
The Changing Role of the State in Development

A remarkable change seems to have occurred in thinking about the role of government in economic development across the globe during the past decade. Less is now considered better. In other words, increasingly countries of all political hues have been moving to policies that favor a reduced role for the public sector and greater reliance on the private sector. This movement has been so strong that, at times, it has been able to overcome resistance from powerful political and economic interests. There are many reasons for this change in strategy: the growing complexity and international integration of economies makes overly centralized decision-making practically impossible; the proven inability of the public sector to perform well, if at all, the myriad functions associated with an interventionist state; and the excessive politicization and corruption generated by overextended and overbearing public sectors.

But the will to change has not always been matched by the ability to effect a change. As the search goes on for the best ways, particularly in developing countries, to marry the functions of the public and private sectors, so does the controversy over the appropriate role of the state in the economy. At one end of the spectrum are proponents of an almost entirely laissez faire state; at the other end are those who favor a promotional role for the state in private sector-led development strategies.

This article does not take sides in this debate. Rather, its central thesis is that a greatly modernized, efficient, and supportive public sector is key to the success of a development strategy that rests on a larger role for the private sector.

Quality of the state's role

In the pursuit of economic and social development, one can identify the major areas in which changes need to be made to improve the quality of the state's intervention. These include (1) the functions of the public sector; (2) the administrative structures; (3) the procedures followed; and (4) the skills and management systems required.

A leaner, specialized, and more effective public sector is needed to support a healthy private sector

Arturo Israel

Functions. Five important functions performed by the public sector need to be identified and improved:

- *The capacity to design, monitor, and implement a consistent set of macroeconomic and sectoral policies.* A consistent and stable set of carefully crafted macroeconomic and sectoral policies is the *sine qua non* of sound development strategies and yields the highest returns. Unfortunately, the developing world is littered with cases of badly thought through and meandering policies, with glaring costs. A preliminary analysis of the successful cases of policy formulation and implementation in developing countries (for example, in Botswana, Chile, Mauritius, and the Republic of Korea) suggests the need for highly qualified staff in key agencies (no more than 200 persons perhaps in larger countries), well versed not only in economic analysis and specialized subject areas but also in communicating across governmental bodies and, crucially, with the political establishment. Such staff are needed, for example, in the ministry of finance, the central bank, the trade agencies, and the main sectoral ministries. Such persons have to be brought to the right posts (with appropriate benefits and status) and then allowed to function.

- *To provide an enabling environment for the functioning of competitive markets.* This can be best begun by dismantling the "disabling" environment through the enactment of the liberalizing policies propounded in recent years, the privatization and liquidation of public sector activities that compete unfairly with private sector ones or are simply nonperforming, and the elimination of restrictions on competition. Legal changes and, per-

haps more important, modifications in the functions of the state need to be made. These include the elimination of many controlling and licensing functions—for example, foreign exchange and financial controls, and industrial and transport licensing. Public sector agencies performing such functions have to be dismantled or reoriented. In practice, this has not been easy. In some countries, entrenched bureaucracies with considerable political power have managed to neutralize or greatly reduce the impact of policy reforms. Powerful interest groups sometimes have acted against the adoption or implementation of, for example, reforms to liberalize quantitative restrictions. Yet, in other cases, powerful central leaders have managed to push for such policy changes in spite of bureaucratic opposition. For example, Mexico dismantled quantitative restrictions over the objections of its Ministry of Trade and Industry, and Tunisia abolished the requirement that firms obtain clearance from the Agence des Promotion des Investissements before entering the market.

Another aspect of the enabling environment is the provision of fair and transparent rules and other operating conditions that would allow the smooth operation of the private sector and competitive markets. Such regulation includes not only the overseeing role (e.g., antitrust, prevention of collusion, or

This article is based on a longer paper, "The Changing Role of the State: Institutional Dimensions," available as PRE Working Paper No. 495 (August 1990) from Zeny Kranzer, Room N-9051, World Bank, Washington, DC 20433 USA.

monopoly) but also the enforcement of financial and technical standards, as needed. It requires a high level of skills (for example, to monitor the banking system), high ethical standards, and consistent political support. Regulatory failure is perhaps the highest risk of a private sector-led development strategy.

Many governmental functions have to be strengthened, and others created, to foster a liberal economic system. These include, as a minimum, the enforcement of technical standards (often a key ingredient for promoting exports), the streamlining of procedures to register property and protect property rights, the enforcement of contractual obligations and disclosure laws, and effective bankruptcy and foreclosure proceedings. In addition, some regulation of externalities is also required (for example, environmental protection), along with establishing mechanisms to assure adequate and accessible information for consumers, producers, investors, and regulators, through disclosure rules and other mechanisms.

Finally, the public sector can play an active or promotional role by creating "positive distortions," or incentives, to promote exports or particular activities in the domestic economy. Some Asian economies (Korea, Singapore, and Taiwan Province of China) have been quite successful in this direction. Such an activist policy, however, requires a delicate balance, both institutionally and politically, which is very difficult to achieve. This is a tall order for any country. The potential for big mistakes is huge; even the best performers have made them.

- *To privatize wisely and effectively.* The state has a difficult role to play in the process of privatization. Aside from the political issues, an important factor slowing down the privatization process in many developing countries has been the lack of technical capacity in the public sector to prepare the units that are going to be privatized and then to negotiate their sale, lease, or divestiture. This capacity could reside in a small unit with a few highly qualified professionals possessing technical and political independence. The extensive privatization process in Mexico, for instance, was "masterminded" by a small team at the Ministry of Finance. Once privatization has been effected, the public sector needs persons with the skills to monitor and often regulate the privatized units to ensure that the expected efficiency gains from privatization will materialize.

- *To conduct an effective dialogue with the private sector.* An essential ingredient of the new development strategies is a better dialogue between the public and private sectors, involving a simple and unfettered exchange of

information, demands, concerns, and points of view. But this collaborative approach should not produce collusion and the negotiation of privileges on either side. This dialogue is particularly culture-bound and will vary from country to country. It must take place at all levels, but in many countries, the institutions required to facilitate it in both the private and public sectors have to be created or reoriented. Most public sector agencies are not attuned to looking at the private sector as their client, with needs and preferences and with a voice that has to be taken into account. This reflects the traditional top-down orientation of most public sectors.

In the private sector, there is an even wider disparity. At one extreme, the small and powerless private firms, including those in the informal sector, are not organized enough to make their views heard by government agencies. At the other extreme, there are powerful private sector associations (e.g., Chambers of Commerce) grouping the largest productive units, which maintain a strong position vis-à-vis the public sector and have often managed to obtain important privileges for themselves. Many public sector agencies dealing with these groups are weak and yield easily to pressure. The essential ingredient for success in this direction is a substantive political reorientation, from an excessive pursuit of privileges to a more open and constructive dialogue.

- *To operate more effectively the enterprises that will remain in the public sector.* Considerable progress has been made in recent years in a large number of countries to help governments set up clear rules of the game for public enterprises, governing their policy framework, autonomy, and accountability. The results have been promising.

In principle, a public enterprise operating in a competitive market and behaving as a competitive unit is not very different from a private sector enterprise operating in the same market. The critical issue is often not ownership but competition. Indeed, many public en-

terprises operating in relatively high technology and "hard" activities (e.g., telecommunications, electric power, and airlines) have been able to maintain a relatively reasonable level of operational performance even under unfavorable general conditions. But their performance has been less satisfactory in "soft" activities, such as education or the provision of services in agriculture or health. The largest gains from privatization might come from the soft activities, especially if they can be made to operate in competitive environments.

Structures. The reorientation of functions discussed above requires a "restructuring" of the public sector. As indicated earlier, a number of agencies directly controlling economic activities (e.g., industrial licensing, foreign exchange and import controls, and price controls) will need to be eliminated or reoriented. However, new agencies or units within agencies will have to be established; for example, regulatory agencies (to oversee the privatized financial sector, capital markets, and technical standards), or those capable of undertaking policy analysis and management. Depending on the circumstances, some regulations could come from the private sector itself. For example, the accounting, auditing, legal, and medical professions may have sufficiently strong internal standards so that the role of the state in their regulation could be minimal.

Because of the nature of their work (mainly economic and technical analysis, instead of the previous processing of paperwork and monitoring of controls in great detail), the new regulatory agencies should be smaller and much more efficient than their earlier counterparts. This is closer to the operation of a think tank and should be managed as such.

Procedures. The proposed reorientation also requires different procedures. Two major changes underline the importance of streamlining decision-making systems. First, the top-down orientation fostered by the public sector *cum* planning orientation of past development strategies needs to be replaced by an approach that includes beneficiaries ("clients") at all levels. This would reduce the distance between the state and the public. The specific mechanisms for this more open approach are country-specific, and the process is undoubtedly helped by a democratic setting, but several measures could be borrowed from developed countries. For example, procedures should be adopted that permit prior comment by all affected individuals or groups—not just those with vested interests—on regulations or even policy changes. Such procedures should be transparent to minimize the risk of collusion and should inform the public about decisions in a language that ordinary people c



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understand. Another crucial element is the provision of appeal by interested parties.

The essence of the argument behind these changes is that individuals and private enterprises are willing to take risks, in part, because they have a reasonable assurance that the state will act in a predictable, open, and systematic fashion, treat them fairly, give them a voice, and inform them of results.

The second, closely related issue is the need for efficient points of contact between public sector agencies and private sector operators. This covers, for example, the tax collection system, technical licensing and control, or credit processing, all of which are often appallingly incompetent. The de-bureaucratization program in Brazil of a decade ago, along these lines, had an important measure of success and other countries followed that experience, albeit only partially.

Skills and incentives. The functions, structures, and procedures described above demand a different kind of civil servant and a changed set of incentives for public sector employees. The staff should have sufficient professional stature and integrity not only to conduct a dialogue with the private sector but

also to withstand its pressures. They should also be able to speak effectively with politicians. This kind of staff might be available in the country, but often is not attracted or retained by the public sector. Some countries (e.g., Brazil, Chile, India, Mexico, and Turkey) could achieve this objective with relative ease. Others have relatively less "stock" of the type of skills required, particularly in the public sector.

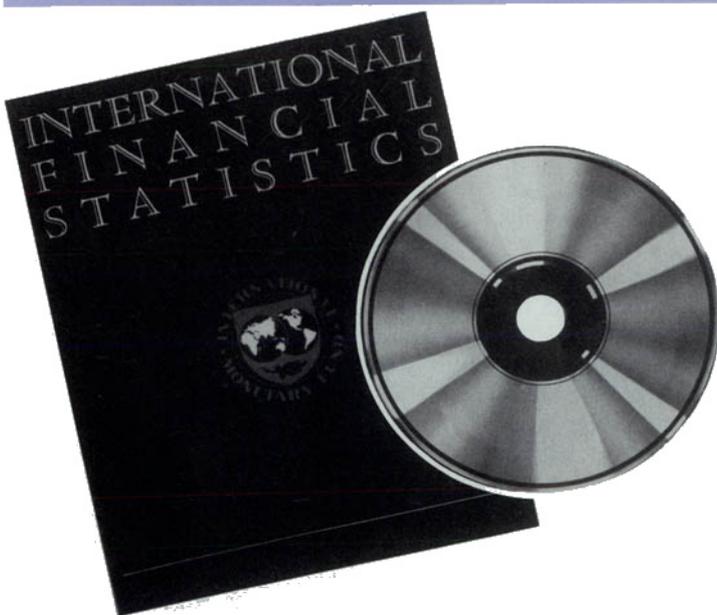
The quality of politics

In discussions about the changed role of the state, there has been surprisingly little analysis of the "quality" or effectiveness of the political process, an essential ingredient of sustained development. An effective political process includes a number of ingredients: a long-term perspective in policy design, instead of a concentration on immediate gains; stable policies; a low level of corruption; and a recognition that political control does not necessarily imply public ownership or operation. Contradictory and excessive political interference in the operations of the public and often the private sectors produces unintended negative results. For example, price controls for

public enterprises aimed at reducing inflation result in higher inflation through increased budget deficits, and political appointments of incompetent staff lead to the bankruptcy or discrediting of agencies that were the sponsoring politicians' power centers. Equally important, the political establishment has to understand that saddling central agencies or public enterprises with an excessive number of often contradictory economic, political, and social objectives makes their effective management practically impossible.

Countries should look for additional approaches beyond the obvious answers of improving the democratic process and accountability of the political system. Strengthening the policy-making technocracy (inside and outside the government) could make it a countervailing force against political pressure, as is the case in many developed countries. In general, the more politicians and parliamentarians can be educated and trained to understand the process and objectives of economic policy and decisionmaking, through seminars and visits, and by retaining specialist staff to guide them, the better the political process will be for development. ■

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