leads to better economic performance:

Fig. 4 : Good economic policy and strong institutions equals faster growth



Note:
PD = Policy Distortion - IC = Institutional Capability
Each growth rate is the annual average for a group of countries. Results based on a regression using panel data from 94 industrial and developing countries in period 1964-93.

Finally, governments and leaders in transition and developing economies must **sell reforms to their people**. They must have a clear vision of where the state is going and communicate this by convincing people that the pain of transition will be worth it - that there will in time be far more winners than losers. Above all, policies need to be inclusive because excluded populations or marginalised groups within a population are fertile material for violence and instability. Thus policy must not only ensure growth, but ensure a fair distribution of economic growth. **International economic and security organisations also have an important role to play** (not least by deflecting the blame for transition pain) by helping to sustain reform through critical periods, by giving technical advice, by offering up a wealth of experience, and, especially, by holding out the prospect of membership and the clear economic and security guarantees that this would bring. In short, **confidence-building**. But crucially, **external assistance is futile without domestic will**.