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The World Bank and Governance

The Bank's Efforts to Help Developing Countries Build State Capacity

Alain de Janvry
Jean-Jacques Dethier

The World Bank
Development Economics Department
Research Support Unit
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Abstract

This paper examines historically the World Bank's twin features: lending to developing economies to achieve tangible results and advocating specific development policies. Section 1 provides some conceptual underpinnings for the view that an effective state is essential for development. It asks whether development can be engineered, and state capacity increased, with large aid flows. Section 2 sketches the historical evolution of what characterizes the World Bank: lending to developing economies and advocacy of development policy. It concludes that, while the Bank discourse explicitly recognizes that developing countries need to improve their governance and build the capacity of the public sector to improve living standards, the Bank's performance in assisting governments in building state capacity and achieving better governance outcomes has been disappointing. Section 3 proposes an interpretation of why this has been the case. The interpretation is structural, and related to the way the Bank is organized. This concerns in particular (1) how its research is prioritized and used for decision-making, (2) how its leadership achieves a consensus between shareholders who hold different views on the role of government in the economy, and (3) how incentives for its staff emphasize disbursement and short-term success, and not capacity building and longer-term institutional sustainability.

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The Bank's Efforts to Help Developing Countries Build State Capacity

Alain de Janvry and Jean-Jacques Dethier [1]

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[1] Alain de Janvry (alain@berkeley.edu) is Professor at the University of California, Berkeley, Department of Agricultural and Resource Economics, and Goldman School of Public Policy. Jean-Jacques Dethier (jdethier@worldbank.org) is Research Manager, World Bank and Adjunct Professor, Georgetown University Public Policy Institute. This paper was presented at the Conference on *Using History to Inform Development Policy. The Role of Archives*, organized by the World Bank, Washington, D.C. October 25-26, 2012.

Section 1. An Effective State Is Essential for Development… but Does It Have the Capacity?

The World Bank influences development through its loans or through the policies that it advocates. The Bank has remained *politically* non-partisan in order to have maximum autonomy but advocates specific views on economic and social policy. Bank top management has sought to resist the pressures from its main shareholders, especially the United States, and has tried to be *politically* neutral vis-à-vis its borrowers—it has worked equally well with right wing and left wing governments (from Allende to Pinochet; from Marcos to Aquino; from Somoza to the Sandinistas; and from Idi Amin to Museveni) and with dictatorships and democracies. However, in terms of economic *policy*, it has not been neutral. By examining the historical record, we can obtain a general picture of the policy views it advocates and of how it influence its borrowers. In this paper, our focus is on the role of the state in development.

The World Bank does not make general pronouncements about the policies that it would like its borrowers to pursue; it operates on a loan-by-loan, case-by-case and country-by-country basis.[2] Its effectiveness is based not just on proposing investment projects and policy reforms to developing country governments but in actually assisting them to design and implement those projects and policies to achieve results.

In reviewing policy and project documents throughout the Bank's history, we found that, while the Bank recognizes the importance of the state for development and has recently made efforts to improve country governance, its performance in improving the governance capacity of developing countries has been weak. This weakness has a high cost in terms of Bank effectiveness. We ask what explains this failure in helping countries improve their governance capacity.

The paper has three sections. In the remainder of this introduction, we provide some conceptual underpinnings for the view that an effective state is essential for development. We also ask whether development can be engineered, and state capacity increased, with massive flows of aid and good projects and programs. The central and main section of the paper sketches the historical evolution of the features which are characteristic of the World Bank: its role of institutional lending to developing economies and its role of advocacy of specific economic and social development ideas. We come to the conclusion that the Bank has not been able to bridge the gap between rhetoric and reality. While it has made a lot of progress in terms of the ideas it is propagating—recognizing that countries need to improve their governance and build the capacity of the public sector to make substantive progress on development and improvements in living standards—its successes in terms of results on the ground have been recognizably weak. In the final section of the paper we ask: Why is it the case? And what could the Bank do to enhance its performance in assisting governments to build state capacity and achieve better governance outcomes? We propose an interpretative thesis of why there has been low performance in building state capacity.

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[2] Even the World Development Reports that it has been publishing annually since 1978 do not provide systematic policy summaries but rather deal with specific (generally, sectoral) dimensions of development.

Some of the greatest successes in raising living standards have come about not by altering individuals' choices but by altering decisions made by governments. (Besley 2012)

A proactive and effective state is essential for development: it is needed to create a favorable investment climate and to facilitate poor people's empowerment and their participation in economic life.[3] Governance and public sector management shape both the investment climate and the efficiency of delivery of the basic services that are at the center of the development agenda. Development requires an environment where markets can function and contracts are honored, and the maintenance of macroeconomic stability, infrastructure, defense, financial systems, and sound administrative, legal, and regulatory structures—which are all tasks for a government. The institutional framework of a country—information, property rights, legal systems, financial systems, and so on—should promote the functioning of markets and the welfare of its citizens. Physical infrastructure (public transportation, power, telecomm, and water) and basic public services (particularly in education and health, which are central to empowerment) have a vital influence on the ability of enterprises or farms to operate effectively as well as on the ability of individuals to participate. All these services depend on public action: government must either deliver them directly or create a regulatory and competition framework that channels private sector participation. The responsibilities of a government also include fostering health and education as well as the social, political, and physical environment that helps people participate in the decisions that affect their lives in the economic and social realm. The story of development is not about government getting out of the way, but about getting government to do the right things in the right way.

In both developed and developing countries, there are many examples of governments that have taken on more than they can manage, given their limited administrative capacity to design and implement policy or to provide basic health and education services. These examples, together with weak revenue raising capacity in many countries, have led some to argue that the state in developing countries should be extremely modest in its objectives and scope. There is some basis to this argument, but it must be set against the scale of the development challenge facing developing countries and the extensive range of state actions needed to foster inclusive growth. Developing country policies during the 1990s and 2000s—at least until the Great Recession of 2008—have improved: regulations and the business climate have been more conducive to growth; macroeconomic management has improved, exchange rates have been more stable, trade barriers have been reduced and openness has increased; and inflation, which typically does the greatest harm to poor people, has fallen significantly. At the same time, governance and institutional quality, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA) index, suggests a more sobering picture: there has been some—but little—average progress around the world in improving governance, controlling corruption, and improving institutional quality, with significant variation across countries.[4] The number of

[3] See Stern, Dethier and Rogers (2005).

[4] As discussed later, the CPIA index is composed of 20 variables in four groups: economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions.

countries that are formally democracies may have increased in the world but democratic institutions often do not function effectively.

Given this policy and institutional picture, can development be engineered and state capacity increased with massive flows of aid and good projects and programs—in other words, can the World Bank succeed in its mission of assisting developing countries in raising living standards? It has been calculated that doubling aid would raise the average ratio of aid to GDP to only about 2 percent in developing countries and 8 percent of total investment—but such ratios are much higher for poor countries, particularly in Sub-Saharan Africa, where the issue of using aid effectively is likely to be of greatest concern. There are two main concerns: first, that large aid flows would be macroeconomically disruptive, and second, that institutional constraints and a weak capacity to design and implement policies would prevent recipient countries from using aid well.

The first concern is that increased aid will reduce recipient countries' medium-term fiscal and debt sustainability. Loans, even if provided on concessional terms, can push a country from a marginally sustainable to an unsustainable fiscal position because of the need to make repayments of principal. Aid can also threaten fiscal sustainability if it finances initial investments but saddles governments with the long-term recurrent costs of investment operations. Concerns about fiscal sustainability are mitigated to the extent that additional aid takes the form of grants rather than loans. The precise implications of additional aid for fiscal sustainability are an empirical matter. Another worry is that increased aid will cause an appreciation of the real exchange rate and reduce the recipient country's competitiveness and growth prospects (this is the so-called "Dutch disease").[5]

The second concern is that recipient countries will have insufficient structural and institutional capacity to absorb new aid—that is, their economies might lack "absorptive capacity." Whereas with macroeconomic complications it is the quantity of aid and its allocation between the tradable and nontradable sectors that matter, here the issue is what is often known as the "quality of spending." Most low-income countries suffer from capacity constraints. One problem is that a large increase in aid (relative to the size of the economy) can overwhelm the recipient government's administrative capacity.[6] Public expenditure and financial management weaknesses, governance deficiencies, and infrastructure bottlenecks can further constrain absorptive capacity. Aid is more effective when countries have good policies and institutions because they can also absorb larger amounts of aid before the diminishing returns to aid set in

[5] The real exchange rate is most likely to be a problem if the increase in aid is rapid and large relative to the economy, if aid-induced spending occurs in nontradable sectors, and if the economy's supply-side response is weak. Thus, whether the impact on the real exchange rate is a serious issue needs to be assessed in light of the specifics of the case. Even in cases where the resulting appreciation is likely to be large, the potential Dutch disease effects need to be assessed carefully. Dutch disease alone need not always be a reason to restrain an increase in aid. First, some appreciation may not harm the economy, especially if aid flows are sustainable. Second, any harm from appreciation should be weighed against the benefits—such as the contribution to productivity and growth—resulting from aid-induced spending.

[6] The observed persistent deviation between aid commitments and actual disbursements is at least partly attributable to the administrative and absorptive capacity constraints of recipient countries (Kanbur, Sandler and Morrison 1999).

strongly. In countries with low capacity, the point of diminishing returns arrives much sooner, so additional aid may not be very productive.

Beyond these two issues—macroeconomic stability and absorptive capacity—the main concern is the potential moral hazard of increased aid. Aid could reduce the incentive for recipient governments to undertake painful but necessary reforms, such as restructuring the tax system to raise more revenue. In this way aid could breed extended aid dependence, as argued by P.T. Bauer (1984), Dambisa Moyo (2009) and others. In weak institutional environments with a high risk of corruption, improving public financial management is essential. This may be particularly relevant if assistance takes the form of grants because, compared with loans, grants are often subject to fewer strict fiduciary requirements. Where additional aid is focused on certain sectors, such as education, it will be important to embed it within a coherent overall public spending framework and a supportive sector policy.

How much additional aid can be absorbed? At the country level, aid eventually reaches a saturation point—defined as the point where additional aid has zero marginal effect on growth (though even at the saturation point, grant aid improves welfare if it is simply consumed). Where this saturation point lies (say, at 5, 10, or 15 percent of GDP) depends on the recipient country's policy and institutional environment. The better the institutional environment, the higher will be the saturation point (Collier and Dollar 2002). There is typically considerable scope for expanding aid before reaching the saturation point. One rule of thumb suggested by Paul Collier is that the saturation point is two to three times the CPIA index for each country, measured as a percentage of GDP (Collier and Hoeffler 2002). Research suggests that returns to aid are particularly high in post-conflict countries where the environment has improved a few years after the conflict; in such cases the saturation point may be even higher, at perhaps five times the CPIA index. With CPIA index scores typically around 3, these saturation points are generally much higher than current aid levels.

To conclude, in poor countries, large-scale financial transfers are unlikely to be effective given the limited absorptive capacity of these countries. So what can be done? Broadly, the answer likely includes an intense focus on capacity building, combined with more direct delivery of human development services and humanitarian assistance. Donors should focus on institution building, capacity building, and knowledge transfer to facilitate change. Given the constraints on government capacity, such efforts should concentrate on a reform agenda that is limited, economically sensible (and mindful of sequencing issues) and socio-politically feasible. This capacity building is likely to include support for "good examples" located in developing regions with reform-minded governments. Local governments or nongovernmental organizations (NGOs) may offer the most appropriate arena for these "demonstration" reforms. Only when central governments develop greater capacity, and when early gains demonstrate the benefits of reform, will countries with weak institutions, policies, and governance be able to make better use of large-scale aid.

In these countries there will often be a case for using aid to improve basic health and education services. To be effective, such funding should probably be channeled through entities other than the central government. Some fragile countries or countries in conflict—with urgent needs but limited capacity to make effective use of large-scale development assistance—will require humanitarian aid, such as food aid.

Section 2. The World Bank and the Developmental State

Viewed in a historical perspective, the World Bank has two features which make it unique (Gavin and Rodrik 1995). The first is that it is a public multilateral organization responsible for directing lending toward developing economies. The second characteristic is that it is a source of ideas on economic and social development, a role (which we call "advocacy") that was not anticipated by its founders and which has become increasingly important as the scope of the Bank's activities and its influence over economic policy in borrowing countries has broadened. In this section, we sketch the historical evolution of both features: the World Bank's approach to country assistance and its ideas about the role of the state in development. In trying to find the best way to assist developing countries, the Bank evolved from an organization limiting itself to financing projects for the "productive sectors" of a few developing economies, to a more political organization that also provides grants to a large number of poor countries. It adopted a project-based approach, then moved into policy lending with conditionality, then at the beginning of the 21st century began to adopt a more comprehensive development approach with attention paid to governance. In terms of development ideas, until the early 1960s, the Bank held fairly standard conservative views about what governments should and should not do. During the McNamara years, it adopted a proactive view of the state's role but focused on project lending rather than policy reform. This changed during the 1980s: as it felt pressure to lend for policy to prevent a decline in developing country living standards, it also adopted the view that government failures were characteristic of developing countries and the policy mantra was "getting prices right," a view that was embedded in structural adjustment loans. Since the 1990s, state intervention has gradually recovered its legitimacy—though this global assessment must be nuanced—and the emphasis has been on "creating a favorable business climate" and a healthy dose of skepticism toward industrial policy interventions and even the regulation of major economic sectors.

Project Lending

Very early on, there were heated discussions at the World Bank about the best way to help poor countries in their development. Should the Bank provide loans linked to individual projects or loans linked to a plan of general development? Between 1947 and 1952, Paul Rosenstein-Rodan repeatedly and vigorously opposed the propensity of the institution toward financing individual projects, a choice that was detrimental to more coordinated plans of intervention (Oliver 1975). Specifically, Rosenstein-Rodan maintained that it did not make sense to link a loan to an individual project because funds transferred from the Bank to a country in this manner would end up financing the marginal project that the beneficiary country would have abandoned if it would not have been able to obtain a line of credit from the Bank. These funds were destined to finance a project that the country would have probably accomplished in any case. This is what we call today the issue of fungibility of funds.

On the contrary, supporters of loans linked to individual projects insisted that the Bank had been conceived as an institution that was supposed to disburse precisely that. They quoted the Bank's Articles of Agreement, which state that "loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development."

According to this point of view, the Bank would be able to borrow at reasonable rates on Wall Street and gain the confidence of North American investors (in practice, the only source of money available on international markets in the years following the Second World War) if it remained strictly adherent to this practice. Only individual and well-monitored projects would have been able to assure American financial markets that the loans were administered according to criteria that sustained stable and responsible economic management (Alacevich 2009).

From the 1940s through the 1960s, the Bank tended to be "somewhat to the right of conventional wisdom in regard to the role of government in the economy" (Kapur, Lewis and Webb 1997). That wisdom—shaped by the Great Depression and the New Deal, the Keynesian policy revolution, wartime economic experience in developed countries, and the independence movements and anti-colonialism in developing countries—favored mixed economies that were neither wholly capitalist nor wholly socialist. Public policy was expected to play a leading economic role. In its early days, the Bank needing above all to demonstrate to Wall Street that it was soundly managed, was more conservative than most of its member governments with respect to the appropriate scale of their market interventions and the private-public division of labor. But the conservative bent was limited. When it started to lend to developing economies, the Bank accepted and advocated—and frequently required—national economic planning, in line with conventional economic thinking in Western countries until the late 1960s. Although adapted to particular national circumstances and traditions, the kind of planning that was encouraged typically was comprehensive. Economic planning came into vogue in and for developing countries, and was encouraged by external bilateral and multilateral development promoters. The World Bank dispatched a number of country missions instructed to determine and report on the development needs of developing countries. The first mission, in 1949, to Colombia, was led by Lauchlin Currie, a professor of economics at Harvard who later settled in Colombia. (The story of this foundational mission is described in Alacevich (2009).) The Currie mission was followed by missions to Turkey, Nicaragua, Guatemala, and Cuba in 1950; Iraq, Ceylon, and Mexico in 1951; Jamaica in 1952; British Guiana and Nigeria in 1953; Malaya in 1954; Syria; and Jordan in 1955.

It was clear to Bank staff that a project request depended on the policy environment the project would occupy and, indeed, on the project's place in the country's overall development program. The Bank's project business was growing. But as its country reports accrued, the institution was strongly inclined to inject country policy, more particularly macroeconomic policy, considerations into its loan transactions.

> As the International Bank acquired more experience in development, it has come to realize that the project-by-project approach, even when projects are judged in the light of the general economic situation of the borrowing country, leaves a good deal to be desired. Although projects proposed for external financing may, in relation to the general economic situation, appear to warrant a top priority, their real significance can be understood only in the light of the country's other proposed investments and the resources available to it. For example, if the projects would be carried out even in the absence of a foreign loan and if the investment program includes other projects of doubtful economic merit, the real effect of the foreign loan may be to release funds for uneconomic ventures. (Eugene Black, World Bank President, to William McChesney Martin, Jr., Chairman of the U.S. Federal Reserve System, in 1951, quoted in Kapur, Lewis and Webb, p. 454)

Lending linked to individual projects remains the norm at the World Bank today. Until 1980, only a small fraction of lending was not project based. Program lending only started after 1980 and was originally conceived (under the name "adjustment lending") as a financing vehicle for short-term balance-of-payments support. For example, between 1961 and 1981, one-tenth of International Development Association (IDA) lending (about US$2.9 billion) was not tied to any particular projects. These "program credits" could be disbursed rapidly and were intended to ease severe foreign exchange constraints. They were accompanied by policy advice aimed at improving a country's overall performance (World Bank 1982, p. 54). They were generally linked to the industrialization program of the country. India received about half of the total for 11 industrial import programs.

Poverty and Policy

The creation of IDA in 1960 transformed the nature of the World Bank. Poverty and social objectives became a central concern and development began to be measured not only in terms of rising real gross national product, but also in improved public health, more equitable income distribution, or declining rates of population growth. During the 1960s, Bank officials were preoccupied with strategies to reduce poverty and generally to redistribute income in developing countries so as to reduce the crushing burden of absolute poverty. Since the creation of the Bank, its management and staff have believed that the main force responsible for sustained economic growth is private enterprise, operating through the market. But during the 1960s, Bank employees also promoted the view that the state should play a proactive role, facilitating economic growth and improving well-being. Through its practical experience in many Asian, Latin American and African countries, the Bank has learned that a productive and dynamic private sector does not emerge in a vacuum and that one essential role for the state is to provide the right environment for entrepreneurial activity to flourish—an environment where contracts are honored and markets can function, where basic infrastructure is ensured, and, of particular importance, where poor people are enabled to participate. Without this role, private entrepreneurship may be diverted into rent seeking or other socially unproductive activities.

During the 1970s, the view that growth would not trickle down to the poor became increasingly dominant—and was backed by increasing evidence. One of the first major research efforts to dent the confidence in trickle-down was the 1970 book by Little, Scitovsky and Scott, *Industry and Trade in Some Developing Countries*, which linked excessive protection and limited job creation. In 1974 the World Bank published *Redistribution with Growth. Policies to improve income distribution and employment*, to provide an intellectual rationale for the approach it was taking, using production-oriented loans or social loans to address poverty.

In April 1968, Robert McNamara became the fifth President of the Bank. He achieved an influence unsurpassed by others and radically transformed the institution. Kapur, Lewis and Webb (1997, p. 472) categorize him as "ideologically to the left of his predecessors." He "greatly valued the efficiency of a market mechanism bounded by sensible public policies, was less hostile to public enterprises than earlier presidents, and saw a major role for the state in developing countries." He advocated macroeconomic policy tracks that were similar to the ones the institution had been promoting but, because he had ambitions for the institution he led and was determined to increase the scale and broaden the impact of IBRD and IDA operations, he

was deeply committed to a new regime of country programming in support of this. He was determined to tackle poverty far more aggressively than the Bank had ever before done. He would become determined to find ways to do more for smallholder agriculture and the rural poor. Other subjects on his agenda included population policy, the environment, urban development, and education. He understood the importance of macropolicy reform but, because of his other priorities, it became a second-order goal. The net result was that, for most of the decade (until the landmark years of 1978-1981, the oil shocks and the Thatcher and Reagan policies), "most of the Bank's policy-influencing efforts were upstaged and ineffective," as Kapur, Lewis and Webb (1997, p. 472) put it.

Several factors inhibited the Bank's influence on policy reform. The first was the reorganization of 1972, which created newly empowered regional Vice Presidents. Area managers were told to expand their investment lending radically. The "pressure to lend" was high, managers were burdened with increased lending targets and had strong personal incentives to meet these new goals and little room left for adding policy burdens to their project transactions (Kapur, Lewis and Webb 1997; Weaver 2008). The second were the oil shocks of the 1970s, which had a profound effect on the Bank's evolving possibilities to influence borrowers' policies. As developing countries were hit by these external shocks, the Bank tried to help them find ways to avoid a cessation of their access to foreign exchange and a major decline in their living standards. The typical developing country that was not an oil exporter was faced with balance-of-payments difficulties, accelerating inflation, high food prices, corruption and mismanagement of public enterprises, speculation in the private sector, destabilizing demands by workers for wage increases, and a visible increase of poverty. Often political tension and racial strife made domestic resolutions of conflict difficult. Most developing countries experienced a large imbalance between aggregate income (generated by factors of production in the economy or borrowed abroad) and aggregate expenditure in the economy, as reflected in the deficit of the current account of the balance of payments. Many countries then entered in crisis when they ran out of foreign reserves and found themselves unable to secure funds from abroad due to reluctance on the part of foreign commercial banks to increase their lending. Under such difficult circumstances, governments were required to take hard political and economic choices and strong measures to stabilize the economy externally and internally.

Inhibited from pressing a policy-influencing campaign in the 1970s, the Bank nevertheless further readied three components that would contribute to such a campaign in the 1980s: economic and sector work (ESW), country program papers (CPPs), and program lending. With the 1972 reorganization's emphasis on country programming and the augmentation of region and country-specific economic staffs, ESW was stepped up markedly. In retrospect, the Bank gave the activity high marks:

> Some of IDA's most important contributions to development have been made through the discussions it has with governments on a broad range of policy issues. Considerable time is spent on general economic and sector work before any actual project lending takes place. Economic reports survey macroeconomic conditions and the main sectors—agriculture, industry, and energy. They tend to study the key issues of investment and savings; public finances; the balance of payments, particularly the performance of exports; and overall prospects for growth. They act as the starting point for discussions with governments on the nature and severity of their development constraints, and on the policies and resources needed to overcome them. Sector reports go into more detail on sectoral developments—specific bottlenecks, investment programs,

> and government policies—and set the stage for project identification. These reports are valued not only by the borrowing country but also by other donors and institutions, since they are usually the most comprehensive and up-to-date assessment of the country's economic prospects and development strategy. The fact that detailed reports are produced periodically for each country underlines IDA's belief that each economy is unique and changing. While IDA recognizes that every government has its own economic philosophy and is free to choose its own development goals, it does point out distortions and inefficiencies that hinder resource mobilization. Macroeconomic and sectoral policies are naturally interrelated, and they often have a direct bearing on the success or failure of individual projects. It is difficult to sustain a good project in an unfavorable environment. Furthermore, fruitful policy dialogue can do more to influence a country's development than even a series of good projects. (World Bank, IDA in Retrospect, 1982)

Adjustment Lending and Conditionality

The World Bank was forced to enter the business of policy advice in large part because of the environment in which its projects were operating (Gavin and Rodrik 1995). Borrowing countries sorely lacked the technical expertise needed to prepare project applications, so Bank staff ended up doing the work for them. In addition, the Bank had to be concerned about the repayability of the loans it was making, and the notion of sovereign creditworthiness required serious thinking. Finally, early on, the Bank recognized that the soundness of the projects to which it was lending hard currency ultimately rested on the overall quality of policy and policy-makers. Hence, the Bank was required from the very beginning to have ideas about what constituted an appropriate policy context. This policy context was initially construed quite narrowly, but its scope broadened substantially over time to matters as diverse as irrigation water pricing, energy subsidies, payments for road construction, transfers to local governments, onlending to state-owned banks, etc. To the Bank's early concern with balanced budgets, sound tax systems, and monetary stability, the need for national development plans was added in the 1950s. The Bank began to stress the role of the private sector during the 1960s, and of rural development and population policies in the 1970s (Gavin and Rodrik 1995). In order to ensure that projects were viable, project legal documents imposed certain conditions regarding tax and price policy, subsidies and other policies but, as the documents of the internal evaluation office (OED) showed, for sovereignty reasons, conditionality could only go so far. Moreover, the scope of the Bank’s action was limited to the project area and policies, as a rule, are national in nature.

The decade of the 1980s saw the rise of adjustment lending, a form of financing that provides short-term support to the balance of payments conditional on policy reforms. This conditionality was linked to the then-dominant approach to economic policy that emphasized fiscal discipline, openness to trade, protection of property rights, market-determined exchange and interest rates, liberalization, privatization, and redirection of public spending toward education, health, and public infrastructure—an approach that would later be dubbed the “Washington consensus.”

The neoliberal counterrevolution had taken hold. Where the planners saw market failure, the neoliberals saw massive government failure, and their response was to move developing-country economies toward unregulated markets. “Getting prices right” was the mantra—an important corrective to the planning ideas, but equally incomplete as an approach to development. These competing ideologies continued to drive decision-making in many countries even after deeper economic analysis and extensive evidence undermined their credibility. The polarization of

development debates, which put a premium on ideology but not on rigorous policy analysis, did little to further the cause of poverty reduction. With the dogma of the market came an insistence on "mono-causal" explanations of development. This led to one-size-fits-all policy approaches, as the general models left little room for actual conditions. The "Washington Consensus" formulated at the beginning of the 1990s is one of those approaches. Its list of preconditions for growth encapsulated many neoliberal precepts in what was often interpreted as a neat recipe for development. Perhaps unfairly, that consensus came to stand for a package of measures aimed largely at getting the government out of the economy—and it was applied with excessive uniformity across countries.

Poverty considerations were set aside during the "adjustment years." The neoliberal perspective that dominated the 1980s considered that growth was all that really mattered for welfare outcomes, and that poverty and inequality would take care of themselves. Proponents of that view downplayed distribution and poverty, and insisted on re-establishing market mechanisms to promote economic growth. At the Bank, funding for research on poverty and income distribution peaked in 1975, then declined considerably, reaching almost zero between 1980 and 1985.

Program lending evolved to become an important developmental instrument for supporting social, structural and sector reforms. During the 1980s, program credits became much more systematic and the transfer of resources from IDA and IBRD became more coordinated with International Monetary Fund (IMF) standby agreements. The Board of Directors approved 191 adjustment operations in 64 IDA countries for $27 billion in the 1980s, or 8 percent of total operations (2,357) and 17 percent of total Bank lending ($156 billion). During the 1990s, adjustment lending increased to 346 operations for $72 billion in 98 IDA countries, or 13 percent of total operations (2,667) and 29 percent of total lending ($245 billion).

The share of adjustment lending in total Bank lending averaged 23 percent in 1990-1997. In terms of the number of operations, the share remained well below 25 percent. The approach to adjustment lending evolved over the 1980s and 1990s. During the early 1980s, structural adjustment loans (SALs) were supplemented by sector adjustment loans (SECALs). There have been roughly equal numbers of SALs (255) and SECALs (233). Subnational adjustment loans (SNALs)—in support of social and structural reforms at the regional or state level in large federal countries like India or Brazil—started in the late 1990s. When emerging markets were buffeted by the East Asia crisis, the Bank introduced special structural adjustment loans (SSALs) for countries with exceptional financing needs. Argentina and Brazil received financing to help them to maintain the reform momentum and safety net protection in the face of major external capital market shocks. Finally, in 2000, the Bank introduced programmatic adjustment loans and credits (PSALs/PSACs) to support medium-term reforms, a series of annual operations under a unifying multiyear framework of policy and institutional reform. These PSALs/PSACs are supposed to provide integrated and sustained Bank support for government reform programs, including institutional reforms and capacity building. They involve incremental phasing and close monitoring of progress.

When adjustment lending emerged in the 1980s, it filled a real need: it represented a major transfer of resources essential to avoid a massive decline in living standards in countries affected by major external shocks. But the results it generated were mixed. On the one hand, there was an

improvement in developing countries' policies. Better macroeconomic policies and greater openness have improved the economic environments of these countries. Inflation fell significantly during the 1990s, macroeconomic management improved, exchange rates were more stable, and trade barriers were reduced. But on the other hand, there was little progress in governance, controlling corruption, and the quality of institutions worldwide—as measured for instance by the governance component of the World Bank's CPIA index—and significant variation across countries. As a result, adjustment was, by and large, a failure. None of the top 20 recipients of repeated adjustment lending over 1980-99 were able to achieve reasonable growth and contain all policy distortions (Easterly 1985). About half of the adjustment loan recipients showed severe macroeconomic distortions regardless of cumulative adjustment loans. Adjustment lending has almost no positive effect on economic growth and little on living standards. This is a conclusion reached by several internal World Bank (OPCS) reports.[7]

Despite good intentions, adjustment lending by the World Bank does not have a good record. To be sure, it includes a number of success stories. But it also includes cases where adjustment programs were misguided or simply not followed. Heavy reliance on conditionality was usually ineffective in the sense that a large number of conditions did nothing to strengthen borrower "ownership" of the reforms. While the focus on improving poor policies was understandable, the design of adjustment programs paid inadequate attention to governance and institutional problems, which were major constraints on the investment climate. Moreover, there was little emphasis on mitigating the social costs of adjustment and even less on equity issues. This lack of specific attention to poverty issues, understandably, attracted heavy criticism.

Although conditionality can support policy changes, it cannot persuade reluctant reformers. The number and frequency of conditions attached to adjustment loans and standby agreements from international financial institutions have little to do with successful policy reforms. Case studies have shown that effective policy reform generally emerges from domestic political consensus—and conditionality from donors does not help, and sometimes hurts, consensus building. There can be exceptions in the cases of ''stroke-of-the-pen'' reforms, such as exchange rate adjustments, where only a small number of decision makers need to be convinced of the benefits of a policy change. But even in these cases, policy reforms risk reversal if they do not command broad support.

The Importance of Institutions

The neoliberal "get prices right" view of the world persisted until the early 1990s as World Bank economists struggled to provide useful advice to post-communist transition countries such as Poland, Hungary, the former Soviet Union and China—a group of countries with characteristics that were fundamentally different from those of developing countries. It soon became clear that economists did not have ready-made answer to the problems of transition economies and this helped the evolution of ideas about development. Thankfully, positive progress was made in at least three areas throughout the 1990s and 2000s. First, institutions and the political economy of

[7] See Adjustment Lending Retrospective, June 15, 2001; Review of World Bank Conditionality, September 2005; Conditionality in Development Policy Lending, November 15, 2007; and Development Policy Lending Retrospective, October 27, 2009.

development were “rediscovered” by economists and integrated in their analyses. Second, one-size-fits-all policy advice was abandoned and policy advice became more country-specific, an evolution that was possible by better models and better empirical tools. Third, thanks to advances in economic research, economic views of the links between poverty and growth became more sophisticated.

The development community gradually moved beyond the twin dogmas of pervasive state control (1960s–1970s) and unregulated markets (1980s–early 1990s). The latter half of the decade witnessed the gradual consolidation of a consensus that states and markets are in fact complementary. Private enterprise operating through the market is the main engine of sustained economic growth. But keeping that engine running and ensuring that it powers poverty reduction require a state that is active in two key areas. First, government needs to ensure that the business climate is conducive to growth. Second, government needs to invest in and empower its people, particularly poor people who might otherwise be excluded, through education, health, social protection, and mechanisms for encouraging voice and participation. Without broad participation and more human capital, growth is unlikely to be fast and sustainable—because excluding large parts of society wastes potentially productive resources and breeds social conflict.

Common sense tells us that no one approach will work everywhere, since the binding constraints to development are unlikely to be the same across countries. Development economics caught up with this view. Even under the simpler earlier models, outcomes of policies depended on the parameters assumed for a given country. The case for country specificity received a boost in the late 1980s and 1990s, as a flowering of theoretical work on new multiple-equilibrium and endogenous-growth models emphasized initial conditions. Take trade restrictions and import-substituting industrialization. The new pragmatic consensus now justifiably advocates more liberal trade regimes for most countries—but recognizes that the costs of following an import-substitution industrialization strategy varied with the country’s characteristics. In large economies with access to foreign technology and equipment, competition and economies of scale moderated the inefficiency cost of trade restrictions. At least in earlier decades, India, China, and Brazil were able to develop manufacturing with fairly closed domestic economies, and some became internationally competitive. But in small countries such as Jamaica, Sri Lanka, and Uruguay in the 1960s and 1970s, the market was too small, and any benefits of inward-looking industrialization were swamped by the costs. Sri Lanka began to grow only after it turned toward export-oriented policies in 1977.

Institutional variation also shapes policy outcomes. In Japan during the Meiji period, and more recently in Korea, public institutions narrowed interest-group pressures, at least enough that they did not block development. Public enterprises were run efficiently and built capacity in sectors that paved the way for private investment. Although governments played a role in allocating credit and foreign exchange, they did so more heavily on the basis of performance than is typical in other countries. But in Bolivia, Zambia, and other countries, where public enterprises and allocations were captured and used for patronage, the same strategies undermined industrialization. Country specificity means that the key is addressing the binding constraints for growth at the right time in the right way, not adopting any one-size-fits-all policy packages. Identifying the most binding constraints and the best policy mechanisms to overcome them certainly is not obvious, putting a premium on sound analysis and the ability to experiment.

In the late 1990s a preoccupation with the role of institutions and governance became dominant. The core ideas behind this new thinking is as follows. Institutions, laws and decisions made by public officials — policies and regulations — define incentives for economic agents and affect the allocation of investment and public expenditure (Dethier 1999). Weak institutions are not only a burden on citizens—they also act as a brake on economic growth by undermining incentives in the private sector. Businesses in poor countries face much larger regulatory burdens than those in rich countries. They face three times the administrative costs, and nearly twice as many bureaucratic procedures and longer delays. And they have fewer than half the protections of property rights of rich countries. Most of these failings do not show up on standard macroeconomic measures of performance, yet they are inimical to development. Societies with weak institutions have not developed the basis for complex economic interactions; they have neither the software nor the hardware for development. The result is dysfunctional markets, weak competitive pressures, and private sectors dependent on government cronyism and corruption. Incentives are misaligned, so that entrepreneurial individuals "invest" their time and resources in competing for rents from the political system. Social norms form around clientelism, rent-seeking, and factional competition, rather than social cohesion and progress. These destructive norms become rational for the individual, despite their negative collective effect, and they often prove difficult to unravel. The breakdown in governance, erosion of institutions, and collapse of social cohesion are typically associated with a radical decline in living standards and rise in inequality—as experienced by low-income countries. Heavy regulation and weak property rights exclude the poor from doing business.

The behavior of interest groups competing for particular rights (economic advantages) according to the rules of established political institutions define the political system. Political decisions are translated into policy and action by the administrative system, with a hierarchy of agents acting on behalf of principals. Public governance is thus characterized by agency structures. Political actors enter into conflict with their agents, who have advantages in terms of information or action concerning the operation of government. Changes in economic interests, protected by the legal system, will induce changes in the political structure. Institutional changes and the lowering of transaction costs may be to the disadvantage of some groups and affect the distribution of rights and welfare in the society, prompting these groups to react—in typical feedback fashion, and with an effectiveness that is a function of their power in society—and clamor for changes in their rights (Haavelmo 1989).

Influential papers by Hall and Jones (1999), Acemoglu, Johnson, and Robinson (2001) and others show that institutions and policies determine the economic environment within which individuals and firms operate. While physical and human capital and policies are "proximate" determinants of growth, institutions are "fundamental" determinants (Acemoglu 2009). The literature on institutions and governance at a time of great disappointment with indiscriminate lending to low-income countries (regardless of whether they were willing to carry out reforms) had a strong influence on development assistance. Indirectly, it had the effect of shifting development resources from countries with poor policies, institutions, and governance to those with better environments for growth. (See the discussion of selectivity in the next section.)

In the 1990s, there were also renewed efforts to focus on poverty reduction. The understanding of poverty broadened from a narrow focus on income and consumption to a more complex vision of the linkages between growth and poverty reduction. Richer countries tend to have better social

indicators. From this fact, the World Bank drew the conclusion that human development promotes income growth and income-poverty reduction. (Not all economists share this view.) The emphasis on poverty in the 1990s was not new but what was new was the articulation of a more complete strategy, combining growth with delivering social services (education, health and social protection) to the poor. In other words, it was the recognition that it was not growth alone that would do it—which was implicitly the view of the 1980s. This new formulation was enshrined in the 1990 World Development Report on Poverty, which included the first standardized global estimates of the prevalence of poverty, and by a shift in the institution's emphasis. A decade later, the Bank took stock of the progress made with the 2000 World Development Report called Attacking Poverty, and the 2006 World Development Report analyzes the relationship between equity and development. Moving beyond the issue of poverty, it presents evidence on inequality of opportunity both within and between countries. It also demonstrates that inequalities are wasteful and inimical to sustainable development and poverty reduction, and makes the case for government investment in people, expanding access to justice, land, and infrastructure, and promoting fairness in markets.

Selectivity and Performance-Based Allocation

The Bank's interest in the quality of government began in the mid-1980s with a relatively narrow focus on the fiscal impact of unrestrained public sector wage bills. Over this period, structural adjustment programs, particularly in Africa, drove pay and employment reforms that sought to reduce wage bills, decompress wage ratios, downsize bloated civil services, and rationalize ministries and agencies. However, the short time horizon and supply-driven nature of adjustment lending were ill-suited to the goals of sustainable performance improvement in the public sector. In some cases, investment lending was also used to support institutional development. These efforts were hampered by the limited flexibility of the traditional project instrument. Bank support to the Africa Capacity Development Foundation, starting in 1991, attempted to bolster regional initiatives. Overall, these early efforts produced mixed results.

Evaluations of these initial actions stressed the importance of addressing the root causes of poor public sector performance—that is, poor governance. Independent and self-evaluations pointed to the political costs and long gestation period of bureaucratic reforms, as well as the need for better country knowledge and more flexible aid instruments to support institutional change (IEG 1999 and 2008). These reviews also pointed to governance or the exercise of public authority—not only institutional capacity or formal structures—as a key determinant of public sector performance. During this period, by clarifying the legal basis for its involvement in governance issues, the Bank set the stage for an expansion of support for institutional capacity building (Levy and Kpundeh 2004, Thomas 2007).

The evidence that project-specific aid is fungible across sectors, and that projects achieve much less development than previously thought, was overwhelming (Feyzioglu, Swaroop and Zhu 1998; Mu and van de Walle 2007). Fungibility means that a $100 million primary education project does not necessarily translate into a $100 million increase in primary education spending by the recipient country. If the government would have built the primary schools anyway, then the $100 million in aid effectively financed other parts of the government budget. In general,

when a donor provides aid for investment in a sector, much of it is passed through as investment in other sectors, as non-investment public spending, or as a reduction in tax revenues.

Starting in the late 1980s, the idea of selectivity began to take shape. In 1998 the Bank published *Assessing Aid: What Works, What Doesn't, and Why*, which turned out to be influential, arguing that foreign aid would have a greater impact on poverty reduction if it were focused on poor countries with stronger economic institutions and policies.[8] A second major advance has been the recognition that successful development assistance requires a conducive political economy in the recipient country. The failure of many structural adjustment programs in the 1980s, whether because of flawed design or poor implementation, underlined the country ownership of reforms. Empirical evidence suggested strongly that conditions on loans—that is, promises of future reforms—were far less reliable as guides to the borrower's reform commitment than past actions. As a result, the extensive use of conditionality fell out of favor with development thinkers. New studies provided evidence that aid was highly fungible: foreign aid to one sector often had the effect of financing investments in another sector on the margin, because the recipient government could redeploy its own resources from the first sector to the second, undermining the intent of the donor. For development assistance to make a positive contribution, therefore, it was necessary that the broader public expenditure program be consistent with development aims. It no longer sufficed to ensure that a single project was well designed and implemented.

The question of the appropriate or reasonable basis for allocating scarce concessional aid resources has been raised at each IDA replenishment negotiation (Denizer, Dethier and Gelb 2011). The Bank's approach has evolved considerably over time. Initially the allocation of IDA funds was needs-based—with needs proxied by income per capita and population in 1960. To counter the politicization of aid during the Cold War, IDA first introduced selectivity to inter-country allocations in its allocation system. At the end of the Cold War, during its 12th replenishment negotiations, IDA took the conscious political decision to give more prominence to governance ratings.

Today the performance-based allocation system uses Country Performance Ratings (CPR) based on the Country Policy and Institutional Assessment (CPIA)—which is an annual assessment of policies and institutions by IDA and IBRD country teams along 16 criteria grouped into four clusters. The cluster that measure governance accounts for 68 percent of the weight and the other three clusters—macro management, structural policies, and social policies—have a weight of 24 percent of the total; and an assessment of portfolio performance also enters into the formula with a weight of 8 percent.[9] IDA attempts to balance needs and performance with a complex formula.[10] However there are also exceptional allocations for post-conflict countries, debt sustainability, regional projects, arrears clearance, and re-engaging countries. In conclusion,

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[8] There is a vast empirical literature on this topic, with no clear conclusions (for reviews, see Dethier 2008b or Arndt, Jones and Tarp 2009). Some researchers have challenged the robustness of these results (Hansen and Tarp 2001, Easterly and Levine 2003, and Rajan and Subramanian 2008). Some studies tend to find a beneficial effect of aid, differing primarily on how much the beneficial results depend on the environment, especially over a longer period (Minoiu and Reddy, 2009). Case-study evidence seems more consistent with the *Assessing Aid* argument. Empirical work based on cross-country data remains work in progress (Temple 2010; Arndt, Jones and Tarp 2011).

[9] The weight of the portfolio implementation experience was increased at the time of IDA12 in recognition of its relevance to the aim of allocating IDA funds where they may be expected to be used most effectively.

[10] The Country Performance Rating is raised to its 5th power and multiplied with population and GDP per capita raised to a negative power (-0.125) to direct more IDA resources to its poorer members out of equity considerations.

allocations are highly selective and countries with high scores can expect to receive six to seven times the per capita allocation of low-scoring countries (World Bank 2001).

The quality of governance in a country is a proxy for its ability to effectively use additional funding, or absorptive capacity, as mentioned in the report *Enhancing IDA's Performance Based Allocation System*, which was prepared for the IDA-13 replenishment negotiations. The IDA-12 discussions had centered on the sharply reduced absorptive capacity of a number of countries in which a minimal level of governance was lacking. IDA-12 introduced a governance discount on the overall rating, based on the country's performance with respect to seven governance criteria (six are part of the CPIA6 and the remaining one, which concerns the procurement process, is part of the Annual Report on Portfolio Performance). [11] Donors and IDA Deputies later expressed satisfaction that the governance discount mechanism had achieved three objectives: signaling concerns about weak governance; making governance a key focus of country dialogue and policy reform; and sharply reducing the allocation of funds in cases of weak governance, where there was a significant risk that IDA resources would not be effectively used. As a result, the ratio of average per capita allocations to countries in the top and bottom quintiles was nearly doubled, from 2.3 when the original rating was used, to 4.2 when the governance discount was applied.

Both the changing thinking on development and political factors affected the evolution of the performance-based allocation system. Initial allocations were based on "needs" for capital and savings in poor countries (emphasized by two-gap models) while later allocations were affected by factors related to governance. This is in line with recent academic research that emphasizes institutional development. However the system can be criticized on several fronts. There is no empirical grounding, for example, for the weights attached to its clusters or for the overweighting of its governance cluster, which was a political decision. Ratings along the 16 criteria of the CPIA have also been criticized as subjective and it is clear that performance-based allocation is not a perfect rationing mechanism. It nevertheless is a transparent system: IDA's performance-based allocation has been rated the most transparent by external agencies and academic researchers.

Budget Support

The country assistance model of the Bank was increasingly being questioned. Drawing the lessons of years of project-based lending led to changes in the Bank's operational approach. Two major trends are discernible. First, there is an increasing emphasis on governance (discussed in the next section). Second, there is a clear trend toward greater budget support at the expense of project aid arising from the recognition that there is fungibility and a clear bureaucratic preference for large disbursements. As Knack (2007) points out, there is very little research on the desirability of one versus the other, in different environments—in particular in countries with strong or weak public expenditure management systems. An argument for more budget support is the tendency of project-based aid to undermine the capacity and accountability of government

[11] The discount works as follows: criteria are rated on a scale from 1 (low) to 6 (high). If three or more of the seven governance criteria are rated 2.0 or lower, a governance discount of one-third is applied to the country's overall IDA Performance Rating. Since the allocation formula more or less squares the performance rating, the allocation impact of the discount is even greater, reducing the country allocation by some 50 percent (Denizer, Dethier and Gelb 2011).

institutions. Yet evidence suggests that the move toward budget support is accompanied by greater donor intrusiveness on the composition of the budget (Dethier 2008b). As donors and recipients gain more experience with budget support, they may learn more about its potential deficiencies, as they have with project-based aid.

The use of conditionality fell significantly starting in the late 1980s, and conditionality's content shifted from short-term economic adjustments to institutional reforms in social sectors and public sector governance. The World Bank (as well as the IMF) reduced the number of conditions attached to loans to developing countries—while it increased the emphasis on "country ownership [of its policy reforms]" and jointly monitorable results. There was also a change in the language: development policy lending replaced adjustment lending in 2004. The overhaul reflected the need for streamlining conditionality and the Bank's acknowledgement that there is no single blueprint for reform that will work in all countries. The shift by donors toward ex post conditionality—that is, aid based on jointly monitored results rather than promises—is a simple recognition of what they have learned from the political economy of reform, especially in former socialist economies in transition.[12] Domestic ownership (and domestic leadership) is essential. Successful reforms are those where government officials know what they want. They would carry out the reform with or without donors.

Budget support is a method of financing the budget through a transfer of non-earmarked resources from IDA (or other donor agencies) to the recipient government's national treasury. This is contrasted with project approaches in which aid is tied to the creation of discrete development projects or the provision of specific technical assistance services, often undertaken outside regular budgetary systems. It is a direct consequence of the findings from the economic literature concerning fungibility. The share of budget support in total aid commitments is between 5 and 7 percent of total official development assistance (ODA) today. By contrast, the other form of fast-disbursing aid, which is sector program support (i.e., aid contributions to a defined sector such as agriculture, education or transport), has increased greatly—e.g., it nearly tripled between 2003 and 2004. Low-income countries received the lion's share (63 percent) of total general budget and sector program support. And, during 2001-2004, low-income countries were the main beneficiaries of commitments for debt relief, which from a macroeconomic point of view is akin to fast-disbursing ODA (Development Committee 2007).

Governance and State Capacity

The failure of structural adjustment programs and the lessons of the past were internalized by putting more emphasis on governance. The Bank's engagement in governance evolved through three stages: (i) between the mid-1980s and the mid-1990s, the institution focused increasingly on the quality of government; (ii) from the mid-1990s through the mid-2000s, governance emerged as a key pillar of poverty reduction; and (iii) since 2007, anti-corruption has been established as an overarching corporate strategy (Thomas 2007, Weaver 2008, IEG 2011). At each stage, the Bank has sought to adapt to historical events and respond to specific issues that have emerged from its relationships with countries.

[12] See the references cited in the 1996 World Development Report, *From Plan to Market* (directed by Alan Gelb).

The emphasis on governance was facilitated by the fact that the Cold War had ended so that dictatorial regimes did not need to be supported politically and economically for foreign policy reasons. Until the early 1990s, the United States and its allies had refrained from scrutinizing the governance failings of proxy states, for fear of undermining what they saw as the bulwark against communist expansion. But with the demise of the Soviet Union, both donor countries and aid recipients decried poor governance as a hindrance to development. The transition in the economies of Eastern Europe and the former Soviet Union in the 1990s—which was far more difficult than many observers had expected—underlined the great importance of the institutional foundations for markets and good policy. The East Asian financial crisis of 1997–98 showed that, even where policies had supported rapid growth and poverty reduction, weaknesses in institutional and governance foundations could threaten the whole edifice of development progress.

The Bank's governance agenda also reflects its attempts to satisfy competing interests. The governance agenda has been shaped by the Bank's shareholders and groups of external stakeholders in civil society, such as Transparency International. The latter have increasingly voiced strongly-held views that the Bank should do more, not less, in support of good governance. Others have called for restraint, particularly in light of the limited success of governance-related efforts. The Bank's approach also sought to respond to client country concerns that how this has worked (that is, its choice of aid modalities) could itself help or hinder governance prospects in aid-dependent countries.

These events converged with new insights on the role of institutions in economic development—as described in the previous section. The evidence linking dismal growth and poverty to corruption, waste, and authoritarian practices in government was overwhelming. For example, as early as 1983, in a comparative study surveying the experience of 40 developing countries, Reynolds wrote that "the single most important explanatory variable [of development] is political organization and the administrative competence of government" (Lin and Nugent 1995, p.2333). The contributions of Douglass North and Oliver Williamson, and the literature on reform and political economy (e.g. Drazen; Roland; Persson and Tabellini) gave this new field a solid basis. A good summary of this vast economic literature on institutions that has profoundly influenced World Bank thinking is the best-seller by Acemoglu and Robinson, *Why Nations Fail* (2012). In addition, evaluative work by IEG and others have helped identify lessons, which—with varying degrees of success—have influenced the direction of Bank work.

In the mid-1990s, the Bank committed itself to tackling the "cancer of corruption" in its own projects and in its support for country efforts to promote good governance. It launched a strategy to help countries combat corruption and announced a zero tolerance policy with regard to fraud and corruption in its projects. The Bank also embarked on a significant policy research agenda. For instance, a series of World Development Reports noted the importance of institutions, capacity, and governance for public service delivery, the investment climate, and poverty reduction. The Asian financial crisis and greater attention to the problems of conflict-affected states further validated the Bank's interest in helping develop market and state institutions.

The traditional Public Expenditure Reviews done by Bank staff were expanded to include institutional issues, such as the policy formulation process or the independence of national audit

offices. Detailed assessments such as the Country Procurement Assessment Review (CPAR) and the Country Financial Accountability Assessment (CFAA) became "core diagnostic" work for IDA.[13] In some cases IDA undertook governance reviews, and teamed up with other development partners in the preparation of Public Expenditure Framework Assessments (PEFA), a benchmarking exercise for public resource and budget management that is comparable across countries. About half of all conditions in Poverty Reduction Support Credits (PRSCs)—conditionality but with another name—are governance-related measures. New research has also pointed out the importance of legal frameworks and enforcement issues for which the World Bank had no direct instruments. As noted by Deaton, "reforming governance and institutions is a much taller order than building a water delivery system or even a petrochemical plant." A successful transition to sound governance would need to originate from within countries and governance-related reforms represent a frontier area for the World Bank.

In 1998, the Comprehensive Development Framework (CDF), which governs the development of these strategies and was introduced by Jim Wolfensohn, was presented to the Board of Executive Directors.[14] Since then, projects are required to carry out national poverty-reduction strategies. In 2001, the World Bank and IMF boards adopted the Poverty Reduction Strategy Process (PRSP), a vehicle for integrating development efforts across sectors and development partners. It has become the key to access by low-income countries to expanded debt relief, and concessional funding by IDA and by the IMF's Poverty Reduction and Growth Facility (PRGF). Major bilateral donors have also shifted from stand-alone projects to multiyear, multidonor projects and programs with the flexibility to direct resources toward reforms across the economy.

The PRSP, while continuing the tradition of structural adjustment, represents a move away from excessive conditionality. Because of selectivity, World Bank assistance is more focused on "willing reformers" articulating a development vision through the PRSP; these are poor countries with relatively good institutions and policies. The process has been hailed by DAC donors as an advance on previous aid-delivery mechanisms for three reasons.[15] First, it is supposed to be country owned. Each strategy is developed by the government of the recipient country (with heavy assistance from World Bank staff) and the strategy paper is discussed by political parties and major groups in society through a participatory process. Second, it is supposed to be a vehicle for coordination and harmonization among donors and reduces the costs of donor fragmentation. Actually, while it is true that there is a real effort on the part of donors to coordinate, aid is so poorly coordinated that *The Economist* calls OECD donors the "non-aligned movement" (Dethier 2008b). Third, the PRSP provides aid with a consistent policy framework and represents a move away from project-based assistance. Countries that have a demonstrated

[13] IDA requires a "minimum package" of economic reporting for IDA countries including Public Expenditure Reviews and CFAAs. The latter was formally designated as an "economic and sector work" (ESW) product of the World Bank in July 2000. This caused an increase in the share of budget-related and fiduciary work. The fact that some IDA countries were also Highly Indebted (HIPC) countries also played a role in this increase since donors wanted to know where the debt relief was going.

[14] The Comprehensive Development Framework spells out four principles. (1) Development strategies should be comprehensive and shaped by a long-term vision. (2) Each country should devise and direct its own development agenda based on citizen participation. (3) Governments, donors, civil society, the private sector and other stakeholders should work together in partnership led by recipient countries to carry out development strategies. (4) Development performance should be evaluated on the basis of measurable results.

[15] DAC is the OECD Development Assistance Committee.

track record of serious economic reforms can receive aid in the form of direct budget support (through Poverty Reduction Support Credits and the like). For accountability purposes, the PRSP identifies clear targets for results and monitors progress toward them. In 2012, the PRSPs for 12 countries (Laos and 11 African countries) were being approved by the Boards of the Bank and the IMF; in 2011 only 5; in 2010 12; and in 2009 18. As of 2007, 62 countries had implemented PRSPs and a third of those were on their second PRSPs.

The change to a more country-owned process has not been trivial. Even though the fact that the government "owns" its strategy and that donors "own" their independent assessments of the strategy (and resulting aid allocations) are two notionally separate issues, in practice, power relationships and local chemistry determine how much one actually influences the other. As long as a transaction has a lender and a borrower, conditionality is inevitable to ensure its enforcement (Kapur 2004). Conditionality as it was applied in the 1980s and 1990s was excessive and failed to deliver results—but it is still early to say whether the new conditionality used since the advent of the PRSP, which is explicitly aimed at making development progress, actually delivers results. Current policies increasingly amount to a three-track system, as argued by Bourguignon and Sundberg (2007). Countries with good governance and good policies receive budget support; intermediate countries face something resembling traditional conditionality, but with greater emphasis on governance and performance; and fragile states are aided through a combination of humanitarian assistance and aid that bypasses the state, for example, by allocation to NGOs.[16]

In 2000, the Bank presented a strategy, *Reforming Public Institutions and Strengthening Governance*, to help strengthen core public institutions such as civil service and public financial management systems, regulatory bodies, the judiciary, and local governments. It also proposed a menu of products to support public sector reforms, e.g., more programmatic lending instruments, new tools for measuring institutional quality, and participatory processes to help reform constituencies (World Bank 2000b).[17] The strategy was also meant to strengthen the Bank's internal organization and skills base. The Bank's work on governance increased sizeably. Support for governance and public sector reform grew as a share of total Bank lending, to more than 25 percent of total Bank lending in volume terms starting in FY99, and reached 35 percent in FY02.[18] This trend was sustained for more than a decade until it was eclipsed by significant crisis-response lending in 2008. A similar trend was observed in the share of governance-related prior actions for development policy lending. They grew in prominence as an instrument of supporting improvements in public sector governance, and public financial management became a mainstay of Bank support in both IDA and IBRD countries. Investment in public sector capacity, including in the infrastructure and social sectors, continued to account for a sizeable

[16] See also Temple (2010).

[17] This was done at the same time that a number of governance variables were added to the Country Policy and Institutional Assessment (CPIA) and that standardized assessments of country fiduciary controls were introduced (using the PERs and CFAAs).

[18] These investment projects and development policy operations with prior actions covered a broad range of themes: 25 on administrative and civil service reform, 26 on decentralization, 27 on public expenditure, financial management, and procurement; 28 on tax policy and administration; 29 on accountability/anticorruption; 30 on public sector governance; 90 on managing for development results; 31 on access to law and justice; 32 on judicial and dispute resolution mechanisms; 33 on legal reform; 34 on legal institutions for a market economy; 36 on personal and property rights; 40 on regulation and competition policy; 57 on participation and civic engagement; and 73 on municipal governance and institution building (IEG 2012).

share of Bank assistance to IBRD countries and, to a lesser extent, IDA countries. Bank assistance for capacity building, in particular, focused mainly on the core public sector, sector administration, and workforce development. More modest commitments were made in support of private sector and demand-side capacity building.

The Bank also attempted to adopt new operational approaches in order to support country ownership and domestic accountability. The launch of PRSPs provided an impetus to try new aid modalities in IDA countries, including a shift to programmatic budget support and multisector investment operations; analytical and advisory activities to develop country-led governance strategies; and efforts to harmonize activities with other donors.[19] In addition, the Bank committed itself increasingly to use—rather than bypass—country systems (World Bank 2003a). The Bank also attempted innovations in its financial and nonfinancial product lines to provide added incentives for institutional change. By the mid-2000s, these efforts produced some tangible results, for example, in public financial management and revenue administration. A 2008 IEG review claims that Bank support in those two areas gained traction (IEG 2008b). So did Bank support for merit-based recruitment and promotion. Outside observers began to take notice of these improvements in the Bank‘s approach. For example, a 2002 global poll of opinion leaders across regions—in particular in Africa—noted that “improvements outweighed setbacks” in the Bank’s efforts to strengthen governance. Certain aspects of Bank support (for instance, civil service reforms and anticorruption efforts) did not produce the desired results. Direct measures, such as the promulgation of anticorruption laws and the establishment of anticorruption commissions, did not reduce the perceived incidence of corruption in countries (IEG 2008b). The global poll showed that efforts to reduce corruption remained one of the Bank‘s least effective efforts.

How to support institution building, particularly in fragile states, [20] was viewed as a major operational challenge. For instance, two separate 2005 reviews (an IEG evaluation and a World Bank Africa Capacity Development Taskforce) found that capacity building efforts in Africa were fragmented. The Bank often lacked the knowledge base and programmatic tools required to make a lasting impact, particularly in sectors. Capacity building was seen as a “governance challenge” because it requires a balance between state building and social accountability. The Bank recommended consolidating its existing capacity-building business lines and expanding new ones (for instance, in areas relating to the demand side). It also identified the need for more flexible lending instruments, a more proactive stance on the use of country systems, and a reform of donor approaches to technical cooperation.

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[19] These efforts were not always successful. The Economist magazine (April 7, 2007, pp 57-58) which ironically calls donors “the non-aligned movement” says that “only about 65 percent of aid actually arrives on schedule, according to the OECD. Finance ministers must cope with shortfalls and windfalls. Zambia was due to receive $930 million in 2005, but ended up with just $696 million. Vietnam, which was expecting about $400 million, got roughly $2 billion. Because the aid they receive is such a capricious, volatile commodity, governments dare not make full use of it. They could hire legions of extra teachers, clinicians and civil servants, but only if they are prepared to fire them when the aid spigot is closed. They could put AIDS-sufferers on anti-retroviral therapies, but only if they are willing to discontinue treatment once the money stops. Not surprisingly, some governments choose to hoard aid rather than spend it. In 2001-03, Ghana received an extra $1.3 billion of aid; $1.2 billion collected in the vaults of its central bank. Aid is also poorly coordinated.”

[20] Of the 62 countries which had implemented PRSPs in 2007, 21 were fragile states.

In March 2005, the *Paris Declaration on Aid Effectiveness* was signed by more than 100 bilateral and multilateral donor organizations under the auspices of the Development Assistance Committee of the OECD.[21] However, implementing this Declaration proved more difficult than anticipated. The Bank and other donors jointly supported policy and institutional reforms through budget support. However, efforts to harmonize donor approaches and use country systems on investment projects were lagging—especially during political crises. Donors that attached explicitly political conditions to budget support programs (e.g., many European Union countries) felt compelled to respond differently from those that focused on economic issues. By the mid-2000s, donors were becoming increasingly aware of the potential unintended consequences of their programs—budget support in particular—on the politics of governance reforms in developing countries (Thomas 2007; Langbein and Knack 2010).

How the quality of the budget process evolved in 16 HIPC countries from 2001 to 2007 is analyzed in a paper reviewing PEFA (Public Expenditure and Financial Accountability) assessments, tracking 11 different indicators (de Renzio 2011). Budget institutions improved in half the countries, but did not change, worsened or showed an unclear trend in the other half. Countries often record advances in certain dimensions but setbacks in others. Mozambique's good performance (especially after 2004) on transparency and policy linkages is offset by changes in control and accountability. Zambia's overall positive performance hides some backsliding in transparency, while Malawi's deterioration is affected by all three dimensions. The conclusions drawn by de Renzio are that economic and political stability are preconditions for successful budget reforms, and that a modicum of government leadership and commitment to reforms, as well as centralized budget institutions, are important to achieve successful budget reform outcomes. The level of technical assistance seems to be less important for a successful budget reform than the overall fragmentation of aid flows and the ways in which technical assistance is delivered. Thus donor hopes of "buying" better budget governance are more likely to be enhanced by better behavior rather than by additional aid resources, which implies that this is likely to work only in countries with enough capacity and interest in reforms.

The use of governance indicators by the World Bank came under increasing criticism from experts, academics, and partner countries. Composite indices, such as the Worldwide Governance Indicators and Doing Business, are based on empirical research on the links between institutional quality and development outcomes and used by the Bank to benchmark governance performance across countries and allocate IDA funds (see above). By the mid-2000s, several papers—including an internal review by IEG (2008)—highlighted the limitations of these indicators. Several issues were raised. Composite scores such as the Worldwide Governance Indicators were relative rankings of countries within a given period and were not meant for time-series analysis. Some indices sought to integrate multiple source indicators, each of which

[21] The Paris Declaration rests on five principles: aid is more likely to promote development when (a) *ownership*: developing countries exercise leadership over their development policies and plans; (b) *alignment*: donors base their support on countries' development strategies and systems; (c) *harmonization*: donors coordinate their activities and minimize the cost of delivering aid; (d) *managing for results*: developing countries and donors orient their activities to achieve the desired results; and (e) *mutual accountability*: donors as well as developing countries are accountable to each other for progress in managing aid better and in achieving development results. In a parallel development, the European Union issued a Joint Statement in 2006 and approved a Code of Conduct for its Member States in May 2007. See OECD, 2006 *Aid Effectiveness Survey on Monitoring the Paris Declaration*.

measured distinct governance phenomena. Correlations between measurement errors across source indicators were also a problem (Arndt and Oman 2006; Thomas 2010). Recipient countries also voiced concerns that changes in rank ordering of governance performance did not necessarily reflect the achievement of reform efforts.

By 2005-06, several bilateral donors—among them the U.S. Agency for International Development (USAID), the U.K. Department for International Development (DFID), the Danish International Development Agency (DANIDA), the French Agency for Development (AFD), the Swedish International Development Cooperation Agency (SIDA), and the European Commission—had launched new strategies on governance. These strategies shared some common themes. They recognized the potential for governments to act not only as "facilitator[s] of networks [of organizations inside and outside the public sector]" but also as vehicles for elites to safeguard their interests and preserve power (OECD 2009). They also accepted that governance reforms required the right political incentives, credible champions, and appropriate demand-side pressures. The Bank was late in recognizing these facts but, following the lead of bilateral donors, adopted a new approach on governance.

The 2007 Governance and Anticorruption Strategy

Beginning with the arrival of Paul Wolfowitz as World Bank President in 2005, governance and anticorruption issues gained an unprecedented level of attention. A very public and sometimes contentious discussion surrounding the Bank's approach to governance culminated in a highly negotiated 2007 Governance and Anticorruption strategy document (Thomas 2007; Weaver 2008). It is a corporate strategy that sought to change the way the Bank did business. It sets forth three main objectives: (a) it should support poverty reduction, (b) it should do so by developing capable and accountable states, undertaking sound policies, improving service delivery, establishing rules for markets, and combating corruption, and finally (c) it should ensure that its funds are used for their intended purposes. In addition, the Bank committed itself to basic principles of engagement: the focus should be on a capable and accountable state to create opportunities for poor people, provide better services, and improve development outcomes; country ownership and leadership are key. Country government is the principal counterpart; the approach should be consistent across countries, even though one size does not fit all; the Bank should engage a broad set of stakeholders with focus on transparency, accountability and participation; and finally country systems should be strengthened rather than bypassed.

These guiding principles are similar to those spelled out in the *Paris Declaration*. In response to shareholder concerns about the perceived arbitrariness of senior management decisions to cut off lending to certain countries, the World Bank strategy reiterated the use of rules-based criteria for allocating resources, as well as its aim to stay engaged even in poorly governed countries to ensure that the poor do not pay twice. At the same time, the strategy placed considerable emphasis—more than earlier strategies—on safeguarding Bank funds from fiduciary risks.

The Bank also developed an implementation plan detailing how it would work with governments, domestic stakeholders, and development partners to support country-level governance improvements and regional and global initiatives (IEG 2012). The plan's success

was to be measured in three ways: a significant and growing number of countries seriously addressing key governance impediments to development effectiveness and poverty reduction; Bank projects and programs increasingly addressing impediments to better governance; and countries and global partners valuing and respecting the Bank's capacity in this area. It was envisaged that these objectives would eventually be reflected empirically in improvements in country governance performance.

Several initiatives—comprising joint workshops, peer-to-peer learning events, clinics, and upstream assessment activities—were launched in 27 countries to help Bank teams systematically diagnose governance challenges and identify ways of addressing them through the Country Assistance Strategy (CAS), sector strategies, and project preparation. They were intended to deepen the Bank's understanding of what can be done to identify governance entry points (for example, core public management and accountability institutions, private sector engagement, and demand-side capacities and frameworks). Following these initiatives, a more targeted effort involving 18 countries sought to enhance Governance and Anti-Corruption (GAC) responsiveness with the help of considerable support provided under the Governance Partnership Facility (GPF).

There was an effort to strengthen staff sensitivity to governance issues and an increase of the use of political economy analysis, actionable governance indicators, and demand-side measures. Guidance notes and toolkits were designed to advise Bank teams on how to address GAC issues in the sectors and to support cross-cutting concerns, such as social accountability. They also included handbooks, tools, and training to support efforts to prevent fraud and corruption in projects. A 2009 Quality Assurance Group (QAG) survey of projects approved in FY08 aimed to establish a baseline for incorporation of generic GAC elements in projects. The Bank increased its involvement in collaborative governance initiatives, such as the Extractive Industries Transparency Initiative (EITI), and in legal conventions, such as the Stolen Asset Recovery (StAR) Initiative, Medicines Transparency Alliance (MeTA), and Construction Sector Transparency (CoST) Initiative. Finally, internal reforms were also carried out (Volcker Panel strengthening the Integrity Vice Presidency; new World Bank Institute strategy emphasizing multi-stakeholder engagements, updating the Bank's disclosure policy, new Operational Risk Assessment Framework for investment lending, recruiting a Chief Risk Officer, etc.)

Significant incremental budgetary and donor resources were deployed over the FY08–12 period to support GAC implementation. This comprised $54 million in incremental Bank budget as well as $61 million in donor funds allocated through the Governance Partnership Facility (GPF), a trust fund financed by the United Kingdom, the Netherlands, and Norway.

Supporting effective public sector reform is a major challenge. Bunse and Fritz (2012), who reviewed World Bank public sector loans over 2000–2010, mention that nearly 70 percent of all developing countries borrowed from the Bank for public sector reforms during that decade, indicating a significant interest on their part. Only a quarter of the countries borrowing for public sector reforms can be considered aid-dependent (i.e., where aid accounts for more than 10 percent of gross national income). Typically, these projects involve areas that are technical (e.g., revising a chart of accounts, introducing a Medium Term Expenditure Framework, or reforming procurement or external audit) as well as areas that are more politically salient or sensitive.

Nearly 75 percent of all projects receive an internal rating of moderately successful or better upon completion.

Political economy obstacles figure prominently in ex-post evaluations. For operations that performed moderately unsatisfactory or worse, they are the most frequently cited source of failure. In addition, many ex-post evaluations across all (well and poorly performing) operations raise concerns about the sustainability of achievements due to political economy (dis)incentives. The Bank does not track over time whether achievements are in fact sustained or not. Evaluations do not address specifically whether and how political economy challenges could have been better managed to make reform achievements more robust and likely to be sustained.

Bunse and Fritz (2012) state that Bank staff seeks to understand commitment only in a limited and implicit way. There are institutional disincentives to fully acknowledge risks in the Bank, especially in country contexts that render success more uncertain. There is some tentative evidence that operations designed with greater explicit awareness of governance and political economy drivers have been more successful in implementation but the number of lending operations for which this can be assessed is small.

The effectiveness of the Governance and Anticorruption strategy during FY08–10 was evaluated by IEG by reviewing the "governance responsiveness" of 50 country programs, 200 lending and trust-funded operations, and relevant economic and sector work over FY04–07 (pre-strategy) and FY08–10 (post-strategy). What IEG means by "governance responsiveness" is how the Bank identified instruments, country programs and projects; how it provided support for institutional strengthening; how it identified and mitigated risks; how project design was improved to be better adapted to country contexts and oriented to produce results; and how preventive measures against fraud and corruption were taken. IEG also carried out econometric analysis, six detailed case studies of country programs, and a review of relevant bank budgets, trust funds, staffing, and institutional arrangements. These methods were complemented by structured feedback from Bank staff and external stakeholders such as governments, donors, and NGOs. IEG also evaluated governance issues in two sectors (roads and primary education), as well as accountability institutions (IEG 2012).

IEG's conclusion is that, with respect to governance, the country programs and projects of the Bank demonstrate continuity but do not show a systematic improvement. This is a far cry from the rhetoric claiming that the 2007 strategy "implied a change in the way the Bank does business." Overall, IEG finds that the implementation of the strategy has been a relative failure. It was focused on the Bank's own capacities and resources, its reputation as a development partner, and its fiduciary risks in investment projects, and clearly stressed that governance is "everybody's business," but the agenda was defined too loosely and there were no clear priorities. The premise of the strategy was that a lack of commitment and capacity of Bank staff posed binding constraints on the achievement of governance objectives but staff did not buy into the strategy. By the end of its third year, its original goal of making systematic and time-bound improvements in the governance responsiveness of operations was no longer widely recognized by staff. In the view of IEG, Bank management should have focused more systematically on pressing strategic and substantive issues facing governance reformers in countries—for example, drawing lessons from the 2008–09 global financial crisis for corporate governance and the

integrity of their financial systems; tailoring public sector reforms to meet the particular needs of conflict-affected states; or how to address deep-seated problems of systemic corruption in some countries.

Section 3. What Explains the Lack of Performance in Building State Capacity?

Successful development requires a proactive and effective state. Adequate institutions and a well-functioning government are necessary to ensure the functioning of markets, the rule of law, the maintenance of macroeconomic stability, and basic public services like education, clean water, etc. History has shown over and over again that development is not about getting government out of the way, but about getting government to do things in the right way.

The World Bank has progressively recognized these facts and, as we have seen, has recognized that countries need to improve their governance and build the capacity of the public sector to function well in all areas that are essential for progress and improvements in living standards. Yet, while its thinking has considerably evolved, results on the ground have been recognizably weak. We can therefore legitimately ask: Why is this the case? What could the Bank do to enhance its performance in assisting governments build state capacity and achieve better governance outcomes?

Our interpretation is largely structural, namely it is related to the way the Bank is organized. This concerns in particular (1) how its research is prioritized and used for decision-making, (2) how its leadership is able to achieve a consensus and voices are equally represented on the two sides of the debate on state roles, and (3) how incentives for its staff emphasize disbursement and short-term success and not capacity building and longer-term institutional sustainability.[22]

Know-how in Building a Developmental State

The first reason for weak performance in state building may be that the development profession does not know enough about how to assist a developing country with a fragile (sometimes failing and post-conflict) state transform itself into a developmental state. History may not be useful for this purpose. Besley (2012) argues for instance that successful state formation in Western Europe and China is not replicable as these states are specific products of history: thousands of years of effective centralized empire management in the case of China, and avoiding the destructive

[22] In ongoing follow-up work, we test our hypotheses with available quantitative information. Since project outcomes are significantly correlated with measures of project size, extent of project supervision, evaluation lags and early-warning indicators flagging problematic projects during implementation (as shown convincingly by authors such as Denizer Kaufman and Kraay 2012), we use a large database on projects and project ratings from 1977 to 2012, to analyze econometrically economic policy projects (6% of total projects); public sector and governance projects (also 6%) and technical assistance projects. If governance-focused projects matter, this would be seen in an interaction term between other project types and governance projects on the outcome of these other projects, i.e., the value of governance projects is to enhance the outcome of the rest of the project portfolio. This interaction could be the larger, the greater the quality of the governance project itself. In other words, governance projects allow improvements in the portfolio of other projects: less emphasis on social assistance and more emphasis on income generation, and governance projects should increase the capacity to absorb more foreign aid (if we take into account the dollar value of other projects and their interaction with governance projects in terms of outcomes).

recurrence of warfare in the case of Western Europe. There is also considerable heterogeneity across countries in initial conditions, with the need to develop idiosyncratic approaches to state construction. As a consequence, recipes are missing, and innovation is necessary. But is the Bank, which claims to be a "knowledge Bank," organized to innovate in assisting state construction?

Through academic research, we know quite a lot about the role of the state in development. The state has roles to play in compensating for market failures (originating in monopoly power, externalities, public goods, and high transaction costs), achieving coordination among actors when there are multiple equilibria, and correcting for social outcomes that may not be desirable. However, where knowledge is lacking is in the process, not the product: How to transform an under-performing developing country state into a developmental state? This is not theory but practice, something that is more in the domain of applied research and experimentation, and is for this reason potentially better done at the World Bank rather than in universities.

This type of research requires close linkages with project implementation and feedbacks from implementation to design. World Bank research, including experimentation and piloting, is thus needed on the subject of state transformation into a developmental state, starting from the conditions of governance in a developing country context with all the market failures and institutional gaps that characterize it. This requires new designs and experimenting with alternative options. Bank investment in research has been low and research has not provided specific guidance for lending, in part because of a poor understanding by Bank management of the role of research, in part because of low effectiveness in guiding research toward addressing the relevant questions and in using research results for innovative program design. This requires a rethinking of how research is motivated, supported, guided, and used at the Bank. The reality is that Bank research, however often outstanding in academic quality, has not been effectively directed and used for the purpose of defining innovative state construction initiatives. This has contributed to weak outcomes in the implementation of the Bank's recent governance strategy, as assessed by IEG. (Supportive evidence: There is little research in DECRG on state construction, and insufficient linkages between Bank research and Bank strategies and initiatives.)

Consensus on the Role of the State in Development

Bank leadership has been generally unable to build a consensus among stakeholders about the role of the state in support of its development programs. A plausible interpretation is political. There is no agreement in Bank membership about the role of the state in development; there are opposing sides in particular between those who view the state as an instrument to compensate for market failures and make markets work better, versus those who view it as a proactive coordinating instrument with direct engagement in some economic activities and extensive public-private partnership initiatives. There is more of a consensus on the role of the state in compensating for undesirable social outcomes, as seen by the Bank's strong performance in the field of social assistance programs. This was, for example, the hallmark of the 1990 World Development Report on poverty that advocated labor-intensive growth and social safety nets. But there is almost no consensus on issues such as industrial policy, intervention in financial markets, climate change or alternative forms of energy, etc. Bank leadership has almost always looked at the role of the state as a divisive issue to be carefully handled, in part by neglecting it.

Successive Bank presidents, selected by the United States, have assumed conservative positions on the role of the state, in spite of mounting evidence from observable outcomes and country demands in favor of proactive roles for the developmental state in achieving both rapid and equitable growth.

An important corollary of this lack of consensus on the state's role in development is the lack of voice of the proponents of proactive states. Japan, Korea, China and mainland European countries are in favor of active government in areas as diverse as social insurance or environmental protection. The voice of the advocates of a proactive state is not commensurate with their shareholder and voting power. This lack of voice is reinforced by the lack of linkage in those countries between academic institutions and policy advocacy. By contrast, the more conservative view on the role of the state has been endorsed by Bank representatives of Anglo-Saxon countries where, traditionally, the linkage between academic institutions and policy advocacy is stronger. In part as a consequence of the lack of consensus and clear priorities on how to create state capacity, there has been underinvestment (relative to effective demand and project needs) in World Bank staff skills on governance matters. As a consequence, many Bank staff has lacked the wherewithal to effectively assist countries in building developmental states.

Staff Capacity and Incentives for Institution Building

Incentives for team leaders and managers are not aligned and do not emphasize the development of state capacity in recipient countries. World Bank team leaders are rewarded for disbursing loans and for short-term achievements that can be monitored and credited—but not for producing longer-term outcomes that would require them to strengthen state capacity in the countries they assist. This is reflected in the use of *ad hoc* institutions for project implementation (like Social Development Funds (SDF), or special Community Driven Development (CDD) implementation units) instead of more sustainable state construction. An example is ZAMSIF in Zambia, a remarkably effective CDD program that lasted for 15 years but collapsed when donors tried to move the program from a special SDF unit to institutionalization through line budgeting and decentralized governance. The lack of alignment of staff incentives for long-term institutional constructions is a well-known feature (see, e.g., Birdsall 2007), which is proving particularly detrimental for investing in state capacity building. Successful development results created by building institutions are long-term and imperfectly observable (due to uncontrollable random shocks such as weather events, overall economic growth, and international market conditions that affect project outcomes). However, indicators of institutional construction can be constructed and serve as intermediate outcomes for performance evaluation. Addressing this issue is fundamental if Bank knowledge is to be applied to develop the capacity of governments in developing countries.

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