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RESUMEN DE LOS TRES CAPÍTULOS
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OVERVIEW

1. Understanding Economic Growth

Economic growth is a recent event in the history of humanity. It is only in the last 50 years that mainstream economics has focused on the determinants of Adam Smith's "natural progress of opulence" and on how growth could be accelerated.

Absent definitive theories, views on growth have been shaped by facts and changed by experience.

New Growth Theory (second half of 1980s and gathered impetus during the 90s) seemed to hold the promise of linking policies to growth performance. It appeared at a time when evidence was accumulating—from the growth experience of the 1970s and 1980s—suggesting that the accumulation of capital was not a panacea, and that misguided policies were costly for growth. Up to then, thinking about growth had been dominated by the Solow model, the basic model with which we still think about economic growth, in which growth is a function of the accumulation of capital, accumulation of labour, and productivity growth. This model leaves out much of what needs explaining. In particular, it views long-run growth as entirely determined by exogenous factors, independent from structural characteristics of the economy such as openness, scale, and saving rate, and, most important, from the policies influencing such variables.

If, as suggested by the growth regressions, policies matter for growth, policy improvements should lead to higher growth. Both in the 1980s and 1990s, policies improved relative to other decades, but growth performance remained well below that of the 1960s and 1970s (Easterly 2001). More recently, empirical research has argued that when a measure of "institutional quality" is included in cross-country regressions, the explanatory power of other variables, including all measures of "policies," becomes negligible (Acemoglu, Johnson, and Robinson 2001; Rodrik, Subramanian, and Trebbi 2002; Easterly and Levine 2003; and IMF 2003e).This suggests that "good" institutions matter more for growth than "good" policies—that "institutions rule."

<u>Growth in Developing Countries: Divergence, Variability and Unpredictability</u>

Research during the 1990s was able to extend the availability of data over long periods.
This made it clear that growth was not a linear process, and that it did not conform to the theoretical prediction that per capita income in developing countries would eventually converge with that of industrialized countries.
The consideration of growth over longer periods also highlights the variability of growth in developing countries. The experience of Latin America since the 1980s, the collapse of growth in Africa in the last two decades, and the economic collapse of Eastern Europe after several decades of sustained growth stand in sharp contrast to the stability of growth among industrialized countries, which have grown at roughly a constant rate (except for the interruption of World War II and recovery years) for more than 100 years. The variability of growth helps to explain why growth in the developing world is so difficult to predict. Ex. In the later 1990s, just before the second most dramatic economic crisis in its history, Argentina was seen as a model for developing countries and believed to have found the path to sustained growth.

<u>Institutions (North's definition)</u>

The importance of institutions for economic prosperity is not a novelty learned from the 1990s. From different perspectives, Adam Smith, Karl Marx, and Max Weber highlighted the role of institutions in the development of a market economy and formation of a capitalist society.
While there are some functions that institutions need to perform in any society, the form through which institutions can perform these functions can vary considerably (Virmani 2004). Most of the empirical work on the importance of institutions leaves open the question of how to improve institutional performance. Merely adopting some other country's laws and formal regulations is no guarantee of achieving the same institutional performance.

<u>Fairness, Growth, and Institutions</u>

Another important strain of ideas in the 1990s came from the resurgence of interest in inequality as an apparent influence on growth and institutional performance. Fairer societies offer their citizens more public goods, more social support, and more social capital. Hence they are more capable of sharing the costs and benefits of improving economic policies, and in turn facilitating consensus building and decision making (Deaton 2003a).

Knowledge is still rudimentary about how institutions emerge and are established in a society, but economic research in the 1990s has provided some insights. First, economic incentives influence what type of institutions emerge and when.

2. Facts and Controversies of the1990s

At the beginning of the 1990s, most economists working on development and many policy makers shared the conviction that more efficient use of resources would lead to growth.

This was believed to require, first, macroeconomic prudence, domestic liberalization, and outward orientation, which in turn required freeing market incentives and opening the economy. Hence fiscal deficit reduction, realignment of exchange rates to eliminate black market premia, lifting controls on prices, deregulation of interest rates and liberalization of the financial sector, and reduction of tariffs and other restrictions on imports all became central to the policy reform programs implemented in the 1990s.

Second, conventional wisdom held that to achieve greater efficiency required a reduction in the role of the state.

Third, it was believed, reforms had to be rapid. In the course of the 1980s the economics profession began to be influenced by the enthusiasm of leading politicians for “the magic of the market.” Arguments in favour of “big bang” and “shock treatment” became prominent. By the time that the transition to a market economy got under way in the former socialist economies, “a belief in gradualism had almost become tantamount to a confession of a lack of reforming virility” (Williamson and Zagha 2002).

Interpreting the Results

From a growth perspective, the net result of the contrasting experiences of the 1990s is that developing countries as a group grew faster than in the 1980s. In East and South Asia this reduced the income gap with industrialized countries, but in other regions, the gap increased. In Latin America, there were clear gains up to 1998, reversed in the late 1990s and early 2000s. Analyzing policy reforms of the 1990s, several studies (Loayza, Fajnzylber, and Calderon 2002; Lora 2001a; Easterly 2001) find that countries that improved their policies—strengthening macroeconomic management, opening up their economies, liberalizing their financial sectors—grew faster in the 1990s. However, they also find a large unexplained negative effect associated with both the 1990s and the preceding decade. Together with analysis of individual country experiences and overoptimistic forecasts by international financial organizations and private entities, these studies give an empirical base to perceptions that the economic policy reforms of the 1990s yielded results below expectations. Explanations of performance must be sought primarily in developing countries' domestic policies.

The mismatch between predictions and results, and the successes of China, India, and Vietnam where there were substantial deviations from the full package of reforms, suggest several possible explanations.

First, sufficient time may not have yet elapsed for results to emerge in all countries. Over time, market-oriented reforms may ultimately yield the results expected. Growth rates in African and other developing countries have rebounded since 1997; Argentina is experiencing its second year of rapid growth after the collapse of 2001–02; and growth rates in Eastern Europe have increased.

Second, perhaps the reforms implemented in the 1990s were not sufficiently ambitious. Insufficient fiscal adjustment in Latin America, very partial privatization in Africa, and insufficient openness to international trade in the Middle East and Northern Africa may explain performance below expectations in these regions. A third possible explanation is that there were incoherencies in the implementation of policies. Argentina introduced a rigid exchange rate without the fiscal and financial conditions needed to sustain it.

Perhaps most important, while reforms in the 1990s focused on increasing the role of markets and decreasing the role of the state, they tended to neglect the role of institutions

The experience also holds some deeper lessons. For example, while at one level Argentina's experience teaches that fixed exchange regimes require a very demanding set of conditions, a deeper lesson is that rigid rules are no substitute for credibility, and that government's discretion needs to be checked, not replaced with rules. Another deeper lesson is that the reforms of the 1990s did not focus on the binding constraints

3. Lessons from the 1990s

Promote Growth, Not Just Efficiency

Reforms need to go beyond the generation of efficiency gains to promote growth. The policy focus of reforms in the 1990s enabled better use of existing capacity but did not provide sufficient incentives for expanding that capacity. While this emphasis on efficiency was warranted at a time of extremely large distortions and waste, it also

explains the frequent instances of stabilization without growth or liberalization without growth.
The experience highlights the importance of the investment climate, and of providing predictable conditions for investors and other economic agents.
It also highlights that growth entails more than the efficient use of resources. Growth entails structural transformation, diversification of production, change, risk taking by producers, correction of both government and market failures, and changes in policies and institutions.

Any growth strategy needs to include actions, both on the policy and the institutional front, that address and support this process of change.

Better policies can bring efficiency gains, and may increase incentives for investment, but without amounting to a growth strategy. They will not necessarily induce the behaviour by private investors and the public sector that is needed to put an economy on a sustained growth path. For this, faster accumulation of physical and human capital by both the private and the public sector are essential, as are gains in productivity (expand productive capacity, different from using existing capacity on a better way) .

In retrospect, it is clear that in the 1990s we often mistook efficiency gains for growth. Expectations that gains in growth would be won entirely through policy improvements (improved resource allocation) were unrealistic. Means were often mistaken for goals, that is, improvements in policies were mistaken for growth strategies, as if improvements in policies were an end in themselves.
Going forward, the pursuit of policy reforms for reforms sake should be replaced by a more comprehensive understanding of the forces underlying growth.
Removing obstacles that make growth impossible may not be enough: growth-oriented action, for example on technological catch-up, or encouragement of risk taking for faster accumulation, may be needed.

Another mistake often made in the 1990s has been the translation of general policy principles into a unique set of actions.

Common Functions and Diverse Ways to Achieve Them

To sustain growth requires key functions to be fulfilled, but there is no unique combination of policies and institutions for fulfilling them. Different policies can have the same effect, and the same policy can have different effects, depending on the context. Common to all successes is that the four functions have been fulfilled: rapid accumulation of capital, efficient resource allocation, technological progress, and sharing of the benefits of growth.

4. Lessons from Policy and Institutional Reform. Experiences in the 1990s

Pragmatic, Incremental Approaches to Public Sector Governance Are More Effective

Economic performance depends partly on governance, which in turn is shaped by underlying institutions, defined broadly as the “rules of the game” that shape the behaviour of organizations and individuals in a society (North 1990, 3).6 A crisis of governance of varying intensity pervades much of the developing world, with the poor paying the heaviest price for it. Public sector reforms in the 1990s sought to change the structure of organs of the state, and incentives within them, in the hope of improving government efficiency and responsiveness. From mega-reforms such as decentralization to less sweeping reforms in budget or personnel management, the aim was to find a balance between the, discretion of politicians and bureaucrats over policy making and policy implementation and their accountability for decisions and actions. The fall of authoritarian regimes and the consequent spread of democratic processes constrained the previously wide discretion of many governments. Decentralization sought to further limit central government discretion while granting local governments more managerial autonomy. Legal, judicial, and legislative reforms were initiated to establish institutional checks on executive power. Public management reforms sought to give public managers more flexibility in decision making while demanding greater accountability from them for their decisions. Perhaps partly because of the immense difficulty of addressing problems in political institutions, many countries and donors in the 1990s focused largely on reforming legal and judicial systems—a channel of political accountability that seemed more amenable to technocratic solutions, often using models directly transplanted from industrialized countries.

Most of the reforms had little effect on behaviour. The ills that they sought to treat—non meritocratic civil services, weak financial controls, opaque or incoherent budget processes—are deeply rooted in local political and institutional arrangements that favour the status quo.

The designs of governance reform strategies in the 1990s typically fell into two broad types: “big bang” or ad hoc incrementalism. Big bang approaches proved to be largely inconsistent with capacity constraints and political realities. Their main results were major changes in formal rules: new or amended constitutions, new legislation, ostensibly independent courts and audit institutions, and so forth. Meanwhile, the informal rules shaping the incentives that face politicians, bureaucrats,
and citizens remained in place. Ad hoc incrementalism has also been problematic.

Many of the ad hoc reforms were symbolic, intended to preserve the old informal rules while pretending to reform. Some represented well-motivated attempts of individual or small groups of reformers who, for lack of support, were undermined by jealousy, intrigue, or fatigue. More important, they tended to be unrelated to a more coherent reform strategy and thus over time many lost their steam.

An important general lesson is that technocratic responses to the governance crisis work only in very auspicious settings—where there is committed leadership, a broad-based coalition in support of reform, and sufficient capacity to carry the reform process forward. Clearly, these conditions exist in only a few developing countries, and rarely in those that most need governance reform. State building is a complex process that requires time, leadership, and social capital. Governance reforms have to find a delicate balance consistent with the country’s politics, history, and culture. What may be needed are highly focused, pragmatic interventions that may be termed “strategic incrementalism.” These interventions are opportunistic because they exploit the willingness to reform, but they are grounded in political realities and consistent with the capacity constraints of the country concerned.

5. Operational Implications

The first implication is the need to redress the balance between analysis of policy instruments and analysis of strategies—understanding strategies as coherent sets of actions that are intended to initiate and sustain growth.

Over the years, in institutions such as the World Bank, the focus of research gradually has shifted away from country-specific growth experiences to focus increasingly on policies—trade, finance, macro, privatization to name a few—with secondary importance given to country contexts. At the same time, outside the World Bank there has been increasing emphasis on individual country experiences (for example, Rodrik 2003b, and the research programs sponsored by the Global Development Network).

The second implication is the need to recognize country specificities in country economic analysis, acknowledging that policies are conceived and implemented within a specific institutional, social, and historic context. Recent economic and sector work at the World Bank already seeks to achieve a better balance between country specificities and the lessons from country experiences, but more is needed fully to recognize that country-specific market structures and institutions have a strong influence on policy outcomes.

Third, analytical work needs to change its orientation, away from seeking to assess how far policies diverge from optimality, to seeking to assess what policy and institutional conditions—for capital accumulation, shared growth, productivity growth, and risk taking in a country-specific context—are needed to set the growth process in motion.

<u>Chapter 9</u>

Improving Public Sector Governance: The Grand Challenge?

Though extensive research had probed the causes and impact of poor governance, and in particular of corruption, it was not until the middle 1990s, with improvements in data and econometric techniques, that large, cross-country analyses emerged on the impact of governance institutions on investment and growth.

This research has shown that corruption—which is both a symptom and cause of bad governance—discourages private investment and, more generally, that the quality of governance institutions has a significant impact on economic growth (Mauro 1995; Knack and Keefer 1995; Wei 1996, 2000; World Bank, *World Development Report 1997*; Kaufmann, Kraay, and Zoido-Lobaton 1999; Kaufmann 2003; Kaufmann, Kraay, and Mastruzzi 2003; Rodrik, Subramanian, and Trebbi 2002).

1. Understanding the Governance Conundrum

Public sector governance refers to how the state acquires and exercises the authority to provide and manage public goods and services.

Fundamentally, public sector governance is about the nature and quality of three principal relationships: between citizens and politicians, between politicians as policy makers and bureaucracy (those responsible for providing public goods and services), and between the bureaucracy as delivery agents and the citizens as clients).

Citizens and Politicians: The Heart of Governance

In an ideal world, citizens can hold politicians accountable for their actions and for policy outcomes, both through elections and through checks and balances on the abuse of power.

But in many countries, the formal trappings of democracy do not translate into accountable decision making for a variety of reasons_ from the lack of a truly independent parliament o judiciary to electoral market imperfections. In either case, the relationship between citizens and politicians is typically governed by weak institutions.

When the rule of law is weak, the risk of state capture is high.

Politicians as Policy makers and the Bureaucracy: The core Principal – Agent Problem.

Delegation almost always gives rise to the principal-agent problem. The principal delegates the implementation of a task to an agent but will need to monitor the agent efficiently to confirm exactly what has been accomplished.

The nature of the compact between policy makers and bureaucrats critically determines the outcomes of policies. When the compact is defective because capacity is weak or accountability impossible, corruption typically takes place.

Bureaucrats and the Citizenry: Where the Rubber Hits the Road

Citizens acquire leverage over the bureaucracy if they can organize themselves into nongovernmental organizations (Rose-_ Ackerman 2004). The capacity to organize gives citizens “voice” (the ability to monitor the performance of the bureaucracy, generate valuable information, and pressure politicians for action) and “client power” (the ability to engage directly with the providers of services).

2. Public Sector Governance Reforms. Lessons from the governance reforms of the 1990’s

Perhaps partly because of the immense difficulty of addressing problems in political institutions, countries in the 1990s turned to the other channel of political accountability: reforming legal and judicial systems, which seemed more amenable to technical solutions.

With the fiscal crunch arising from the debt crisis of the 1980s, efforts to prune and rationalize the role of the state led to privatization of state-owned enterprises. Budget and financial management reforms were initiated, and even challenging and controversial New Public Management reforms were undertaken in a great number of developing countries.

The public sector reforms had essentially two thrusts. The first was to build the capacity of the public sector—personnel skills, systems, and processes—to formulate and implement policies. The second, whose emphasis increased during the 1990s, was to instill clearer and more binding accountabilities in civil servants to policy makers and politicians.

Capacity constraints are binding: strategic incrementalism may be the only option for many developing countries.

Word Development Report 1997 argued that the state should match its role to its capacity, since taking on too much makes the state less effective. This was certainly evident in the attempts of many developing countries to adopt NPM approaches.

NPM reforms are a challenge even in countries with strong capacity. In environments where the basics are very weak, resort to NPM-style performance management techniques has been associated with poorer performance, as measured by increases in administrative corruption (Anderson, Reid, and Ryterman 2003; Schick 1998).These authors found that the most significant factor contributing to better performing public organizations is the creation of merit-based personnel management practices: putting in place recruitment and selection systems, performance evaluation procedures, promotion.

Hence, what may be needed instead are highly focused, pragmatic interventions that may be termed "strategic incrementalism." These interventions are opportunistic because they exploit the willingness to reform, but they are better grounded in political realities and consistent with the capacity constraints of the country concerned. Knowing what is appropriate in which country situation is often half the battle.

Enclaving is a potential path to sustained reforms of the civil service.

The challenges of politics and capacity constraints have led some countries to experiment with enclave approaches to civil service reform, spinning off selected government entities from central government ministries. Increased autonomy for revenue collection agencies became a key feature of governance reforms in Latin America in the early 1990s.

In practice, the performance record of these agencies has been mixed. Performance problems have resulted mainly from lack of political support, tensions between the autonomous revenue agency and the ministry of finance, and poor organizational design, including weaknesses in the new accountability regime. Nonetheless, on the whole the record suggests that, with enough political push and proper design, these agencies can improve tax administration and be sustainable.

The important lesson is that enclaving must be strategic if it is not to constrain and/or distort the capacity-building efforts of government.

Values, commitment, and pride in public service matter as much as controls and compliance.

NPM reforms sought to introduce stronger market-based incentives as a means of reforming government bureaucracies. Emulating the experiences of developed countries such as New Zealand and the United Kingdom, developing-country governments adopted performance management techniques that grew out of reforms in the private corporate sector and sought to enhance the autonomy and accountability of public sector managers and staff. Such reforms have arguably led to improved service and performance in developed countries, but have had little success in developing countries.

Industrial countries' experience with industrial performance and workplace transformation shows that workers' dedication to the job is an important explanation for improvements in performance (Tendler 1997).Recognition of this relationship has caused firms that perform well to pay close attention to innovative practices that increase worker dedication. Tendler contrasts this with the development literature, which has been rife with suspicion that "civil servants are self-interested, rent-seeking, and venal, unless proven otherwise." Her research in Ceará, Brazil, demonstrates that the creation of a sense of calling and ownership around public service by a committed leadership, a dedicated work force, and an informed and engaged civil society can increase acceptance of reform and improve service delivery.

Decentralization is a political choice, whose design and implementation may not improve service delivery.

Design well, decentralization can move decision closer to the people, enhance the efficiency and responsiveness of service delivery (Faguet 1997; Kahkonen and Lanyi 2001; Bardhan and Mookherjee 2000), support economic growth, and offer a potentially powerful tool for alleviating poverty. But designed inappropriately, or introduced without strong local participation and accountability (of local officials to local citizens), it can lead to macroeconomic instability, declining service levels (Martinez-Vazquez and Boex 2001), heightened regional disparities or conflicts (Smoke2001), and increased corruption (Brueckner 1999).

Though providing a detailed road map to guide strategy is a task requiring fundamentally new research and analysis, the following discussion suggests a possible approach to governance reform strategies in developing countries.

A recent survey of firms conducted by the World Bank in Eastern Europe and Central Asia provided information that can be used to array the countries of that region along a two-dimensional matrix, with an administrative corruption index on one axis and a state capture index on the other. Since administrative corruption reflects the quality of the compact and state capture affects the strength of political accountability, the quality or state of governance in a country can be broadly characterized by these two indexes. The matrix in figure 9.4 suggests a classification of countries into four possible types: capable, weak, captured, and restrained. Each type faces different challenges and different opportunities for reform.

Capable: In capable states, administrative corruption tends to be low and state capture not heavily entrenched. Examples are Korea, Chile, Hungary, and the Czech Republic. In capable states, the challenge is usually to increase the quality and efficiency of public services, so as to best utilize limited public resources. In these countries it is often possible to undertake difficult systemic reforms using a more or less technocratic approach, providing there is leadership and support that coalesces around the reform objective

Weak: states lack many of the basic structures needed to manage the public sector. Many have only recently emerged from conflict or attained statehood. Bureaucratic capacity and accountability are weak, and administrative corruption is high. Often weak states have largely escaped capture by business interests, not because accountability mechanisms are effective, but because the state is itself insufficiently developed to be captured. In fact, as these basic structures are established, the risks of state capture quickly increase. In weak states, the primary challenge is to ensure that taxes are collected, key services are delivered, and budget execution is sufficiently controlled. Given limited bureaucratic capacity, it is especially important that reform efforts be targeted and that international support for these reforms is highly coordinated.

Captured: These states have serious problems of administrative corruption and their environment makes them highly subject to capture. Many have an urgent need to build capacity in the public sector, but investments in capacity are unlikely to produce sustainable improvements, because political corruption (grounded in rents) permeates the system at all levels. The challenge in these states is to break the stranglehold of special interests, for example by breaking up powerful monopolies if capture is by private interests or by reducing military expenditures if capture is by the military.

Restrained: The bureaucracy in these states tends_to have sufficient capacity and accountability so that administrative corruption is relatively mild. Political accountability is likely the weakest link in the chain,_resulting in a high level of state capture. Reform options are_limited in such states while the existing leadership is well entrenched. When a genuine change in leadership occurs, and where civil_society is relatively robust and can play an important role in stimulating demand for change, reforms can emerge fairly fast and can potentially be sustained.

Conclusion

Improvements in governance are critical to ensuring sustainable development. Perhaps the most important lesson of the 1990s is that technocratic responses to improve governance work only in very auspicious settings—where there is committed leadership, a broadly based coalition in support of reform, and sufficient capacity to carry the reform process forward. Clearly, these conditions exist in only a minority of developing countries and rarely in those countries in most urgent need of governance reform. This is the crux of the challenge for the decade ahead. Meeting the challenge requires a good understanding of the political dimensions of reform, and, in particular, of how reform can be used to identify and build constituencies that are capable of sustaining the reform momentum.

In this context, a focus on “drivers of change” is promising (Duncan 2003).While the particular drivers will naturally vary from country to country, the common thread of this approach is a focus on solving the specific, highly salient problems facing individual communities—for example in health care, sanitation, or business regulation.

These are problems around which constituencies for reform both inside and outside government may be easier to build and maintain than, say, upstream reforms in civil service reform or financial management. Whether this focus on problem solving and results-oriented drivers of change will help countries to navigate the difficult terrain of governance reform in the next decade remains to be seen

Chapter 10

Does democracy help?

A striking phenomenon of the 1990s was the rise in the number of countries selecting their leaders through competitive elections. The number rose from 60 countries in 1989 to 100 in 2000. Among poorer countries (those with less than the median country's per capita income), the number nearly tripled, from 11 in 1989 to 32 in 2000.
Unfortunately, democratization does not ensure economic development.
Why are democratic institutions less accountable—more vulnerable to narrow interests, rent seeking, and venality—in some countries than in others? Why are commitments by some governments more credible than others?

To answer these questions, this chapter focuses on two propositions.
First, elected governments are most likely to make policies favoring narrow segments of the population at the expense of the majority when citizens are ill informed, or cannot trust promises made prior to elections, or are deeply polarized.
Second, elected governments are most credible and most likely to respect private property rights when they confront checks and balances on their decision making.

1. Elections Have an Uneven Impact on Development.

Cross-country analysis shows, however, that there is little association between competitive elections and the quality of government. The modest improvements that took place in the policies of newly democratized countries are better explained by increases in income per capita.

Consistent with these findings, a large literature finds no consistent, significant effect of elections on economic growth. For example, Przeworski (2000) find no difference in growth rates between countries that have competitive elections and those that do not.

2. Characteristics of Democracies That Influence Policy Success and Failure

It is less clear that institutional differences can explain the differences in development performance among democracies.

There is, then, no strong evidence that either special interest group organization or formal differences in political and electoral institutions account for the different policy choices of developed- and developing- country democracies. Still, the arguments that these elements should matter are persuasive and seem to have great validity in richer countries. Their relative weakness in explaining outcomes in poorer countries suggests that the underlying conditions of political competition in these countries differ from those in richer countries

There are three other explanations, all related to imperfections in electoral markets, for why policies are more likely to neglect the public interest in poor democracies but not rich ones: lack of voter information, the inability of political competitors to make credible promises and be trusted, and social polarization. Each of these is important to understanding policy formulation and reform.

Imperfections in electoral Markets

Differences in economic performance across democracies can be explained with respect to imperfections in electoral markets. Numerous imperfections in electoral markets make it difficult for citizens to hold politicians accountable for policies. The discussion below focuses on three imperfections—uninformed voters, non credible political competitors, and social polarization—that offer powerful insights into the underperformance of many democracies.

Uninformed voters

In political markets, the information that voters have about the characteristics of political competitors and government performance is crucial. Without information about the attributes of political competitors, about what politicians are doing, and how their doings affect citizen's well-being, citizens cannot easily reward high-performing politicians.

This encourages poor performance. Politicians confronting uninformed voters can invest resources to persuade them of their accomplishments, through advertising or meetings, for example. But financing these efforts, whether from their own pockets or those of special interests, or from government funds, carries a social cost: special interests demand policies that diverge from the social interest in exchange for campaign financing, while government funding diverts resources away from the provision of goods and services to the electorate.

Credibility of Politicians

When challengers cannot make credible policy commitments to citizens, citizens have no reason to prefer them over incumbents. Even if incumbents do badly, citizens have no reason to believe that challengers will do better. This insulates incumbents from pressure to perform.

Credibility may also be partial in the sense that politicians can make credible promises to some voters only. Credibility resides in individual politicians or in “patrons” rather than in political parties. The problem of credibility is therefore closely related to the phenomenon of clientelism, which is widely argued to characterize political relationships in poorer countries, and involves patrons and clients who are bound together by reciprocal, long-lasting patterns of exchange. These exchanges form the foundation of reputations that allow patrons to deliver votes at election time. Unfortunately, narrowly based credibility gives politicians incentives to underprovide public goods and to extract large rents.

A dysfunctional public sector limits the ability of politicians to make credible promises. This is the problem of capability that was discussed in chapter 9. If an education ministry is deeply dysfunctional and is likely to take years to reform, and if citizens cannot observe changes in the ministry until these are reflected in schools, even favorably inclined politicians are unlikely to make promises about education.

Social Polarization

Social Polarization undermines the accountability of government to citizens. One type of social polarization emerges when substantial groups of citizens have deeply opposing interests on most salient political issues. These divisions can run so deep that one group of citizens cannot contemplate electing a representative from the other. Elected representatives from one group then have no incentive to satisfy the concerns of citizens in the other.

Majority disdain for the interests of identifiable minorities is another manifestation of social polarization. The more pronounced the disdain, the greater the distortion in the provision of public goods, and the more likely that minorities will be excluded from government services.

3. Government Credibility as a Prerequisite for Development

All of the foregoing relates to the reluctance or inability of political decision makers to adopt policies in the broad public interest. A related problem for development emerges when policies, once enacted, are not credible.

Lack of Government Credibility Undermines Growth

The most notable effect of credibility is on investment and growth. Investors rely on government promises to respect investor's rights to their assets. When those promises are not credible, investments slow down or take inefficient forms. The growth effects are immediate: annual growth in income per capita in poor countries with the most secure property rights is between 2 and 4 percentage points faster than in poor countries with the least secure property rights

Earlier chapters in this report attribute the weak effects of policy reforms on growth partly to institutional weaknesses in countries. The inability of countries to secure property and contractual rights is a core element of these weaknesses.

Lack of government credibility also dampens incentives to invest in public infrastructure or to make other social investments. The payoffs to these investments depend on the willingness of economic actors to make complementary investments that take advantage of them. Where expropriation is more likely, private investors are slower to respond to improved public infrastructure, and governments correspondingly reduce their allocations to these investments.

Sources of Low Government Credibility: Lack of Reputation and Short Time Horizons

What makes government policies credible? Certainly the elements of political competition that allow political competitors to make credible preelectoral promises help to ensure the credibility of the policies they implement after they take office. However, many policies are not the subject of pre-electoral debate. Even when they are, the gains from reneging on policies, once implemented, are often greater than the gains from reneging on preelectoral promises to implement them in the first place.

The horizons of political actors—how long they expect to be in power or to be competing for power—can mitigate these additional threats to credibility. Governments that expect to be in office many years have more to lose from current policies that upset future growth, such as investment-deterring expropriation, than do governments with short horizons.

These results do not imply that governments should be immune to threats of removal. They do imply that in countries where accountability mechanisms are flawed, extending the horizons

of governments by making them more secure in office may be the only means to create sufficient incentives to maintain secure property rights.

Sources of Low Government Credibility: Political Institutions

Multiple institutional arrangements have been proposed to solve the problem of government credibility, but in the end, only political institutions— particularly institutional checks and balances—have demonstrated a consistent effect on the credibility of government decision making.

In all of these cases, the question remains why the introduction of formal institutions is not sufficient to ensure sustained development across countries. Our earlier analysis suggests that the reason may be rooted in the underlying conditions of political competition. Improvement in these conditions, therefore, is likely to be an important complement to institutional reform. These results make a compelling case for reformers and development activists to take political market imperfections into account in designing strategies to speed growth and development.

4. Lessons: Making Politics Work for Policy When Governments Are Not Credible and Electoral Markets Are Imperfect.

How should we formulate strategies of policy reform, given imperfections in the market for political office and limitations on the credibility of government commitments? And what reforms might mitigate these political and institutional problems directly?

The traditional answer to the first question is to buy off the opposition to reform. This formula requires political leadership: buying off the losers who are in a position to block reform, and exploiting windows of opportunity such as crisis or a change in government But when the imperfections in the market for political office loom as large as they do in many countries, or when political institutions provide few checks on opportunistic behaviour by politicians, adequate compensation may be impossible → If politicians cannot make credible promises to voters, they cannot make credible promises of compensation to losers from reform. And if citizens are poorly informed about what politicians do in office, losers may be unable to observe whether governments have actually delivered the promised compensation. Hence remedying the underlying imperfections in electoral markets is a prerequisite for successful reform.

Mitigating Electoral Market Failures

What measures might alleviate imperfections in the markets for political office? Mitigating electoral market failures essentially means reducing politicians' incentives to engage in clientelist behaviour. Moving out of clientelism is risky for politicians. Shifting resources to public goods may leave clients sufficiently dissatisfied to desert their patron, while public good benefits may materialize too slowly to attract new bases of political support before the next round of political competition. In any case, the beneficiaries of improved public services may not credit the incumbent politician for the improvements.

How to shift political competition away from clientelism is a key challenge of institutional reform that is not yet well understood. Some steps are probably key to reform, however**:** increasing public information, and increasing the credibility of political promises.

Increasing Credibility to improve the quality of public goods

Leaders can build credibility by being vocal, emphatic, and specific about their reform goals. Specificity make it easier for citizens to judge when leaders have failed.

Public sector reform can help too. A political competitor is unlikely to promise improved provision of public goods if the organization needed to supply those goods is dysfunctional, since citizens cannot easily distinguish whether reform failure is caused by bureaucrats or politicians

Mitigating Political Market Failures: Institutional and Legal Reforms

Even though institutional factors do not systematically explain the underperformance of some democracies relative to others, institutional reforms can promote policy reform. Such reforms include changing electoral rules, reinforcing checks and balances (are not a substitute for solving electoral market failures, however their absence undermines prospects of sustainable reform), introducing laws that regulate campaign contributions, and decentralization. These last two institutional reforms can reduce both electoral market failures and the lack of credibility, although they can potentially exacerbate them as well by reinforcing clientelist political patterns.