

[DRAFT: NOT FOR QUOTATION OR CIRCULATION]



# Governance and the Law

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Yellow Cover Draft

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## World Development Report 2017 on *Governance and the Law*

### Overview

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#### **Improving governance to meet today's development challenges**

0.2 Confronting the challenges faced by today's developing countries—poor service delivery, violence, slowing growth, corruption, and the natural resource curse, to name a few—requires a rethinking of the processes by which state and nonstate actors interact to design and implement policies, what this Report calls governance. Consider the following cases which have recently attracted global attention.

0.3 *Demanding better services in Brazil.* In 2014, the world watched as people in Brazil demonstrated in the streets, complaining about the quality of public services—transport, education, and health—as the FIFA soccer world cup approached. Brazil had gone through twelve years of inclusive and sustained growth which had resulted in more than 30 million people being lifted out of poverty and a strengthening of the Brazilian middle class. But these same middle classes that contributed with their taxes to the provision of public services were now demanding better quality and coverage, including “FIFA-standards for our schools.” Why did this change come about? Brazil's social contract had fragmented: low quality services had gradually led the upper middle classes to demand private services, weakening their willingness to contribute to the fiscal system. The concentration of wealth and the gap between private and public services led to perceptions of unfairness by those who expected more from the state given their own contributions.

0.4 *Media, contestation, and violence during the Arab Spring.* The protests that erupted in Brazil surrounding the world cup demonstrate the instrumental role played by the internet and new social media in facilitating collective action. Across the Arab world in 2011, these technologies allowed citizen grievances to reach a tipping point. Social protest erupted into violence as members of society chafed at their lack of access to state institutions, resources, and services. These events highlighted the limitations of social media, which was effective in coordinating protests but could not yield sustained representation of interests and promote social change. To follow the terminology of the 2016 *World Development Report* (WDR) on digital dividends, “analog” complements are needed to maximize the potential of social media.

0.5 *China's growth performance and growth challenges.* China's successful track record of economic growth is well known. For four decades, as China has increasingly integrated with the global economy, it has grown at double-digit rates and lifted over 700 million people out of

poverty. Yet according to many commonly used indicators, China's institutional environment during this period remained static. Does this imply that institutions do not matter for growth? No. Rather, a deeper understanding of China's development shows that adaptive policy decisions and enhanced state capacity were essential to economic success and were facilitated by deep changes to the mechanisms of accountability and collective leadership. China's experience highlights the need to pay more attention to how institutions function and less to the specific form they take. Yet China today faces a growth slowdown. Maintaining rapid growth and avoiding a "middle income trap" requires the political will to switch to a growth model based on firm entry, competition, and innovation. In many middle income countries, this transformation has been blocked by actors that benefited from early growth and have no incentive to join coalitions for further reforms.

0.6 *Illicit financial flows and the Panama Papers.* In early spring 2016, the leak of 11.5 million confidential documents from a Panamanian law firm became breaking news worldwide. The "Panama Papers" contained information on the assets held in offshore companies by wealthy individuals in more than 40 countries. Though many of these assets were not illegally acquired or illegally held, prevailing global sentiment condemned the practice for allowing elites to conceal taxable income from domestic authorities. The volume of *illicit* financial flows (IFFs) now exceeds official development assistance in developing countries, depriving these countries of valuable resources and reinforcing existing inequalities. Tax evasion undermines the legitimacy of the state, which is based on the delivery of public services, and increases the capacity of actors to "opt out," obstructing development. Fighting the illicit flow of capital abroad is an important development goal, but doing so successfully requires understanding the incentives of a complex network of actors, including domestic and foreign state institutions, corrupt domestic and foreign public officials, and foreign financial institutions.

0.7 *Confronting the resource curse in Nigeria.* Just one year after a decade of large windfall revenues due to high oil prices, Nigeria was requesting budget support. Instead of saving to invest in the future, much of Nigeria's oil wealth had been squandered. According to a former president of the central bank, over 20 billion dollars were lost to corruption, highlighting a lack of accountability. Nigeria's institutional context did not provide the commitment capacity to save revenues from natural resource extraction to support long term development and reduce fiscal volatility, protecting a macroeconomic environment more prone to long term investment. Corruption had become a built-in feature of government interactions, rather than a problem that could simply be eradicated. Although many countries have demonstrated that the "resource curse"—the paradox that countries with abundant natural resources may have slower growth and worse development outcomes than countries without resources—can be avoided through effective economic and fiscal policies, these policies were not credibly adopted or implemented in Nigeria.

0.8 As these examples highlight, technical answers to problems such as improving service delivery, controlling corruption, or spurring economic growth abound; and there is no dearth of resources either. Many policies that should be effective in generating positive development outcomes, often fail to be adopted or are poorly implemented. Model anticorruption laws and institutions frequently fail to curb corruption. Fiscal policies do not always reduce volatility and lead to long term savings, particularly in countries when revenues come from natural resources. Decentralization does not always result in better municipal services and targeting at the local level. Redistributing resources does not always results in less violence. Although the development community has focused on learning what policies and interventions are needed to generate better

outcomes, it has focused much less on learning why these approaches often fail to generate successful results under different circumstances.

0.9 Seventy years after Bretton Woods, how to ensure that policies lead to sustainable development outcomes remains an open question. This report is part of a trilogy of World Development Reports (WDRs), alongside *Digital Dividends* (2016) and *Mind, Society, and Behavior* (2015), which examine how policymakers can make fuller use of behavioral, technological, and institutional instruments to improve state effectiveness for development. The Report shows that in order to understand policy effectiveness, one must understand how policies are designed and implemented in a specific context. Policies do not occur in a vacuum. Rather they take place in complex political and social settings, in which individuals and groups with unequal bargaining power interact within changing rules as they pursue conflicting interests. The process of these interactions—governance—is fundamental to the study and practice of development (box 0.1). Governance must be taken seriously if implementation gaps are to be overcome.

### Box 0.1 The basic concepts

#### What is governance?

*Governance* is the process through which state and nonstate actors interact to design and implement policies, within a given set of formal and informal rules that shape and are shaped by power.<sup>a</sup> This Report defines *power* as the ability of one actor to make others undertake an action that is in that actor’s interest, and that the others would not otherwise take (Dahl 1957; Lukes 2004).

Depending on the context, actors may establish a *government*, as a set of formal state *institutions* (organizations and rules) that enforce and implement policies. Also depending on context, state actors will play a more or less important role with respect to nonstate actors, such as civil society organizations or business lobbies. In addition, governance takes place at different levels, from international bodies, to national state institutions, to local government agencies, to community or business associations. These dimensions often overlap, creating a complex network of actors and interests.

#### Governance for what? Achieving the goals of security, growth, and equity

There are many important aspects of governance that are valuable in and of themselves (that is, that they have intrinsic value)—in particular, the notion of freedom. In economic terms, freedom can be seen as an opportunity set, and development can be seen as “the removal of various types of unfreedoms” (exclusion from opportunities), where these unfreedoms reduce people’s capacity of “exercising their reasoned agency” (Sen 1999). As essential as such an intrinsic value of freedom is, its instrumental value also matters because of the “effectiveness of freedoms of particular kinds to promote freedoms of other kinds” (Sen 1999). These positive relationships are what economists call complementarities. The Report acknowledges the intrinsic value of various dimensions of governance, while also recognizing their instrumental value to achieve equitable development.

The analysis of this Report starts from the normative standpoint that every society cares about freeing its members from the constant threat of violence (*security*), about promoting prosperity (*growth*), and about how such prosperity is shared (*equity*). It also assumes that societies aspire to achieving these goals in environmentally sustainable ways. The Report assesses governance in terms of its capacity to deliver on these outcomes.

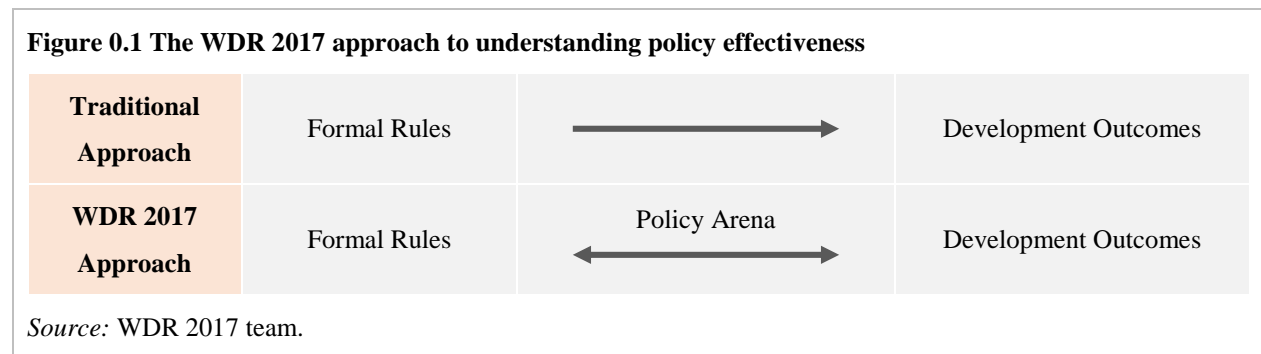
This approach is consistent with the transition from a dialogue based on ideology to a dialogue based on ideals, which has transpired in the global development community over the past few decades. The establishment of the Millennium Development Goals (MDGs) in 2000 and the recent ratification of the Sustainable Development Goals (SDGs) by member countries of the United Nations are examples of these efforts to set common goals for social and economic advancement. SDG 16 calls for promoting “peace, justice, and strong institutions,” and is explicitly related to governance. Nevertheless, as this Report will argue, beyond the intrinsic value of SDG 16, it also holds important instrumental value, as the attainment of SDG 16 will aid in the attainment of all the other SDGs. Indeed, the achievement of all the development goals will require a solid understanding of governance dynamics in order to enable more effective policies.

<sup>a</sup> This general definition is consistent with the World Bank’s corporate definition, which emphasizes formal institutions and the role of state actors.

**Rethinking governance and development: Three principles**

0.10 The WDR 2017 focuses on ways to improve governance to free societies from the constant threat of violence (security), promote prosperity (growth), and ensure that prosperity is shared (equity), while also protecting the sustainability of the development process for future generations. This Report proposes an analytical framework to advance our understanding of how governance can be improved to promote more effective development policies in these areas. This endeavor requires understanding in more detail the dynamic relationships between the policy-making and policy-implementation processes, the institutional functions required for policies to be effective, and the power configurations that shape and constrain these processes to affect development outcomes.

0.11 The framework contains three key elements: the *policy arena*, where actors bargain over policy design and implementation; the *formal rules* of the game (institutions) that shape the policy arena; and the *development outcomes* to which policies aim to achieve. Traditional analysis has focused on the interaction of the formal rules and the development outcomes. For example, analyzing how decentralization can improve service delivery at the local level. This report emphasizes that the effectiveness of policies to deliver on outcomes depends on the nature of the policy arena which mediates the interaction between the two. (figure 0.1)



0.12 This Report views the policy-making and policy-implementation processes as complex bargaining processes between different actors. The policy arena is where the different bargaining power of actors comes into play. Their relative power comes from the rules themselves (*de jure*) or from concrete aspects like control over resources (*de facto*). Ultimately, this means that the effectiveness of policies depends not only on *what* policies are chosen, but also on *how* they are chosen and implemented—which depends on the relative distribution of power. For example, decentralization reforms in Maharashtra, India actually ended up reinforcing inequalities rather than improving targeting to beneficiaries as those with more power at the local level were better able to influence the redistributive programs than the poor (Anderson, Francois and Kotwal 2015). While these power structures tend to be persistent, change is possible. The formal rules can change over time as coalitions are formed among different actors within the policy arena.

0.13 Traditional development orthodoxy has so far emphasized the centrality of three assumptions in promoting development outcomes: the forms of those policies, the capacity to implement them, and the impersonal application of the rules. These assumptions have shaped the conventional solutions of the international community to the problem of policy failure in developing countries: first, invest in “good” laws and policies; second, build organizational and

technical capacity to implement them; and third, strengthen the “rule of law.” The framework proposed in this Report has important implications for revisiting these approaches.

0.14 This Report argues that while it is important to look at forms that have worked in others contexts, gauge what capacity is needed, and stress the importance of the rule of law, these aspects are not enough. WDR 2017 proposes three new principles, which build on these foundations. First, “think of function, not only form”; it is important to think about the functions institutions must perform, and not only what form they should have. Second, “think of power, not only capacity”; while capacity building matters, how to use the capacity and where to invest in capacity depends on the relative bargaining powers of actors. Third, “think of the role of law, not only the rule of law”; in order to achieve the rule of law, countries must first strengthen the different roles of law (table 0.1)

**Table 0.1 Three new principles for rethinking governance for development**

<b>Traditional approach</b>	<b>Three new principles for rethinking governance</b>
Invest in designing the right <b>form</b> of policies	Think about <b>functions</b> , not only form
Build the <b>capacity</b> to implement those policies	Think about <b>power</b> , not only capacity
Strengthen the “ <b>rule of law</b> ” to ensure those policies and rules are applied impersonally	Think about the <b>role of law</b> , not only the rule of law

Source: WDR 2017 team.

### **The functions of governance: Commitment, cooperation and coordination**

*First principle: “Think about functions, not only form”*

*It is not only about the form of the institutions countries have, but how effectively those institutions perform their functions that matters for development.*

0.15 What do effective policies have in common? Even when policymakers agree to adopt pro-development policies, if there is no credible commitment to deliver on those policies, if there is no cooperation to comply with those policies, or if they are unable to change expectations to coordinate behavior, these policies will likely remain ink on paper.

0.16 As a first precondition, policy effectiveness requires commitment. Policies can get truncated by changes in circumstances and reconfigurations of the incentive structure for actors who make decisions in the policy arena. Contracts are always incomplete and establishing credible commitment is, thus, complex. Think of the Nigeria example discussed in the previous section. The institutional context did not provide the commitment capacity to save revenues from natural resource extraction to support long term development and reduce fiscal volatility, protecting a macroeconomic environment more prone to long term investment.

0.17 How can long-term development goals be internalized by actors responding to short-term political cycles? The so-called natural resource curse—the inability of resource-rich countries to overcome the voracity-effect and strengthen their fiscal capacities is closely related to this difficulty to establish credible commitment to use resources with a long-term perspective and to prevent corruption, while the natural resource extraction is generating large revenues. Moving from an equilibrium based on rent-distribution—a deals-based system—to one based on rules that assign and constrain responsibilities and authority is more difficult in the presence of large rents, and when there is a lack of commitment devices at the hand of the actors. Bringing best practice fiscal rules—forms that have worked in other contexts—may not solve the undermining restrictions for commitment.

0.18 Effectiveness also builds on the willingness to contribute to the public goods—and not to free-ride on others. Consider the Brazil example discussed above, where citizens organized to demand higher quality of public services. Brazil is not alone. It faced a common problem of Latin American countries, namely the fragmentation of a social contract in which low quality of service provision led gradually the upper middle classes to demand private, instead of public services, weakening the willingness to fiscally cooperate to the provision of public goods. The tax morale of societies—whether people are intrinsically motivated for cooperation to public service provision—tends to be affected by the quality of the services received in exchange and by the process through which decisions for resource allocation are made. Willingness to cooperate leads to higher social cohesion in society.

0.19 Additionally, the expectations and beliefs of people about what others will do in response to public action also matters. People gathering at a bank to withdraw their savings because they believe that others will do it—and fear losing their patrimony—could lead to a bank run and eventually a banking crisis. People’s decision to invest or innovate may be delayed if the profitability of their investments relies on others also investing. Countries competing to attract investment by lowering environmental standards and corporate tax rates are situations where coordination fails and societies are locked into less desirable situations. Indeed, what people believe about how others will react to policies and laws is also a key determinant of effectiveness. If laws, for example, are such that actors believe the others will comply, they would then find in their own interest to comply as well.

0.20 The coordination role of laws and policies has been shown to be extremely powerful in delivering effective public actions. Pro-development leadership may play a role in this regard. This coordination function, unfortunately, is better understood when it fails. The effectiveness of policies to re-shape those beliefs and coordinate on socially desirable actions becomes then a way out of potential traps. The “missing middle” phenomenon in terms of firm size in countries such as India has been associated with a coordination problem for small firms whose growth profitability depends on other firms growing as well and where imperfections in credit markets and excessive regulations exacerbate the lack of coordination.

0.21 Commitment, cooperation, and coordination are thus the key functions through which governance affects development and policies become effective (table 0.2). The discussion that follows explores how commitment, cooperation, and coordination matter for promoting security, growth and equity.



**Table 0.2 Institutional functions: commitment, cooperation, and coordination**

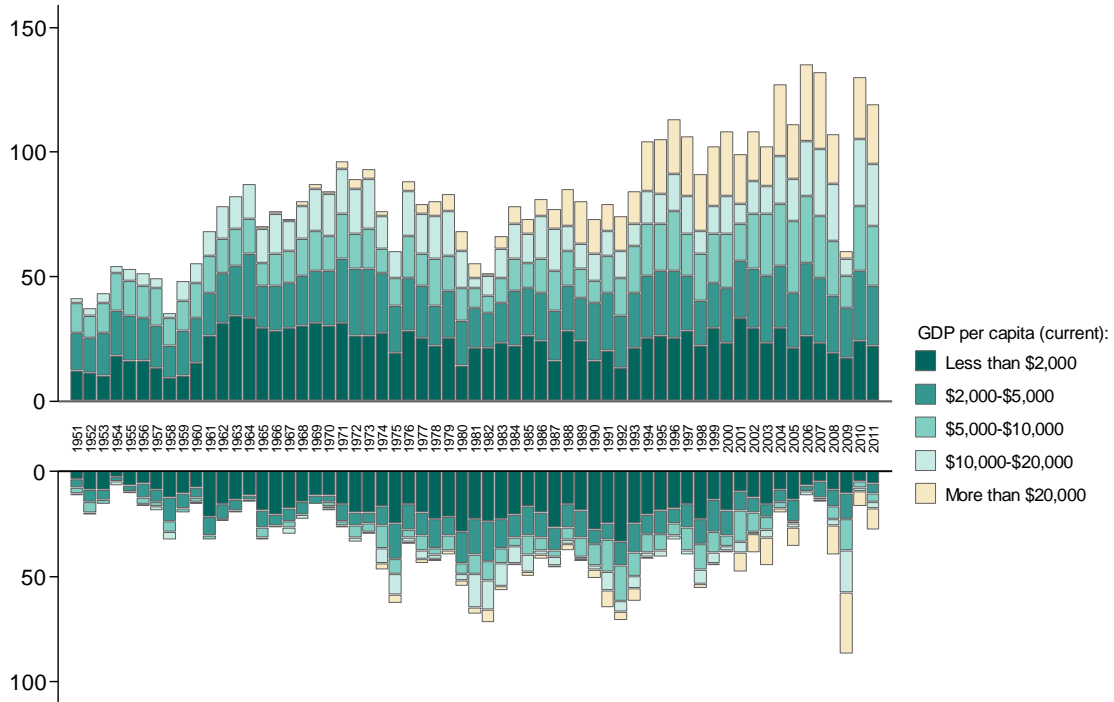
Function	Some examples of why these functions matter
<b>Commitment</b>	<ul style="list-style-type: none"> <li>• Decision-makers may want to spend windfall revenues now instead of saving them for others to spend in the future</li> <li>• Politicians may resist continuing policies that have worked in the past and prefer to propose policies that are associated with their political group</li> <li>• Service providers may want to renegotiate when the political cost of accepting failure or suspending service is high</li> </ul>
<b>Cooperation</b>	<ul style="list-style-type: none"> <li>• People have incentives to free-ride or behave opportunistically by, for example, not paying taxes because they can still enjoy public services</li> <li>• Some actors potentially affected by policies may be excluded from their design, which weakens compliance and leads to fragmentation</li> </ul>
<b>Coordination</b>	<ul style="list-style-type: none"> <li>• Investment and innovation requires individuals to believe the others will also invest</li> <li>• Financial stability relies on beliefs about credibility of policies</li> <li>• Laws serves as a focal point for individuals to behave in certain ways</li> </ul>

### ***Governance and security***

0.22 Security is a foundation for sustained development. Most long-term growth comes not from episodes of rapid growth—as commonly believed—but from countries not shrinking during and following crises and violent conflict (figure 0.2). Social choices, political change, and the development process itself are inherently conflictual. However, conflict does not and need not necessarily lead to violence (defined as the use or threat of physical force). Conflict and violence are not the same, and have different determinants. Conflict is not necessarily negative, and may in fact be a powerful engine for positive change. Violent conflict, on the other hand, is destructive. At the micro level, violent conflict can result in the destruction of productive assets and livelihoods, displacement, disruptions in household composition, and damage to the productive capacities of household members.

**Figure 0.2 Growing faster does not explain long-term growth; shrinking less—and less often—from crises or wars does**

Number of countries experiencing positive or negative annual growth in income per capita, by income level, 1951–2011



Sources: WDR 2017 team, based on Wallis (2016) with data from the Penn World Tables 2015.

Note: Countries are categorized by per capita income (in terms of purchasing power parity, PPP) in the given year.

0.23 While the development process constantly generates demands for the redistribution of power and resources, there are many instances in which conflict does not lead to violence. For example, the abundance of natural resources in Canada or Botswana, and the ethnic and religious heterogeneity in Malaysia and Switzerland, have not resulted in violent outbreaks. The underlying reason for this has to do with governance. Secure and prosperous societies are those where governance addresses the conflicting preferences and diverging interests of individuals and groups without the recourse to violence.

0.24 Policies can reduce violence when governments can credibly commit to honoring agreements, and when citizens comply willingly with governments' rules and policies. When commitment is not credible and cooperation is difficult, contending sides walk away from the bargaining table, citizens do not comply with governments' rules, and violence prevails. Warring factions may renege on peace agreements, policy makers may default on promises to transfer resources to discontented groups or regions, disputants may fail to abide by court judgments, or policemen may abuse citizens instead of protecting them.

## ***Governance and growth***

0.25 In the long term, growth in per capita income has two sources—investment and productivity (efficiency). Governance can affect investment and efficiency through two types of institutional functions. The first deals with commitment: that is, creating an environment in which firms or individuals feel secure in investing their resources in productive activities, and have the incentives to use them efficiently. The second pertains to socially beneficial collective action to coordinate investment decisions and promote cooperation between investors to solve potential market failures.

0.26 In the absence of credible commitment to the security of property rights (that is, when there is a risk of expropriation), the incentives for investment or innovation will be limited. Firms and individuals that experience lower security will invest less in productive activities. Moreover, differences across firms in the level of security from expropriation will affect the efficiency of resource use. If the more productive firms in an economy experience less security than the less productive ones, then investment by productive firms will be inefficiently low, leading to misallocation of resources and thwarting growth. Enforcement of contracts governing economic transactions is also critical because problems with contract enforcement prevent specialization and optimal division of labor (North 1990; Costinot 2009). Empirical studies find that a strengthened formal enforcement system can foster the creation of new business relationships, promote trade in goods, and increase the flow of credit to firms.<sup>1</sup>

0.27 Some forms of collective action, such as coordinating investment and ensuring cooperation to prevent free riding, can solve potential market failures that can impede growth and investments in public goods. The insight that a failure to coordinate investment activity could lead to underdevelopment is decades old.<sup>2</sup> Suppose large-scale factories are more efficient, but investing in them is not profitable for individual firms unless done simultaneously in a group. This could be because those industries provide markets for one another, so the market size is too small to justify large-scale investments unless all the industries expand together. There are two possible outcomes, or “equilibria,” in such a situation. The first is one in which no firms invest in large-scale factories, and efficiency levels stay low. The second, better outcome is one in which firms are able to coordinate a simultaneous move to large-scale, efficient production. Such coordination problems can occur in many contexts, ranging from finance and adoption of technology to innovation and industrial clusters.<sup>3</sup>

## ***Governance and equity***

0.28 In addition to creating an environment for prosperity, governance matters for influencing how that prosperity is shared by shaping the functioning of markets and by reshaping the resulting

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<sup>1</sup> Johnson, McMillan, and Woodruff (2002a) find that well-functioning courts help firms switch to new suppliers. Better contract enforcement is also associated with higher lending and lower rates of default (Japelli and others 2005, Castelar and Cabral 2001; Cristini, Moya, and Powell 2001). There is also evidence that better contract enforcement enhances the productivity impact of trade liberalization (Ahsan 2013).

<sup>2</sup> Rosenstein-Rodan 1943. Murphy, Shleifer, and Vishny (1989) model a more recent version of this idea.

<sup>3</sup> Hoff (2000) reviews models of coordination failures in a wide range of contexts, including social norms and corruption. Cooper (1999) reviews macroeconomic models of coordination failures, while Rodríguez-Clare (2005) reviews microeconomic models of coordination failures.

distribution—for the current generation and the next. Policies that allocate and redistribute resources—including the proceeds of growth—within and across generations enhance equity. The two main redistributive policy instruments are the provision of public goods and services, and fiscal policies for public spending and revenue collection.

0.29 The extent to which society can ensure opportunities to all individuals relies on its ability to provide high quality services, such as health and education. For investments in service delivery to take place, resources must be raised and redistributed. This is particularly important for the poor and disadvantaged, since they are most likely to be excluded in the presence of market failures. Indeed, no high-income country has achieved improvements in terms of equity without significant taxation and public spending to protect individuals against shocks (such as illness, unemployment, and old age) and reduce welfare disparities within and across generations (Barr 2001; Lindert 2004). In addition, for individuals to realize the returns of such investments, they need access to economic opportunities in adulthood, especially access to markets that allow them to use the assets that they acquired.

0.30 In order to do so, there is a need for cooperation to collect taxes to fund investments in public goods and there is a need for credible and consistent enforcement of laws to expand opportunities and level the playing field and for ex-post redistribution. For instance, if property rights are secure only for some, those who are not protected as much as others will respond by underinvesting (Goldstein and Udry 2008). Furthermore, if individuals think that their effort will not be rewarded because of discrimination of various forms, they may exercise less effort (Hoff and Pandey 2006). The credibility of commitments made by policy makers is also key for the enforcement of sanctions and compensation when redistributive goals are pursued.

### **Underlying determinants of governance: Power, political will and institutional capacity**

*Second principle: “Think about power, not only capacity”*

*Investing in the capacity to implement policies may not promote better outcomes if underlying power structures thwart implementation.*

0.31 Effective policies in this Report are those that perform three key functions: enabling credible *commitment*, enhancing *cooperation*, and inducing *coordination*. But why are policies so often ineffective in doing so? Answering this question requires digging below, to expose the power configurations in society. Power is expressed in the policy arena by the ability of groups and individuals to make the system act in their interest. It is a fundamental enabler—or constraint—to policy effectiveness.

0.32 The development community has largely focused its reform attempts on designing best practice solutions and building the capacity need to implement them. In this sense, capacity is often considered a prerequisite for policy effectiveness. While capacity is certainly important, and in many cases it constitutes an overriding constraint, it also is a proximate cause. Building capacity increases the stock of resources available to implement policies. Thus it strengthens the bargaining power of the state, making commitments more credible. On the other hand, current capacity is also the result of past decisions to invest—or not to invest—in building such capacity. Given limited resources and conflicting preferences, individuals and groups in positions of power may choose to

allocate resources and build capacity in those regions and sectors that advance their interests or those of their constituencies, and thus strengthen their hold on power.

0.33 At a given point in time where capacity can be thought of as a stock. How and where to use such capacity, however, is also the outgrowth of a bargaining process. Even in the presence of existing physical and administrative capacity, policies may still be ineffective if groups with enough bargaining power have no incentives to pursue implementation. In addition, existing power structures are reinforced by prevailing norms, as socially accepted, persistent, shapers of behavior. Such norms may reinforce or undermine policy effectiveness.

0.34 How does this matter concretely for security, growth, and equity? The discussion that follows explores how the underlying power structures can constrain how policies function in promoting these development outcomes.

### ***Power as a constraint to policy effectiveness for security***

0.35 Violent conflict is ultimately the respective product of three factors: the unchecked power of individuals, groups, and governments (such as when police forces abuse slum dwellers instead of protecting them, or when ruling elites repress peaceful citizens); failed bargains between participants in the bargaining arena (such as when peace talks between rival factions break down, or when disputants fail to reach an agreement over a dispute); or the exclusion of individuals and groups from the bargaining arena (such as when important constituencies lack access to state resources, or when powerful groups are excluded from the policy-making process).

0.36 Modern societies are fundamentally characterized by the concentration of security arrangements in the hands of the state, which has a monopoly over the means of violence and coercion (Mann 1984; Weber 1965). At its core, the state's monopoly over violence is the outcome of a collective agreement between powerful actors over who can use violence and when its use is acceptable (Wallis 2016).<sup>4</sup> While the state's monopoly over violence is a necessary condition of security, it is by no means sufficient to guarantee the long-term security of people and property. Violence can, and often does, come at the hand of the state itself, particularly through its military and its police. Ruling elites often resort to military force against civilians to avoid having to share power (Acemoglu and Robinson 2006). Police forces often threaten and brutalize the population of gang-ruled urban slums instead of protecting them, as occurs in some U.S. and Latin American cities. Governments, or the private interests that have captured them, often violently expel local communities from their land for reasons ranging from granting concessions to mining corporations to expanding infrastructure projects (Hall and others, 2011; Moyo and others, 2015).

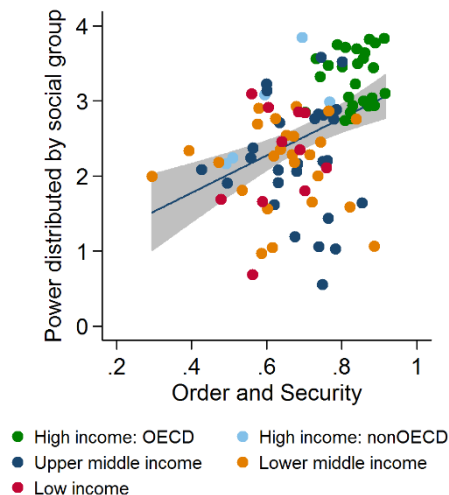
0.37 Large power asymmetries between contending factions make it easy for the stronger side to renege on its promises and hard for the weaker side to hold it to account for failing to commit (Walter 2009). Power asymmetries rooted in governments' monopoly over of taxation resources account for the likelihood of violent repression (Besley and Persson 2009). They also explain why some wars last more than others (Fearon 2004). The uneven distribution of power among parties to a dispute stands in the way of reaching and enforcing mutually satisfactory bargains—and as

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<sup>4</sup> Max Weber, in his essay, "Politics as a Vocation," originally theorized the monopoly over violence as one agreement between powerful groups over the use of violence. It is not given or imposed, it is an agreement. The authors are grateful to John Wallis for making this important point.

would be expected, correlates with violence (figure 0.3). Stronger disputants have few incentives to make concessions and concede power and resources, and many incentives to renege on agreements over time, as the literature on bargaining power suggests.<sup>5</sup> Solving disputes and enforcing contracts through the threat or use of force then becomes the more rational strategy for a powerful actor because the benefits of its use outweigh its costs, like the risk of sanctions (Schelling 1960; Walter 2015).

**Figure 0.3 A more even balance of power is associated with positive security outcomes**



*Source:* World Justice Project, Rule of Law Index 2015 Factor 5, “Order and Security” (consisting of “Crime is effectively controlled”; “Civil conflict is effectively limited”; “People do not resort to violence to redress personal grievances”) and V-Dem v.6 (“Power distributed by social group”) (where a score of 0 means political power is monopolized by one social group and a score of 4 means that social groups have equal political power).

0.38 Violence can also emerge when powerful actors are excluded from the policy bargaining arena. Lack of access to state institutions, resources, and services usually takes place along identity fault lines. The distribution of power among ethnic groups, measured by their access to central state power, is a strong predictor of violent conflict at the national level, whether in the form of repression by the state or rebellion against the state.<sup>6</sup> Cross-country statistical analyses using the Ethnic Power Relations dataset for all independent states from 1945 to 2005 indicate that states that exclude large portions of the population based on ethnic background are more likely to face armed rebellions (Wimmer, Cederman, and Min 2009). The existence of norms that exclude certain groups like women and minorities from the bargaining arena where disputes are settled reinforce power asymmetries and perpetuate inequitable and insecure outcomes (Platteau 2000).

0.39 Violence of another kind occurs when the state’s monopoly over violence falls apart (Bates 2008a; 2008b). This organized violence, the result of a bargaining failure, becomes the preferred—and rational—way to for certain individuals and groups to alter the distribution of power in their

<sup>5</sup> Wagner 2000; Powell 2004, 2006; Fearon 2004; Walter 2015.

<sup>6</sup> However, lack of access to state power is not the only determinant of violence; the capacity to mobilize against governments also matters (Cederman, Wimmer, and Min 2010), and so does the opportunity to mobilize. On the former, see (Fearon and Laitin 2003).

favor or to pursue their interests (Fearon 1995; Walter 2009). Such is the case of broken states, like Libya, Somalia, and the Republic of Yemen; peripheral areas of many stronger states, such as in the Arab Republic of Egypt, Nigeria, and Pakistan; but also the so-called “ungoverned spaces” (which are often just “differently governed”), such as inner-city neighborhoods of Baltimore and Chicago, even some French “banlieues” (Pujol 2016).

### ***Power as a constraint to policy effectiveness for growth***

0.40 The evidence suggests that governance indeed has a sizable effect on long-term growth. While it is possible for economies to grow without substantive changes in the nature of governance, it is not clear how long such growth can be sustained. Consider the case of countries stuck in “development traps.” Contrary to what many growth theories predict, there is no tendency for low- and middle-income countries to converge toward high-income countries. While it has been argued that countries can fall into “middle-income traps,” the evidence suggests that both low-income and middle-income countries are at risk of growth stagnation. What is it that keeps some countries from transitioning to a better growth strategy, when their existing growth strategy has run out of steam?

0.41 With a few exceptions, policy advice for these countries has focused on the proximate causes of transition, such as the efficiency of resource allocation or industrial upgrading. However, the real problem may be political: powerful actors who gained during an earlier or current growth phase (such as the factor-intensive growth phase) may resist the switch to another growth model (such as one based on firm entry, competition, and innovation, in the process of “creative destruction”). This can be especially problematic in middle-income countries that have initiated some reforms. These countries can become trapped in a “partial reform equilibrium” (Hellman 1998), in which actors that benefited from early growth have no incentive to join coalitions for further reforms. Box 0.2 presents another example of the political challenges in transitioning toward a different growth strategy, related to investments in environmental sustainability.

0.42 How effective policies are in addressing growth challenges depends on the relative influence of different interest groups. Influential groups are sometime able to “capture” policies and make them serve their narrow interests. In the 1990s, for example, some of Indonesia’s largest industrial groups had strong connections to then-President Suharto. Between 1995 and 1997, rumors about President Suharto’s health circulated on several occasions. In every episode, the more closely that industrial groups were connected to the president, the more their stock market returns fell (figure 0.4). This fall in value was greater the more serious the health rumor. Because this decline was not connected to other changes in market conditions or the productivity of connected firms, the drop in share price is a proxy for the private benefits of being able to capture policy through political connections.<sup>7</sup> Using a similar method, the estimated value of political connections in the Arab Republic of Egypt in the Mubarak era is about 13 percent to 16 percent of firm value.<sup>8</sup> These results contrast with the findings in the U.S.: Fisman and others (2012) find that political connections to Vice President Dick Cheney in the U.S. result in no change in the market value of

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<sup>7</sup> Fisman 2001.

<sup>8</sup> Chekir and Diwan 2014.

companies. This could be linked the ability of the institutions in the United States to more effectively constrain power.

**Box 0.2 Why some people see red when they hear “green growth”**

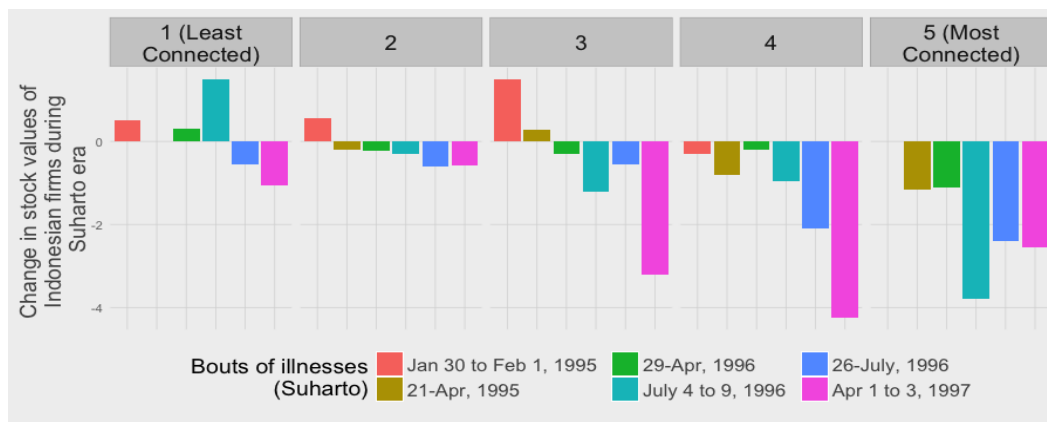
“Green growth is about making growth processes resource-efficient, cleaner and more resilient without necessarily slowing them” (Hallegatte and others 2012). There are many reasons why environmental conservation is also good for long-term economic growth and development. Economic production depends on the stock of natural resources and on environmental quality (“natural capital”). By preventing environmental degradation, green growth strategies can increase natural capital. Environmental protection can also contribute to growth indirectly by correcting market failures. For example, a policy that addresses market failures leading to urban congestion can improve air quality and increase urban productivity. Greener growth can also improve well-being directly by improving air and water quality.

However, switching to greener growth strategies could impose short-term costs on some groups in society. Take the case of agricultural policy. In 2005, faced with food insecurity, Malawi introduced a fertilizer subsidy for smallholder maize farmers. Intensive use of fertilizer, such as that promoted by this subsidy, can have substantial long-term costs on the environment and the economy. But the subsidy did lead to an immediate increase in farm output. Moreover, it would not be easy for small farmers to adopt greener approaches using smaller but more targeted doses of more organic fertilizers. Getting rid of the subsidy would therefore hurt maize farmers for some years (Resnick and others, 2012).

It could be that the groups that stand to lose from green growth policies in the short term have oversized influence over the policy arena, and are able to block reforms and undermine commitment. Since many of the benefits from cleaner technologies are intangible and dispersed, and the costs are concentrated, the potential losers from such reforms are likely to be better able to organize. They can also constitute an electorally vital constituency. Malawi’s fertilizer program has been popular among small farmers. When the subsidy was introduced, the incumbent party needed their support because it had a relatively weak rural vote base. Indeed, the government greatly increased the subsidy funding as the 2009 elections approached.

In other cases, switching to greener growth strategies could entail losses for influential groups of consumers and firms. For example, South Africa announced an ambitious climate change plan in 2010—one that would greatly reduce the share of electricity generated by coal-fired plants, in a country where coal is a relatively abundant source and electricity is in short supply. The plan, despite being watered down, has been opposed by consumers, labor unions, and business interests, particularly those in the mining sector and heavy industry (Resnick and others, 2012). These examples show that the design of policies must take into account the potential resistance from short-term losers.

**Figure 0.4 The value of political connections: Indonesia during Suharto’s era**



Source: Fisman (2001), figure 1.



0.43 The effects of this capture can be costly. A case in point is how politically connected firms are able to obtain preferential treatment in business regulation for themselves as well as to raise regulatory barriers to entry for newcomers—such as access to loans, ease of licensing requirements, energy subsidies, or import barriers. This stifles competition and leads to resource misallocation, with a toll on innovation and productivity. For example, between 1996 and 2002, politically connected firms in Pakistan received 45 percent more government credit than other firms, even though they were less productive and had default rates 50 percent higher. Based on the productivity gap between firms, the annual cost of this credit misallocation may have been as high as 1.6 percent of GDP (Khwaja and Mian 2005).

***Power as a constraint to policy effectiveness for equity***

0.44 Policies to improve equity, while being potentially beneficial for growth in the medium and long term, often adversely affect the interests of specific groups, particularly in the short term. Those affected by equity-oriented policies may be concerned about losing rents or about seeing their relative influence reduced, and thus may attempt to undermine the adoption or implementation of those policies. For example, they may choose to invest in keeping state capacity low to deliver public goods only to narrow groups of “clients,” to prevent the adoption of more progressive taxation, or to limit the ability to monitor policy effectiveness (box 0.3).

**Box 0.3 The need for political will to gather development data**

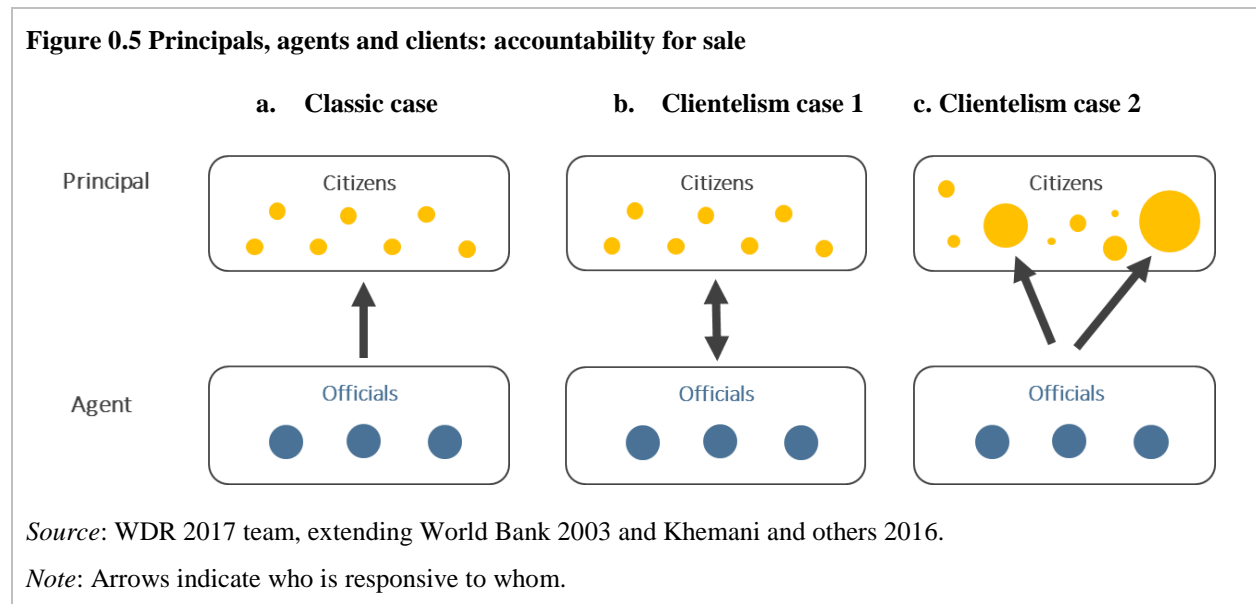
For years the development community has invested heavily in developing statistical capacity in Africa. It has done this through economic resources as well as technical expertise. However, the results have been disappointing. Many countries in the region still lack the data to monitor socioeconomic conditions such as poverty, inequality, and service delivery. Many voices are now demanding more money and more capacity building to solve this problem. However, this view neglects the fact that in order for countries to develop statistical capacity, there is a need for political will to do so.

Indeed, political incentives could even lead those in power to actively undermine capacity. Some elites in African countries consider high-quality data systems a tool the opposition could use to audit their performance. They thus have incentives to establish either weak statistical offices or partisan ones, staffed with political supporters rather than with technical experts (Beegle and others 2016). Of course, this practice is not unique to Africa. Argentina, after building a reputation for high-quality data collection and independence from the political sphere, decided during the Kirchner administration to replace the technical experts with supporters who first manipulated the data to reduce the poverty estimates and then stopped measuring poverty altogether (Noriega, 2012; Roitberg and others 2016).

0.45 Public sector workers play a key role in policy implementation. In a political equilibrium with *clientelism* (where the incumbent public officers support only limited groups of society in exchange for their support), they may extract rents through the diversion of financial resources, withholding of their effort in the form of absenteeism, or corruption hampering the delivery of services such as education or health. For example, the availability and quality of health care is often poor in India. In a representative sample of rural areas of Madhya Pradesh, 40 percent of doctors in public health facilities are absent at any given time. Doctors in public facilities spend on average 2.4 minutes with a patient and complete only 16 percent of a checklist of examination item and questions on medical history. The same doctors perform better when they are in the private sector—indicating the importance of incentives. However, virtually no doctors conducted all the examinations indicated when a child had diarrhea. Patients are much more likely to receive

an unnecessary treatment than a correct treatment. Only 3 percent gave only a correct treatment (Das and others, forthcoming).

0.46 This Report, like WDR 2004, *Making Services Work for Poor People*, views service provision as a series of relationships whereby principals must monitor agents (figure 0.5 panel a). WDR 2004 describes two routes for service delivery. In the long route, policy makers are the agents of citizen-voters, as well as the principals of providers (World Bank 2003). In the short route, citizens are principals who monitor the providers more directly. However, politicians are initially political candidates. In order to be elected—given their difficulty in credibly committing to broad public policies that are difficult to monitor—political candidates commit to targeted benefits because they can more credibly deliver them (figure 0.5 panel b). Thus they may become dependent on the support of certain groups, including public sector workers. In such settlements, citizens expect less from politicians (because they receive some targeted benefits), while providers extract rents (because rents help ensure politicians’ reelection) (Bold and others 2016a). In other cases, officials may be responsive only to those citizen groups that wield greater influence, such as favoring the interests of teacher unions over those of students (figure 0.5 panel c). The costs of this capture can be rather high. For example, in Brazil, students who are in school municipalities with lower levels of corruption score significantly higher on average on tests of mathematics and Portuguese than students in school municipalities with higher levels of corruption. In clientelistic settings, states tend to have low tax revenues and provide few public goods, undermining economic activity and future taxation.



0.47 Depending on the existing balance of bargaining power between different groups, such as local and national elites or service providers and users, the effectiveness of seemingly “good” equity-enhancing policies on paper may be surprising in practice. For example, while on paper decentralization or participatory development may seem like a way to be more responsive to local needs, entrenched inequality at the local level may result in capture of policies (Bardhan 2002). This is what happened in the case of anti-poverty programs in Maharashtra, India. Decentralization reforms were passed thinking that local village councils would be better able to target beneficiaries

and that beneficiaries could better monitor the results. However, in reality, local elites blocked redistribution.

### The role of law: Incentives, contestability and preferences

*Third principle: “Think about the role of law, not only the rule of law”*

*In order to close implementation gaps and achieve the rule of law, countries must first strengthen the role of law*

0.48 In order to improve the functional effectiveness of policies it is necessary to understand the mechanisms that sustain agreements among actors in the policy arena. These mechanisms can be *deals-based*, in which personal relations or mechanism such as rent distribution are used to enforce agreements, or *rules-based*, in which formal laws and legal institutions are used to enforce agreements. Corruption can be thought of as a deals-based way to sustain agreements among certain individuals or groups (box 0.4). In general, mechanisms to regulate decision making and implementation through formal rules render legitimacy and induce further positive dynamics.

#### Box 0.4 Controlling corruption: From deals to rules

Corruption is often defined as the use of public office for private gain. In the WDR 2017 framework, corruption is a deals-based way to sustain agreements among certain individuals or groups. While in the short term corruption may be able to “grease the wheels of the economy,” in the long term it harms growth by diverting resources from more productive uses, and it generates inequities by disproportionately benefiting those in power. Moreover, it undermines legitimacy because it damages public perceptions of the fairness of the decision-making process (Ackerman 2016).

Policy strategies that frame corruption as a *principal-agent problem* attempt to control it through mechanisms such as enhanced compensation schemes, anticorruption commissions, or monitoring devices. Success is often mixed, as these efforts frequently fail to address the underlying determinants: notably, social norms and power imbalances. Indeed, corruption is less about individual transactions and more about networks of actors. Formal rules and anticorruption strategies are only likely to be effectively enforced when they are aligned with the interests of powerful groups. If these groups do not want rules to be enforced—for example, if they can feasibly interact with one another in deals-based ways and generate rents through political connections—it is unlikely that the rule of law will emerge through enforcement efforts.<sup>a</sup>

The first step in rethinking corruption is to recognize that corruption is not a social “malady” to be eradicated, but a built-in feature of governance interactions. All societies start off by being “owned” by a few individuals who control all resources. Countries today are on a continuum of governance between a system in which rules are applied by virtue of personal status, and one in which they are applied impersonally. Moreover, norms can reinforce existing power dynamics. Just as some norms may lead to more impersonal application of the rules, entrenched corruption may also lead to a higher tolerance for corrupt behavior. Corruption can thus become an *equilibrium*, as corrupt systems make it costly for individuals to behave honestly.

The first generation of high-income members of the Organisation for Economic Co-operation and Development (OECD) has achieved a balance between resources and constraints (legal and normative) through institutional forms that other countries have since tried to replicate, without achieving the desired function: *credible commitment of those in power not to abuse it for private gain*. Conversely, it is still commonplace in many new democracies for each election’s winners to misallocate public resources in turn.

However, the level of development of a country barely explains half the variation in control of corruption. (Mungiu-Pippidi 2015). A large sample of countries shows how some countries overperform while others underperform in their expected levels of controlling corruption, given their levels of development. What lies behind these large variations across countries? The evidence suggests that control of corruption is achieved not when a certain level

of development is reached or some anticorruption tool is adopted, but when the right balance between resources and constraints is struck.

How can the right balance between resources and constraints be achieved? Local power dynamics and existing social norms need to be taken into account. The role for collective action and broad reform coalitions is also paramount. If the demand for controlling corruption is weak because rents are used efficiently to buy off strategic groups, collective action becomes impossible and the equilibrium remains with particularism as the norm. In contexts where levels of development and political arrangements do not yet allow the effective enforcement of formal rules, anticorruption strategies should sequentially attack corruption at critical points where it is both feasible to curb corruption and those efforts will have a high impact on development.

*Source:* Prepared for WDR 2017 based on contributions from Alina Mungiu-Pippidi, Mushtaq H. Khan, and Martin Schmidt. See spotlight 2.

0.49 Law is the primary rules-based mechanism through which agreements are sustained as it is the tool through which policies are codified and implemented, as well as the tool through which power is allocated and contested. However, the existence of laws by no means leads to their intended effects. Deeper types of governance reform may be needed. Reaching and sustaining agreements is difficult because policies are not spot transactions like buying a book or using a taxi; they require cooperation over time. Ultimately, whether actors will be able to reach agreements to design and implement welfare-enhancing policies is determined by who is able to participate in the decision making process, what are the incentives they have to pursue certain goals, and what are their preferences and beliefs. Thus, in order to improve policy effectiveness and ultimately to expand the set of possible policies that can actually be implemented and sustained over time, it is necessary to reshape the policy arena where actors bargain.

0.50 Law can play an important role in this process. While law is simultaneously a product of social and power relations, it is also a tool for challenging and reshaping those relations. The Report examines the role of law in reshaping the nature of the policy arena to increase its *contestability* by under-represented actors, change *incentives* by changing payoffs to lower the cost of compliance or increase the cost of non-compliance, and change *preferences* or beliefs by enhancing substantive focal points around which coordination can occur. Depending on the primary functional challenge (that is, whether the policy needs to enable commitment, cooperation, and/or coordination), the entry point may be different (table 0.3). As these functional challenges are interdependent, these entry points act as complements to one another.

**Table 0.3 Enhancing the effectiveness of policies: Entry points**

Functional challenge	Entry points to enhance effectiveness of policies		
	Incentives	Contestability	Preferences/Beliefs
<b>Commitment</b>	•		
<b>Cooperation</b>	•	•	
<b>Coordination</b>	•	•	•

*Source:* WDR 2017 Team.

0.51 The incentives actors have to enforce agreements are fundamental for enabling credible commitment as this challenge requires consistency in the face of changing circumstances. The coercive power of law depends on the existence of a credible threat of being caught and punished, or a credible commitment to obtaining the reward for compliance. Stronger incentives to hold policy makers accountable can also strengthen voluntary compliance, as repeatedly delivering on commitment can build trust in institutions.

0.52 The contestability of the policy arena is fundamental for enabling cooperation, as this functional challenge requires voluntary compliance from actors. A more contestable policy arena is one in which actors or groups who have reasons to participate in the decision-making process have ways to express their interests and exert influence. As contestability determines who is included and who is excluded from the bargain, it is closely linked to the notion of inclusion but maintains important differences as it focuses primarily on the barriers to participation. The inclusion of more actors in the decision making process is not a guarantee of better decisions, but a more contestable policy arena is associated to higher levels of legitimacy and cooperation. When procedures for selecting and implementing policies are more contestable, those policies are perceived as “fair” and tend to induce cooperation more effectively. This encompasses both ex ante procedure (which relates to the means by which law is made, and the extent to which it is participatory and transparent) and ex post procedure (the extent to which it is applied consistently and fairly). If various actors believe the process is exclusionary, or reflects only the interests of some groups, they may not comply with it or may outright oppose it. Public hearings, stakeholder consultations, social audits and participatory processes are just examples of instruments that make the arena more contestable.

0.53 The different preferences and beliefs of actors shape their policy goals. This is fundamental to enabling coordination, as this challenge requires changing actors’ expectations. Law can effectively reshape preferences and coordinate expectations about how others will behave by serving as a focal point. Here law acts as a sign post—an expression—to guide people as to how to act when they have several options, or, in economic terms, when there are multiple equilibria (Basu 2015; McAdams 2015). In this case, people comply with the law because doing so facilitates social and economic activities.

0.54 Ultimately the *rule of law*—the impersonal and systematic application of known rules to government actors and citizens alike—is needed for a country to realize its full social and economic potential. But this ideal comes about as a result of an endogenous process of contestation that shapes societies’ adherence to principles of rule of law over time—sometimes a very long time. As Gordon Brown, the former prime minister of the United Kingdom, noted, “When it comes to rule of law, the first five centuries are the hardest.” Box 0.5 discusses the challenging process of transitioning to the rule of law. Pragmatic policy design that takes into account how these different roles of law can bolster the effectiveness of development policies can ultimately move countries on a trajectory toward a stronger rule of law.

### **Box 0.5 Transitions to the Rule of Law**

Compared to the extensive literature on transitions to democracy, a surprisingly small amount of systematic work has been done on transitions to a modern rule of law. There are actually three separate transitions to consider: first, the shift from a customary, informal, and often highly pluralistic system of law to a unified modern one; second, how powerful elites come to accept legal constraints on their power; and third, how countries successfully adapt foreign legal systems to their own purposes.

The shift from a customary and/or pluralistic system to a codified modern one is usually motivated, at base, by actors who see a single formal system as better serving their interests, particularly economic interests in expanded trade and investment. Scale matters: at a certain point, the personal connections that characterize customary systems become inadequate to support transactions between strangers at great remove. However, transition costs are high, and customary rules are often preferred by existing stakeholders. This means that political power is critical in bringing the transition about.

Formal law is usually applied first to non-elites (“rule *by* law”); the shift to “rule *of* law” occurs when the elites themselves accept the law’s limitations. North and Weingast have argued that constitutional constraints become self-reinforcing when power in the system is distributed evenly and elites realize that they have more to gain in the long term through constitutional rules. What this theory doesn’t explain, however, is why these same elites stick to these constraints when the power balance subsequently changes and one group is able to triumph over the others. Similarly, independent courts are always a threat to elite power; why do rulers come to tolerate them when they have the power to manipulate or eliminate them? This suggests that constitutionalism needs to be underpinned by a powerful normative framework that makes elites respect the law as such. Subsequent respect for law depends heavily on the degree of independence maintained by legal institutions—the judiciaries, bars, law schools, and other structures that persist even after their normative foundations have disappeared.

Finally, with regard to the import of foreign legal systems, perhaps the most important variable determining success is the degree to which indigenous elites remained in control of the process, and can tailor it to their society’s own traditions. Thus Japan experimented with a variety of European systems before settling on the German civil code and Bismarck constitution. Later in the twentieth century, China, the Republic of Korea, and other Asian countries similarly adapted Western legal systems to their own purposes. In other cases, such as Hong Kong, India, and Singapore, the colonial power (Britain) stayed for a long time and was able to shape the local legal norms in its own image. Even so, India today practices a far higher degree of legal pluralism than Britain itself, as part of the process of local adaptation. Less successful were cases in Sub-Saharan Africa, where customary systems were undermined by colonial authorities, but not replaced by well-institutionalized modern systems.

Much more research is needed into the question of legal transitions. It is clear that a fully modern legal system is *not* a precondition for rapid economic growth; legal systems themselves develop in tandem with modern economies. It may be that the necessary point of transition from a customary to a formal legal system occurs later in this process than many Western observers have thought. But relatively little is known about the historical dynamics of that transition, and thus there is too little by way of theory to guide contemporary developing countries as they seek to implement a rule of law.

*Source:* Prepared by Francis Fukuyama for the WDR 2017.

0.55 The discussion that follows explores how the changes in incentives, contestability, and preferences can enhance policy effectiveness for security, growth, and equity.

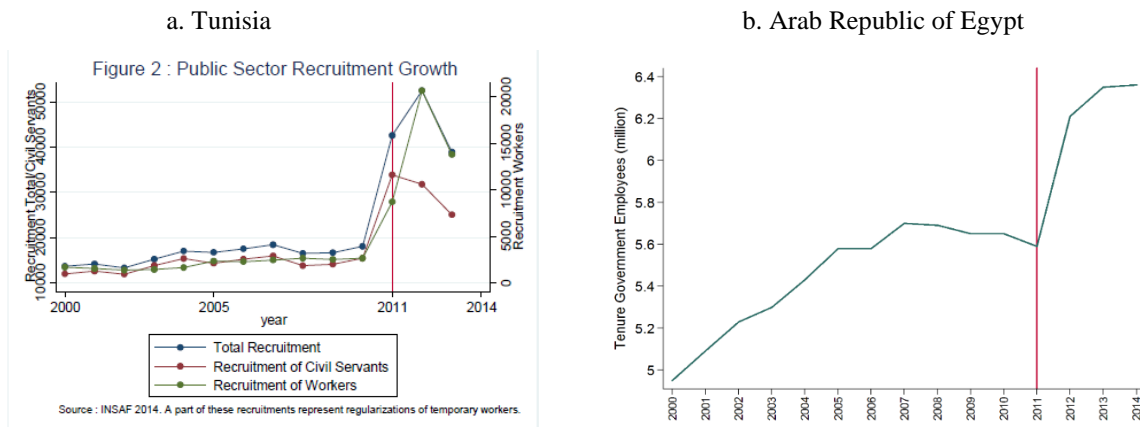
#### ***Enhancing policy effectiveness for security***

0.56 Whether formally or informally, institutions of governance can solve commitment and cooperation problems in ways that create incentives not to use violence. Four governance mechanisms matter for improving security outcomes: power sharing, resource redistribution, dispute settlement, and sanctions

0.57 Mechanisms that encourage power sharing, such as legislatures that guarantee the representation of all factions, can reduce the incentives to engage in violence by raising the benefits of security. Power-sharing arrangements are especially relevant for societies divided along ethnic and religious identity lines, such as in Bosnia and Herzegovina, Northern Ireland, Kenya, Lebanon, and South Africa, but also in countries where the conflict is a legacy of opposing ideologies, like Colombia. Power-sharing bargains that lead to peace and security typically take place between elites. They encourage cooperative behavior by providing elite groups with the incentives to compromise with each other and to inspire inclusion among their followers; and by offering alternative avenues for contesting power.

0.58 Mechanisms that redistribute resources can also reduce violence by re ordering power and changing incentives. They manifest themselves in budgets, social transfers, and victim compensation schemes. Some government interventions to reduce urban crime in Latin America display a comparable pattern of increasing security by reducing poverty and inequality. For example, Brazil’s conditional cash transfer program, Bolsa Familia, had a strong negative causal effect on urban crime in São Paulo as a result of increases in household incomes and changes in peer group membership (Chioda, De Mello, and Soares 2012).<sup>9</sup> Employment in the public sector is also a potential instrument that can bring about stability by ensuring the loyalty of key constituencies. This is visible, for instance, in the dramatic increase in the numbers and salaries of public employees following the Arab uprisings in 2011 (figure 0.6). While political patronage can solve the first-order problem of violence, it can also lead to corruption and can have ruinous effects on budgetary sustainability and administrative efficiency.

**Figure 0.6 Recruitments of civil servants increased exponentially in Tunisia and Egypt in the aftermath of the Arab Spring**



Source: Brockmeyer, Khatrouch, and Raballand 2015 for Tunisia; Darwish 2015 for Egypt, based on figures from the Egyptian Central Agency for Organization and Administration (CAOA).

0.59 Dispute settlement mechanism can also help ensure security. Mechanisms of dispute resolution include mediation, conciliation, and negotiation, where parties try to reach mutually

<sup>9</sup> Other studies have also examined the links between inequality and crime: Becker (1968); Ehrlich (1973); Chiu and Madden (1998); Imrohorglu, Merlo, and Rupert (2000); Fajnzylber, Lederman, and Loayza (2002); Bourguignon, Nuñez, and Sanchez (2003); Soares (2004).

satisfactory, self-enforcing agreements on their own. They also include litigation and arbitration, where disputants rely on a third party such as a judge or a jury for resolution and for providing the credible commitment needed to enforce the resolution. These institutions can be informal, like elders councils in a village, or formal, like courts, ombudsmen, and peace negotiators. Ultimately they work by reshaping preferences to stabilize expectations for parties to reach self-enforcing agreements.

0.60 Detering and sanctioning opportunistic behavior can also prevent conflict from turning violent. This reduces the incentives for violent behavior by increasing the cost of violence. Police presence, for instance, can potentially raise the cost of crime and violence, providing an incentive for individuals to refrain from or reduce criminal or violent acts. Constraints on power and state legitimacy promote governments that can credibly commit not to use violence against their own people. Over time, they may shift behavior away from violence by changing norms and attitudes toward violence, leading to the internalization of new norms. Ultimately, they can foster a culture of compliance based on legitimacy.

### ***Enhancing policy effectiveness for growth***

0.61 Sometimes, when the possibility of capture looms large, policies that are first-best on the basis of economic efficiency are less implementable than second-best ones. Adopting an implementable second-best design could therefore be more effective than choosing the seemingly first-best policy prone to capture. Moreover, the possibility of future capture can be reduced by anticipating the possible effects on the balance of decision making ability among the actors involved, when considering alternative policy designs.

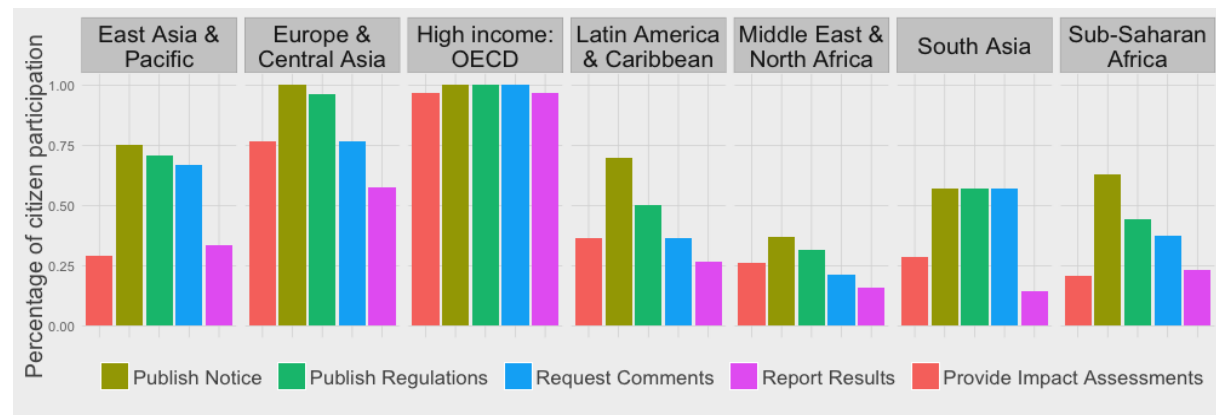
0.62 The experience of the Russian Federation and Eastern European countries in their transition toward market economies is illustrative (Roland and Verdier 1999) Compelled by the then-dominant economic argument that the privatization of state-owned enterprises (SOEs) was of first-order importance in enhancing economic efficiency, Russia and many Eastern European countries focused on a rapid, large-scale privatization of SOEs. While this may have made sense on purely economic grounds, the way in which the privatization wave was implemented created a new class of oligarchs that resisted the next generation of pro-competition reforms. Many of these economies are still struggling with inefficient, oligopolistic industries. In contrast, Poland chose to focus first on reforms that made it easy for new firms to enter, and privatized existing firms more gradually. This sequencing created a class of young firms that were collectively interested in further reforms, while preventing the sudden emergence of an influential group of large firms that could block reforms (Jackson, Klich and Poznanka 2005).

0.63 Better design of public agencies can help expand the set of implementable policies. First, how public officials are selected into service and the incentive structure that they face within their organizations matter. Recruitment and compensation schemes should take not just economic motivation into account, but also intrinsic motivation for public service and existing norms of behavior. For policies where there is a significant role for discretion during implementation, credible monitoring mechanisms can further discipline implementation. Establishing and maintaining greater accountability in public agencies can also help in balancing influence in the policy arena. For instance, general-purpose oversight agencies can act as a check on the capture of agencies in charge of specific policy areas. Mechanisms that help give a bigger say in the policy



arena to less powerful, diffuse interest groups could help balance the influence of more powerful, narrow interest groups. Participatory mechanisms in regulatory institutions are still relatively uncommon in low- and middle-income countries (figure 0.7).

**Figure 0.7 Formal avenues for broad-based participation in regulatory decision-making are limited in low- and middle-income countries**



Source: WDR 2017 team, using the World Bank's citizen engagement in rulemaking data.

0.64 Capture is thus not an inevitable outcome of close business-state ties. As long as influence and incentives are balanced through robust public agency design and accountability mechanisms, firms and business groups can have a positive influence on policies for growth. Contemporary case studies suggest that business associations have helped governments improve various dimensions of the business environment, such as secure property rights, fair enforcement of rules, and the provision of public infrastructure, through lobbying efforts or better monitoring of public officials. For example, the footwear manufacturers' association in Brazil, the coffee federation in Colombia, and the textile manufacturers' association in Thailand have all played a role in reducing information costs about export markets.

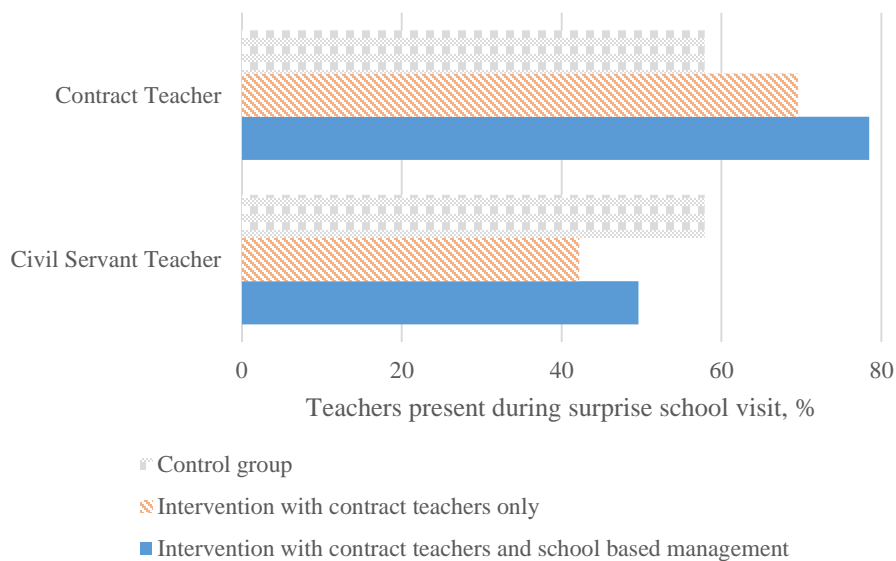
### *Enhancing policy effectiveness for equity*

0.65 In order to facilitate reforms to enhance equity, it is necessary to support collective action in order to improve social participation and reduce capture; and improve commitment by reducing information asymmetries. Directly involving disadvantaged groups in policy bargaining arena can increase cooperation. For example, in Ghana, informal public transport workers were successfully included in the formal tax design starting in 1981, thanks to the delegation of tax collection to informal sector associations. This arrangements is believed to have increased tax revenues (Joshi and Aye 2009), and introduced a culture of tax compliance in a sector previously neglected by the tax authority.

0.66 Involving communities can work to strengthen the quality of service delivery in and decrease absenteeism in hospitals in schools, provided that they have clear mandates and tools to monitor providers. An intervention designed to strengthen local accountability and community-based monitoring in the primary health care sector in Uganda was remarkably successful in improving both health services and outcomes in the participating communities (Björkman and

Svensson 2009). In this respect, information is a critical tool, however results on its impact are limited and contrasted. A promising result on the impact of information comes from Pakistan, where a randomized experiment that provided information to parents on the performance of private and public schools increased test scores, decreased private school fees, and increased primary enrollment (Andrabi, Das and Khwaja 2015). “Empowering” users by involving them in management can also help improve services and reduce capture. For example, when school councils of parents are well trained and have credible sanctions, they can improve school results (Bruns, Filmer, and Patrinos 2011). In a reform experiment in Kenya to hire contract teachers, capture by civil service teachers was lower by one-third in a subgroup of schools that received training in school-based management. In this subgroup, the school committee was better able to monitor the hiring of contract teachers, and capture—in the form of absenteeism and hiring of relatives—was reduced (figure 0.8, based on Duflo, Dupas, and Kremer 2015).

**Figure 0.8 Empowering parents with school-based management training helps decrease capture (teacher absenteeism) in Kenya**



Source: WDR 2017 team based on Duflo, Dupas, and Kremer 2015.

Note: Bars show the percentage of teachers present in school during a surprise visit. In intervention schools that do not receive a school-based management (SBM) training, civil servant teachers are less likely to be present than in schools of the control group: they decrease their presence in response to the availability of additional contract teachers.

0.67 Building coalitions among elites and citizens that enhance the credibility of equity-enhancing policies is essential. For example, in order to adopt policies that could impose losses on certain powerful groups, it may be necessary to bundle them with other policies. This was the case when Colombia managed to pass a wealth tax levied on the richest 1 percent of the population because it explicitly devoted tax revenues to security and crime reduction, which was perceived as being particularly beneficial to the business community (largely represented in the top 1 percent of the Colombian population). Sequencing reforms can also help increase their credibility, such as in the case of energy reform in the Islamic Republic of Iran in 2011. In order to ease households’

concerns about the government's commitment to using savings from the reform for redistribution, transfers to households were made before the increase in energy prices, although access to the deposits had been frozen until the day when energy prices were increased.

0.68 Over time, policies that effectively improve equity also redistribute power, making the policy bargaining more contestable and power less asymmetric. After a period of inclusive growth with greater income mobility, when the middle class grew in Latin America, people started demanding better quality services and demonstrating in the streets demanding better governance (Ferreira and others 2013). On the other hand, inequitable growth, and the concentration of wealth in the hands of a few leads to dynamics of consolidation of power, can lead to perceptions of unfairness, and thus to weaker incentives for cooperation and coordination by those excluded from the benefits of development.

### **The drivers of change: Elite bargains, citizen engagement, and international influence**

0.69 Even though it is an inevitable fact that power is unequally distributed in every society, equitable development can still be achieved if elites, citizens, and international actors work together to build coalitions for positive change. While the current state of the policy arena—including the rules that shape how actors bargain, the preferences of those actors, and the relative balance of power among them—is highly endogenous, it can also change over time. The primary engine of this change is collective action. Change occurs when individuals and groups act together and mobilize to reshape the nature of the policy arena. That is, they work together to change the contestability, incentives, and preferences of actors.

0.70 Law can be a powerful force for change. By its nature law is a device that provides a particular language, structure and formality for ordering things, and this characteristic gives it the potential to become a force independent of the initial powers and intentions behind it. Thus, even where state capacity and legal institutions are weak, law can be a powerful instrument for enhancing collective action of state and nonstate actors to press their interests and change the nature of the policy arena. Change happens at many levels, and is often the result of overlapping dynamics stemming from elite bargains, citizen engagement and mobilization, and international influences (box 0.6)

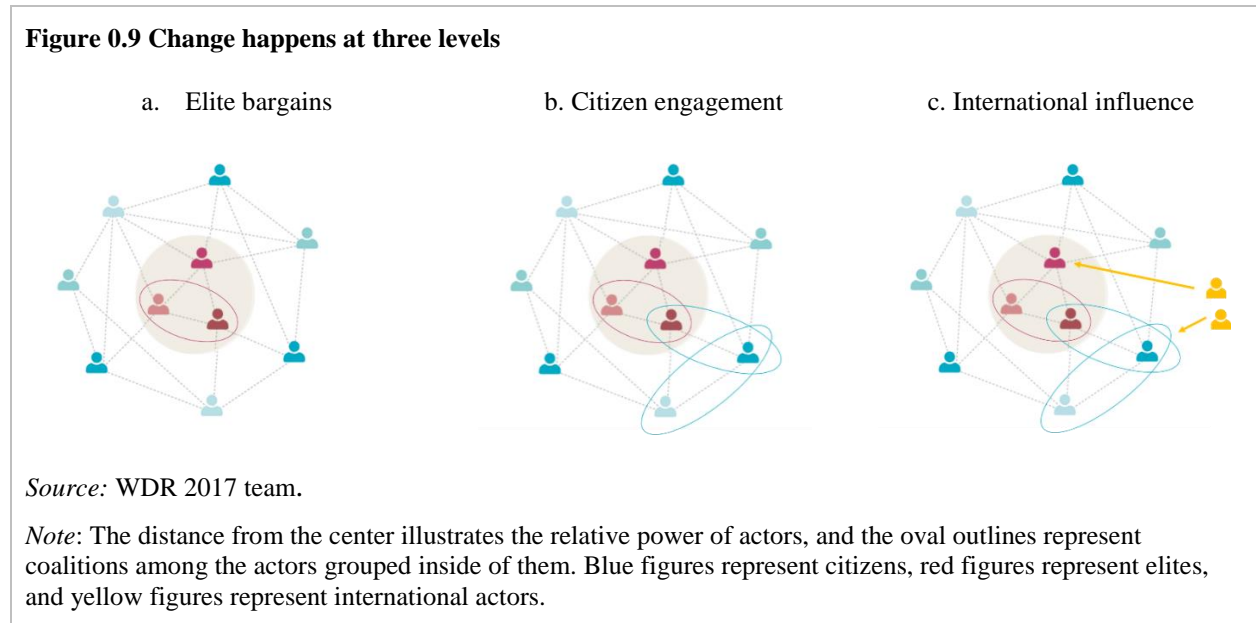
#### **Box 0.6 Who is who in the policy arena? The shifting continuum of power between elites and citizens**

Participants in the policy arena can be grouped into elites and citizens according to their relative degree of influence. What distinguishes elites from citizens is their ability to *directly* influence the design and implementation of a certain policy. Elites can vary from one policy to another. For example, a group that is an elite in the area of health may not be an elite in the area of crime control. Certainly, this dichotomy between elites and citizens is imperfect because it does not account for different degrees of relative power among individuals within those groups (elites or citizens), nor does it express how their relative power differs from one policy to another. As Stephen J. Gould (1987) notes in his classic text, *Myth and Metaphor in the Discovery of Geological Time*, “Dichotomies are useful or misleading, not true or false. They are simplifying models for organizing thought, not ways of the world.” The reality is much more complex and nuanced. This Report views individuals as being on a continuum with respect to their position of power in the policy arena. Elites are not necessarily bad or self-interested, and citizens are not necessarily good and public spirited. Both groups act as people do in other spheres of life: understanding their motivations matters to anticipate their conduct.

0.71 All countries, regardless of their level of economic and institutional development, are subject to elite bargains (figure 0.9, panel a). When influential actors resist change, suboptimal policies and governance institutions can persist that are detrimental to development. Under certain circumstances, however, elites may voluntarily agree to limit their influence, in their own self-interest; such as in order to strengthen their own authority in the long term, or to provide insurance against a future loss of power. In these bargains, as elites institutionalize increasingly broad commitments to one another; they move from narrow deals to broad rules.

0.72 However, elites are just one of many actors in society. While elites may wield great influence individually, citizens can successfully mobilize to protect their interests, effectively engaging with elites, and ultimately shifting power relations in their favor by influencing the outcome of the policy bargaining process. The interaction between elites and citizens is a two-way dynamic, with both sides playing decisive roles in enabling change: elites in seeking citizen support and opening up new spaces for contestation; and citizens in organizing to overcome collective action problems and apply pressure on elites (figure 0.9, panel b).

0.73 Moreover, the dynamics of governance do not occur solely within the boundaries of nation-states. Countries today face an interconnected, globalized world characterized by a high velocity and a high magnitude of “flows” in terms of capital (portfolio flows and direct investment), trade (goods and services), ideas (technology and norms), and people. While international actors cannot engineer development from the outside, these transnational flows play an important role in influencing the domestic bargaining dynamics by strengthening (or weakening) local reform coalitions (figure 0.9, panel c).



0.74 The discussion that follows explores the dynamics of change stemming from elite bargains, citizen engagement and mobilization, and international influences.

## ***Elites may adopt rules to constrain their own power***

0.75 Changes to the “rules of the game” that determine policy formulation and implementation reflect bargaining outcomes that result from elite actors acting in their own interests (box 0.7). Reforms that limit the arbitrary exercise of power today may be necessary for elites to maintain or enhance their power or provide insurance against a future loss of power. Formal institutions—moving from deals to rules—can enhance the credibility of commitments, overcoming coordination challenges between elite actors, and strengthening the stability of elite bargains. In cases of long-term successful transformation, elite actors have adapted to changing circumstances by generating more capable, contestable, and accountable institutions; these institutions themselves helped enable further development.

### **Box 0.7 Who are elites and what do they do? Results from a survey of elites in 12 countries**

All social science disciplines and development practitioners recognize the importance of elite actors in determining development outcomes: from Aristotle’s “oligarchy” to early twentieth century “elite theorists,” including Michels (1911), Pareto (1927), and Mosca (1939), to recent grand theories of economic and institutional co-evolution, including North, Wallis, and others (2009) and Acemoglu and Robinson (2012). The international community increasingly looks at the consequences of different “political settlements,” which can be understood as elite bargaining equilibria that emerge at critical junctures in a country’s development (Di John and Putzel 2009; Khan 2010; Parks and Cole 2010). Yet the set of conceptual research tools available to scholars of elite bargaining and to development practitioners remains limited, as does agreement on who exactly are elites.

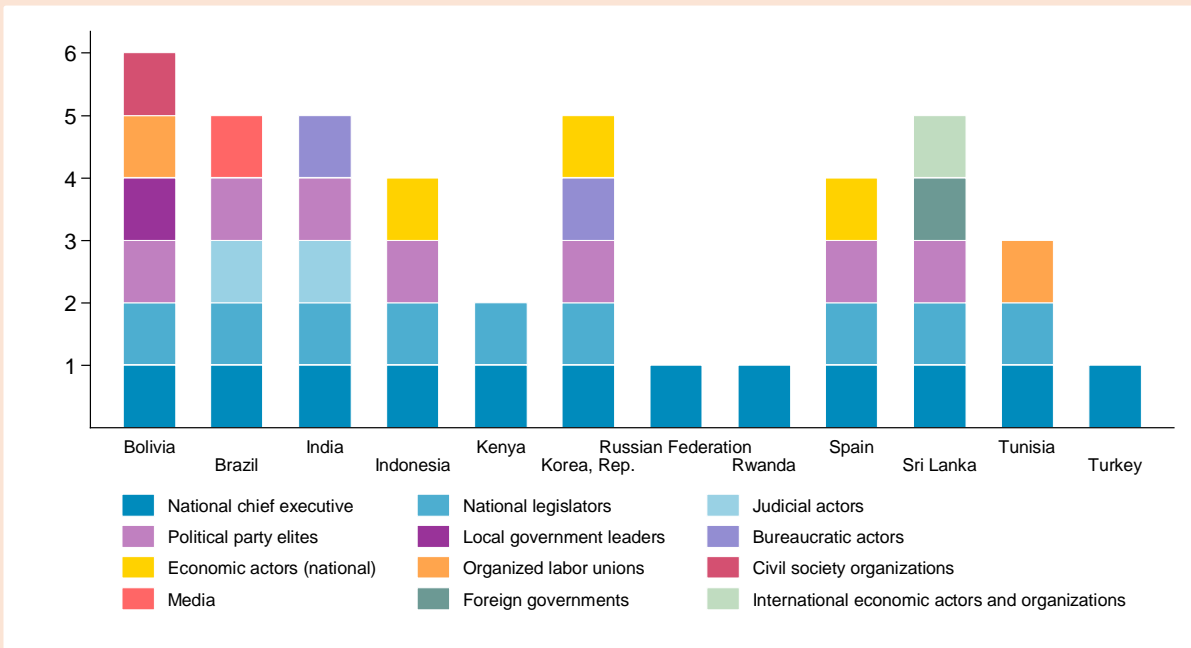
To help fill this gap, as part of *World Development Report 2017*, the World Bank, in collaboration with the V-Dem Institute, has conducted expert surveys to generate cross-national indicators that enable comparison of who holds bargaining power and how they wield this influence. The surveys cover over 100 years of data in 12 countries across 6 regions. Resulting data help identify how the distribution of elites maps onto the national structure of bargaining power and the formulation and implementation of laws governing the exercise of power.

The survey reveals that the identity of the influential elite actors within a ruling elite coalition that makes national policy decisions differs greatly over space, time, and issue area. For instance, although national chief executives are part of the elite ruling coalition in all 12 countries surveyed as of 2015, the other actors vary greatly, both in number and representativeness (figure BO5.1, panel a). Although in Russian Federation, Rwanda, and Turkey, the national chief executive monopolizes decision making, in Bolivia, the ruling coalition is much more varied, consisting of legislators, party elites, local governments, labor unions, and civil society organizations.

Ruling elites also differ within countries over time. In the Republic of Korea, during the Park regime, the bargaining strength of military actors, bureaucratic actors, and economic actors increased steadily (panel b). The transition to democracy after 1987 resulted in greater strength for new actors, particularly political parties, legislators, and the judiciary, but economic and bureaucratic actors remained highly empowered. In contrast, Brazil has experienced much more volatility in empowered elites, particularly before the 1990s (panel c).

**Figure B0.5.1 Elite actors within national ruling coalitions vary greatly across countries and over time**

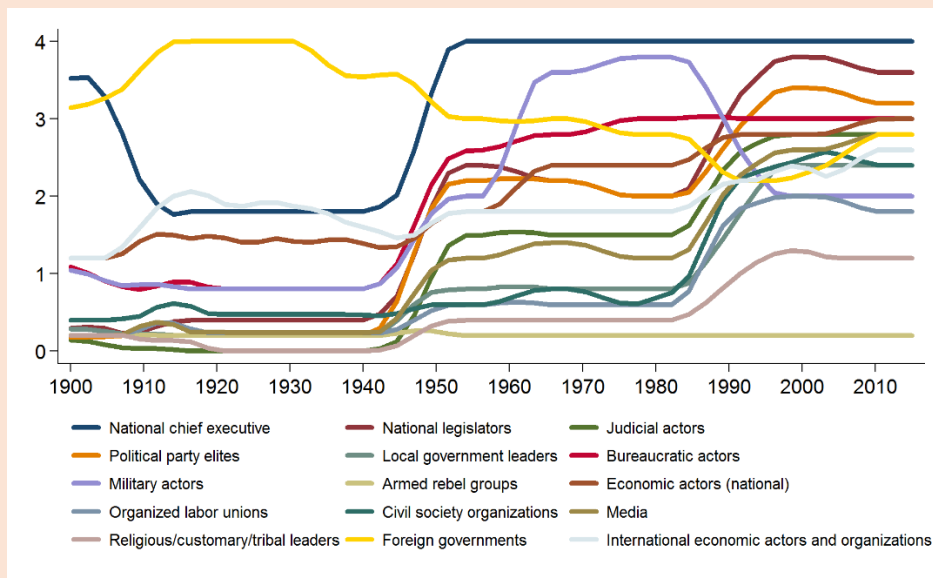
a. Twelve-nation comparison of number of groups in ruling coalition in 2015



Source: WDR 2017 team.

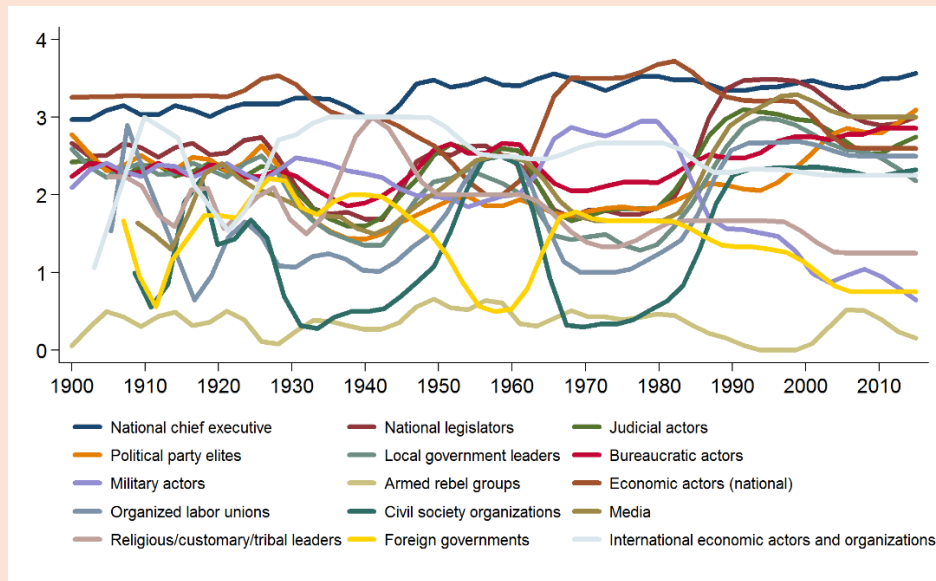
Note: Panel a shows the number of elite groups that have relative strength greater than 3 (on a 0–4 scale), but does not show the relative strength of these groups.

b. Relative strength of elite actors in the Republic of Korea, 1900–2015



Source: WDR 2017 team.

c. Relative strength of elite actors in Brazil, 1900-2015



Source: WDR 2017 team.

0.76 To maintain their own influence, coalitions of decision-makers may have incentives to broaden the policy arena, including adding new actors in formal decision-making bodies of the state and increasing accountability to other elites (horizontal accountability). Despite a preference for keeping coalitions small, elites may choose to broaden them to improve stability when the potential for conflict rises. Bringing new actors into credible institutions for contestation may be less costly than repressing them, and expanding the formal accountability space may help provide internal commitments that facilitate agreement. In Africa, for example, adding one additional cabinet member lowers the risk of a coup by 23 percent to 25 percent, all else equal (Arriola 2009). Broadening the policy arena can also be more sustainable than increasing payoffs. When rising elites are paid off rather than included in decision making, systems may become overly dependent on the source of rents, making them unable to withstand shocks that undermine this rent source. For instance, in South Sudan between 2005 and 2011, the distribution of rents structured power relations and held together heterogeneous factions—until the rents proved elusive, undermining the patronage-based elite bargain, and making the country one of the most fragile in the world (Twijnstra 2015).

0.77 Institutionalizing accountability to citizens (vertical accountability)—for instance through the introduction of elections or electoral reforms—may also be a rational elite strategy to maintain privilege, particularly in the face of rising demands from the opposition elite. When there are splits among elite actors, the introduction of vertical accountability mechanisms may enhance the bargaining power of one faction. Moreover, when bottom-up citizen movements threaten elite interests, elites may choose to introduce preemptive vertical accountability mechanisms to respond to societal demands before such pressure reaches a tipping point. In the case of Europe in the nineteenth century, the extension of suffrage was predicted by the threat of revolution, proxied by revolutionary activity in neighboring countries (Aidt and Jensen 2014) and by strikes in the home country (Kim 2007).

0.78 Political insurance takes place when ruling elites, acknowledging threats to their continued dominance, introduce rules to constrain their own influence, with the hope that they will bind not only themselves, but also their successors. The adoption of cohesive and constraining institutions increases with the likelihood that the incumbent will be replaced. This is an elite variation on John Rawls's veil of ignorance: design institutions without knowing whether you will be subject to them or be able to master the institution in the subsequent period. Fiscal transparency, for example, ties not only the hands of current elites, but also those of successors. This is consistent with the actions of certain states in Mexico: Freedom of Information laws are much more likely to be passed when opposition parties are stronger and when there is greater executive office turnover (Berliner and Erlich 2015). In some competitive settings, reforms may be complementary; for instance, the likelihood of democratic transition increases if elites develop constitutions that protect their interests after they leave office.

0.79 Leaders can also spur elite-driven change by solving coordination challenges or by transforming the beliefs and preferences of followers. Leaders can play two main roles: transactional leaders and transformational leaders. Transactional leaders solve coordination challenges. Using an array of bargaining tactics and strategies, these leaders can coordinate among elite actors to overcome common agency problems and reach positive-sum outcomes. They change the incentives of other elites by taking into consideration who wins and who loses over time. By overcoming information and coordination challenges through intertemporal positive-sum good politics, they can reduce the polarization of elite preferences without shifting norms. Transformational, leaders can actually change elite preferences or gain followings by shaping preferences. They are entrepreneurial in coordinating norms and can effect large changes in society by changing the environment in which politics play out, often by reducing the polarization of elites. Perhaps most notably, successful leaders have been responsible for nation-building efforts that have increased cooperation in many countries with successful development experiences, many of which did not begin as homogenous nations.

### ***Citizens influence change by voting, organizing, and deliberating***

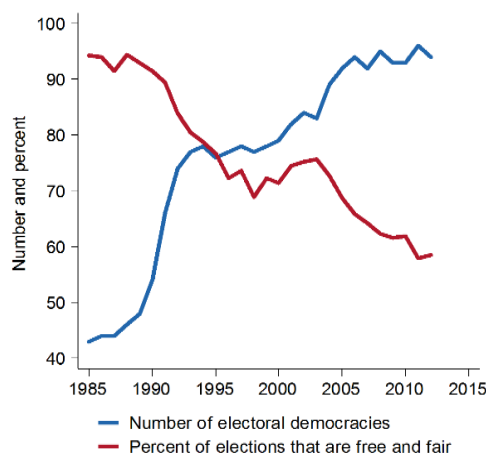
0.80 How do citizens come together to act as agents of change? While ordinary individuals are unlikely to influence the policy arena on their own, mechanisms of engagement—such as elections, political parties, or social movements—often help individual citizens overcome collective action challenges. By enabling individuals to coordinate and cooperate with one another, these mechanisms facilitate citizens' bargaining ability to engage with elites. Bargains are further shaped by the existing institutions of vertical and horizontal accountability, which define the "rules of the game" in the policy arena. Citizens' mechanisms of engagement work through the three dimensions of change. They change the incentives of actors, such as when coordinated voters are able to shape the incentives of local politicians to deliver on electoral promises. They can reshape the preferences of actors, helping frame collective claims and interests in the policy arena; for instance, enfranchising previously excluded voters can lead to a significant policy shift in favor of their preferences. Mechanisms of citizen engagement can also enhance contestability—such as when civic associations, and spaces of deliberation create an "enabling environment" for citizens' agency, opening up more inclusive bargaining spaces.

0.81 Elections are one of the most well-established mechanisms available to citizens to strengthen accountability and responsiveness to their demands. By doing so, they can help improve



the level and quality of public goods and services. A study across 28 countries in Sub-Saharan Africa shows that multiparty elections and leadership changes associated with electoral mechanisms significantly reduced infant mortality rates through improved health care (Kudamatsu, 2012). In principle, the ballot box balances bargaining power between citizens and those to whom they delegate decision making, for instance, helping to curb rent-seeking behavior of local officials. Evidence suggests that multiparty elections in Kenya successfully constrained the ability of leaders to divert public resources for partisan goals (Burgess and others 2015). Yet, elections are not enough. Although they have become the most common mechanism to elect authorities around the world, they are increasingly perceived as unfair (figure 0.10).

**Figure 0.10 Electoral democracies are spreading, but the integrity of elections is declining**



*Source:* WDR 2017 team based on Polity IV (number of electoral democracies) and Bishop and Hoeffler 2014 (free and fair elections).

0.82 Elections alone are an insufficient mechanism to produce responsive and accountable governments for several reasons. To maintain power, incumbent leaders may resort to manipulation strategies—such as banning certain political parties or adopting complex voting registration regulations—that undermine the integrity of the electoral process. Elections face other challenges. Enhancing contestability is a critical one, as voter turnout can be biased toward certain groups, leading to unequal influence in the policy arena. In addition, average voters may not have the information required to assess government performance properly. The provision of reliable information—such as from independent media or oversight agencies—can change incentives, increasing voters’ willingness to punish incumbents for poor performance and bad practices. Persistent preferences are another central challenge, as entrenched social norms shape the expectation of what politicians are supposed to deliver. Many societies are organized around patron-client exchanges, in which voters expect politicians to deliver benefits in return for support. Attempts to break this exchange are costly and likely to fail, as these relationships often constitute self-reinforcing equilibria. Candidates who adopted clientelistic messages in the 2001 presidential elections in Benin, for instance, were more effective in mobilizing electoral support than competitors who used broad-based policy messages (Wantchekon 2003). Moreover, voting is a

limited instrument of control, as citizens face coordination challenges to remove governments that perform poorly, limiting the potential of credible threats.

0.83 Political parties, as a form of political organization, can serve as a complementary mechanism to represent and articulate citizens' collective interests, aggregate their preferences, and channel their demands in the policy-making process. Parties can help solve citizens' coordination problems, and integrate different groups into the political process, encouraging a culture of compromise and reduced societal tensions. In Tanzania, for example, the power-sharing agreements within the Chama Cha Mapinduzi party have been instrumental in accommodating the demands of various leaders. The evidence shows that programmatic parties—those organized around a well-defined agenda of policy priorities—are associated with better developmental outcomes. These parties maintain a coherent position over key policy issues, stick to these policy commitments over electoral rounds to attract votes, and deliver on them once in office.

0.84 Ordinary citizens and marginalized groups sometimes find political parties unwilling to reflect their preferences, acting instead as 'gate-keepers' to protect vested interests and existing power structures (explaining the disenchantment of citizens with political parties, which rank globally as the least trusted political institution). The rise in social movements across the world suggest that citizens are increasingly mobilizing to hold government accountable and voice their discontent when confidence in institutions and their capacity to articulate their interests is undermined.

0.85 Social movements can facilitate coordination and commitment by mobilizing citizens around specific issues. They bring new demands and interests into the bargaining space, reshaping the preferences of actors, and expanding the boundaries of the policy arena around previously neglected issues. Box 0.8 explains how pressure from social organization by international and domestic women's group eventually achieved female suffrage in Switzerland, leading to other important policy changes for gender equality. However, political and social organizations can also lead to undesirable outcomes, violence, rent-seeking practices, and can also be captured by clientelistic elites.

**Box 0.8 Direct democracy delayed women's voting rights in Switzerland**

While most European countries enfranchised women during the first decades of the twentieth century, Swiss women were first allowed to vote in federal elections only in 1971, 65 years after the first country in Europe—Finland—did so. Yet Switzerland has had a tradition of direct democracy for centuries. What explains the late enfranchisement of Swiss women?

To change the constitution, the political system required a national referendum, in which only men were allowed to vote. Several petitions and motions initiated by women's groups in the first half of the 1900s were unsuccessful in achieving women's suffrage. Who participated in that process to change the rules was thus an important determinant of which rules persisted. But so were the existing social norms and the lack of incentives for change. Reflecting those deeply held norms, Switzerland also lagged behind most Western countries in removing other legal gender inequalities, notably those preserving the legal authority of the husband.

Under heightened international pressure, Switzerland was close to a turn in guaranteeing women's rights in 1957, when, for the first time, the Swiss Federal Council called for a national referendum on women's suffrage. "If Switzerland had not been a direct democracy, women's right to vote would have taken effect immediately," Stämpfli (1994, 696) notes. The mandatory national referendum took place in 1959 when 69 percent of the entirely male electorate voted against the constitutional amendment. Still, women gained the right to vote on cantonal affairs in three Swiss cantons (Geneva, Vaud, and Neuenburg) in 1959–60. It wasn't until 1971 that the majority of Swiss

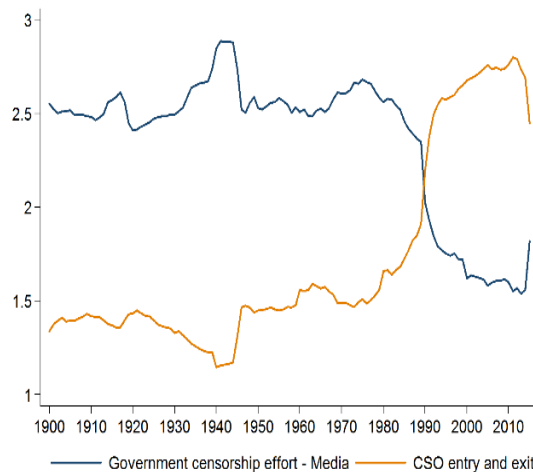
men voted in favor of women’s suffrage. Reform coalitions among many actors played a significant role in bringing about this change, including international influence and domestic action by women’s groups, such as the Swiss Association for Women’s Suffrage.

The change in female suffrage in Switzerland made it possible for new actors—women, in this case—to participate in the process of policy design and implementation, changing the incentives of politicians to be responsive to their preferences and interests. It also reflected a change in societies’ norms with respect to women’s rights. This led to further important policy changes in the 1980s. An amendment to the constitution to guarantee equal rights of all Swiss, men and women, was approved in a referendum in 1981. A few years later, in 1984, women were granted equal rights in marriage to men, eliminating legal requirements such as the wives’ need to have their husbands’ permission to work outside the home, or to initiate legal proceedings, or to open a bank account (World Bank Group 2016).

Sources: Stämpfli, Regula (1994); World Bank WBL, 2015.

0.86 Recent evidence suggests that the global trend might be changing toward a shrinking civic space (figure 0.11). After a continuous expansion over the last decades, the last few years have witnessed a reversal in the opening of civic space. Many governments are limiting the institutional environment in which citizens engage, setting up legal barriers to restrict the functioning of media and civic society organizations, and reducing their autonomy from the state. While the dynamics of social organizations are not entirely predetermined by the external environment in which they operate, as illustrated by diverse experiences, these trends could have an effect on future civic activism.

**Figure 0.11 After decades of progress, civic space is shrinking globally**



Source: WDR 2017 team based on V-Dem (2016).

Note: The scale was reversed for the media censorship variable (low score indicates less censorship). The average is based on a sample of 167 countries, with smaller coverage in 2013–15. CSO = civil society organization.

0.87 The role of public deliberation—spaces and processes that allow group-based discussion and weighting of alternative preferences—can also help level the playing field. Citizens’ participation in local governance as another form of social organization can be instrumental in improving the quality of deliberation and the legitimacy of decisions made, by clarifying needs and demands of local constituencies. However—as can also be the case in social movements—

these processes of participation and deliberation might also reinforce rather than rebalance existing power relations. Participatory approaches to development sometimes fail to consider the possibility of ‘civil society failures’, where, in weakly institutionalized environments, the poor are less likely to participate, and participatory mechanisms can be “captured” by local elites. Such failures are not necessarily ameliorated by the availability of new technologies. On the contrary, as discussed in WDR 2016, information and communication technologies might actually reinforce socio-economic inequalities in citizens’ engagement. In Brazil, for example, the use of internet voting on municipal budget proposal reveal stark demographic differences between online and offline voters—online voters are more likely to be male, university educated, and richer.

### ***International actors influence domestic bargains***

0.88 Increasing transnational flows of capital, trade, ideas, and people over the past four decades have had profound effects on domestic growth, equity, and security outcomes—both directly and indirectly through their effects on governance dynamics. This world is very different from the one in which today’s developed countries emerged: cross-border flows were low; they received no aid; they were not subject to a proliferation of transnational treaties, norms and regulatory mechanisms. For developing countries, the era of globalization and ‘global governance’ presents both opportunities and challenges.

0.89 As the velocity of flows across borders increases so too do the instruments and mechanisms that are used to manage these flows. To change domestic policies and governance dynamics, international actors can introduce transnational rules, standards, and regulations (hereafter referred to as transnational rules). These rules can seek to achieve a global good such as preventing races to the bottom through enhanced cooperation; they can help induce domestic reform through incentives—such as trade and regional integration—to generate credible commitment of domestic actors; or they can serve as focal points for domestic actors to improve coordination by changing ideas and diffusing norms.

0.90 In the same way that firms in a perfectly competitive market lower prices in order to attract consumers’ demand, whenever goods, services, and capital are freely exchanged and move internationally, countries have an incentive to adopt competitive strategies to gain market shares or attract investment. Such strategies can involve lowering tax rates on capital to attract foreign investment, lowering sales taxes to encourage foreign consumption, lowering sales prices to increase export of goods and services, but also decreasing welfare benefits to make labor cheaper or reducing benefits to repel immigration. These are examples of *races to the bottom*. Whereas competition among firms allows social welfare to be maximized, these races to the bottom push countries toward inefficient equilibria that tend to reinforce initial inequalities in welfare and power within and among countries. If all countries coordinate and adopt the same policy, such as international labor standards (Basu and others 2003), they can move to a welfare-enhancing equilibrium. For instance, in parallel with the creation of a common market, the European Union set up a Code of Conduct to prevent countries from engaging in harmful tax competition and to harmonize value added taxes on goods and services, and, less successfully, corporate taxes and capital income taxes.

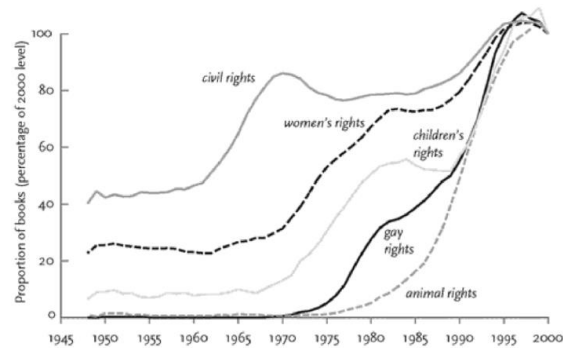
0.91 Efforts to attract investment and expand trade can provide positive incentives for improvements in domestic governance; international agreements on economic integration can

provide credible commitments that domestic actors will follow through on economic reforms. The success of the European Union (EU) integration process, for example, demonstrates the power of inducements. Prospective member countries had to change domestic rules to abide by 80,000 pages of regulations in the *acquis communautaire*. For those countries, the potential economic benefits of joining the EU outweighed any loss of domestic autonomy in specific areas, and the benefits of accession were used by elites to overcome domestic resistance to the required reforms. EU membership contributed to the consolidation of democratic institutions in former dictatorships in the European periphery, such as Greece, Portugal, and Spain in the 1980s and central and eastern European countries in the former communist bloc in the 1990s and 2000s.

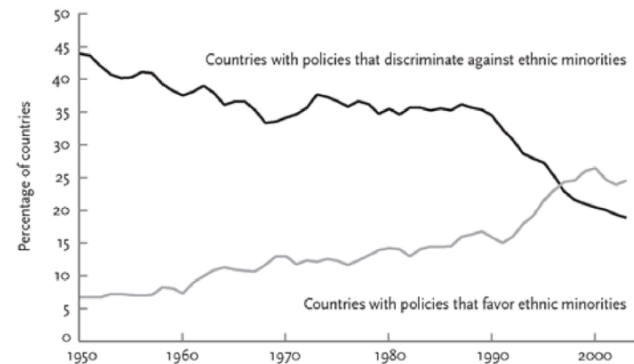
0.92 Along with technology, global ideas and values are spreading increasingly rapidly across countries. The convergence of international ideas has had many positive effects. In the past century, there has been a “Rights Revolution” by which norms for the protection of minority rights have spread globally, changing government policies (Pinker 2011) (figure 0.12). Global treaties and agreements have facilitated the spread of these norms. Referring to international norms, ordinary citizens and disadvantaged groups that are otherwise weak can strengthen the legitimacy of their claims and successfully challenge prevailing norms, putting pressures on governments to transform state institutions and reform public policies. The experience of human rights struggles in Latin America countries during military dictatorships illustrates this point, as well as the mobilization against the apartheid government in South Africa. Indeed, the most transformative cases of social movements of the twentieth century—including labor rights, women’s rights, and civil rights, and, more recently, indigenous and environmental movements—have all explicitly adopted the language and instruments of international rights (Heller 2013).

**Figure 0.12 There has been a global spread of rights-related norms, facilitated and supported by global treaties and agreements**

a. Use of “rights” terms in English-language books, 1948-2000



b. More countries have policies helping ethnic minorities than discriminating against them



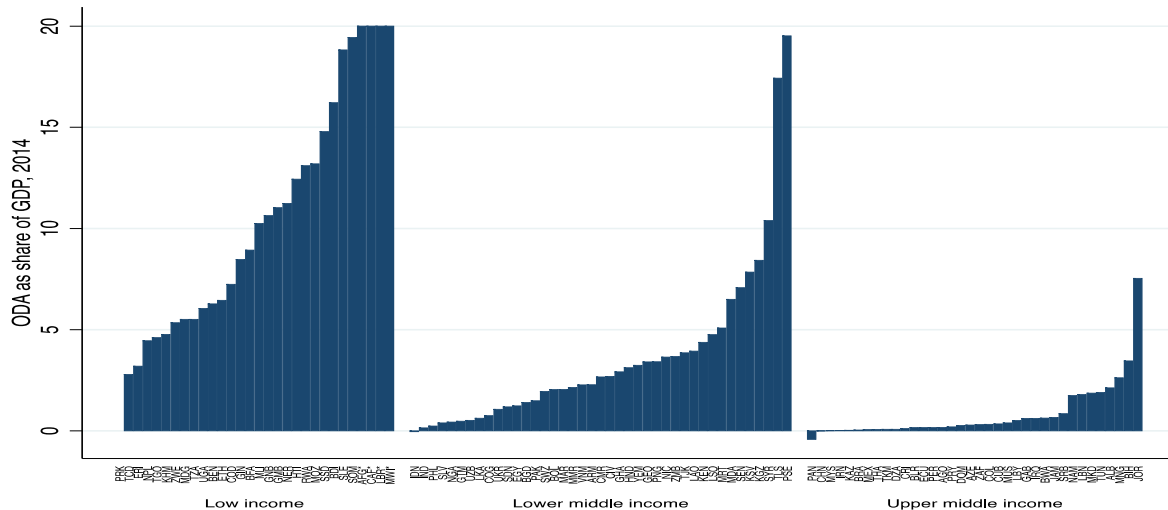
Source: Pinker 2011.

0.93 Since the end of the Second World War, official development assistance (ODA) or foreign “aid” has been one of the most prominent policy tools used by rich countries to induce security, growth, and equity outcomes in poor countries.<sup>10</sup> While the term “aid” has normative connotations,

<sup>10</sup> Foreign aid refers to official development assistance as defined by the Organisation for Economic Co-operation and Development (OECD).

aid itself may not always have a positive impact on development. The literature on aid effectiveness is voluminous but tends to be inconclusive. Ultimately what emerges is that aid is neither inherently good, nor inherently bad for development. What matters is how aid interacts with prevailing power relations and impacts governance. In some cases aid can undermine the relationship between the state and its citizens by making the state less responsive to their demands. For example, the more that states rely on revenues from the international community, the fewer incentives that they have to build the public institutions necessary to mobilize domestic revenues through taxation. And the less that states rely on their domestic tax base, the more state-citizen accountability erodes (Moore 2004). Currently, aid represents more than 10 percent of GDP for half of all low income countries, and over 30 percent of total revenues for approximately 40 countries (figure 0.13). The empirical evidence linking aid flows to decreased taxation is mixed (box 0.9). Aid has thus been likened to a natural resource curse: a windfall of unearned income that enables irresponsible government spending and behavior, unconstrained by the kind of state-citizen social contract thought to lie at the heart of modern democracies.<sup>11</sup>

**Figure 0.13 Aid is a large share of GDP and revenue in many developing countries**



*Source:* WDR2017 team based on data from OECD (for ODA); World Bank Africa Development Indicators (for FDI/GDP); World Bank World Development Indicators (for GDP and remittances/GDP); and International Monetary Fund, *World Economic Outlook*, (for general government revenues).

*Note:* FDI and remittances refers to the latest available data point; ODA data are as of 2014. FDI = foreign direct investment; ODA = official development assistance.

<sup>11</sup> The “aid curse” argument is made by Collier 2003; Moss and others 2006; Djankov, Montalvo, and Reynal-Querol 2008.

### Box 0.9 Domestic resource mobilization, foreign aid and accountability

There is a growing consensus that increasing domestic resource mobilization can enhance accountability, particularly if such efforts are explicitly linked to the provision of public goods. If ruling elites need to depend on broad-based taxation, they are more likely to include citizens and others elites in policy bargains. But does foreign aid undermine domestic resource mobilization—and hence accountability to citizens?

Studies testing that hypothesis initially showed a negative correlation between the two (most notably Gupta and others 2004). More recently, these studies have been refuted by the adoption of different datasets (Morrissey and Torrance 2015) or different econometric techniques. For instance, Clist and Morrissey (2011) invalidate the contemporaneous negative correlation found in Gupta and others (2004) by introducing a lagged effect of aid and taxation, concluding that the relationship is negligible. Although the behavioral effect of aid flows undermining accountability has been tested and isolated in experimental settings (Martin 2014; Paler 2013), in reality the relationship is more complex and seems to depend on three factors: the type of aid (for instance, whether it is grant or debt; budget support or project-specific); the contemporaneous effects of conditional policies associated with the aid; and, more importantly, the governance setting specific to each country. Moreover, even were aid to reduce incentives for domestic resource mobilization, the removal of aid may result in societally sub-optimal taxation policies to raise revenues, leaving the poor worse off.

The effects of domestic resource mobilization depends on how domestic funds are mobilized. Many available taxes may not have the capacity to enhance accountability, e.g., resource taxation, or may have distortionary effects, e.g., trade taxes. International corporate tax competition and trade liberalization have also diminished states' capacity for domestic resource mobilization (see earlier discussion on races to the bottom). In environments with low savings rates or the potential for capital flight and tax evasion, consumption taxes are most likely to be effective, but also the most likely to be regressive. Frequently in these cases, domestic resources are mobilized in ways that may increase poverty—for example, by increasing consumption taxes—without specific mechanisms of compensation. In 9 out of 25 countries with available household survey data around 2010, fiscal policy itself increased the \$2.50 per day poverty headcount ratio: in other words, in these countries more poor people were made poorer through the taxing and spending activities of governments than benefited from those activities (Lustig 2016).

Progressive, nondistortionary taxes exist, but may require greater capacity in tax administration systems; in these cases, aid may be effective at increasing domestic resource mobilization. Many developing countries are often characterized by high levels of informal employment, small establishments, and relatively weak bureaucracies, all of which make increasing revenues difficult. In these countries aid can help increase domestic resource mobilization through technical assistance that can help governments enhance the economic efficiency of their taxation systems. This can come through the transfer of technologies, skills training, legal support, and other forms of assistance, including improving taxpayer education.

Notwithstanding the importance of domestic resource mobilization for the expansion of responsiveness and accountability to citizens, it is worth noting that many countries may be too poor to have the capacity to collect enough revenues to address important development goals; may harm the poor in the process of collecting domestic resources; or may be politically unable to pass reforms to increase revenue. In countries where poverty rates are higher than 65 percent (mainly in Sub-Saharan Africa), for example, there is no feasible redistribution scheme that allows eradicating poverty only transferring resources domestically from the rich to the poor (Ravallion 2010 and Ceriani and others 2016). Moreover, in many developing countries, poor individuals are often impoverished by the fiscal system, when both government taxation and spending are taken into account (Lustig 2016). Finally, political power might be concentrated in the hands of few, rich individuals whose interests collides with those of the poor. In such instances, where there is need to mobilize a larger set of individuals to counter-weight the political influence in the hands of the few, domestic resource mobilization might be very difficult to achieve (Ceriani and others 2016).

0.94 *Development assistance failures*—defined as well-intentioned interventions that become ineffective because they reinforce an equilibrium that sustains the outcome that the intervention attempted to change—can arise from interventions that are blind to the existing power balance. Development assistance failures are *not* unavoidable or intractable. Like market failures and government failures, they can be addressed. Development assistance failures can be avoided when donor engagement supports the emergence of more accountable and equitable governing

arrangements that embed in the domestic context. When and how these positive effects take place, however, is difficult to predict in advance, given the web of intersecting and evolving factors that determine how donor initiatives engage with local political dynamics. The development community has recently been in engaging in efforts to “think politically” about aid, however, many of the operational imperatives that arise from greater attention to these challenges—such as the need to increase flexibility of implementation, tolerate greater risk and ambiguity, devolve power from aid providers to aid partners, and avoid simplistic linear schemes for measuring results—run up against long-established bureaucratic structures, practices, and habits. Moving beyond technocratic approaches, and learning how to take into account the openings and constraints presented by shifting politics, are key to the ability of foreign aid to induce and sustain pro-development governance reforms.

### **Even though power is unequally distributed, development can be made equitable**

0.95 When can meaningful changes occur in the nature of governance? This Report argues that because governance depends on the relative bargaining power, incentives, and preferences of different actors, this question cannot be answered by looking only at changes in institutional forms, state capacity, or rule of law. The development path is bumpy: shocks (such as terms of trade shocks and natural disasters) and gradual developments (such as urbanization or a growing middle class) alter the bargaining influence and preferences of actors, often benefitting one at the expense of another. In the face of these changes, governance arrangements that cannot accommodate new actors or demands could collapse. For example, violence traps can be understood as unstable bargains in which elites are highly polarized and the costs of losing control are great, leading to violent conflict. Middle-income traps can be understood as situations in which elite coalitions cannot adapt to changing economic conditions by dismantling unproductive systems to distribute rents and supporting newly productive economic actors.

0.96 Thus, adaptability to changes in the relative bargaining power, incentives, and preferences of different actors matters. Successful reforms are not just about “best practice” versus “best fit.” They require adopting and adjusting institutional forms in way that solve the specific commitment and collective action problems that stand in the way of pursuing further development.

0.97 Although the conditions that determine whether countries will adapt in ways that allow for more security, growth, and equity are contingent on history and are highly specific to context, there are a few circumstances that make such adaptability more likely. In particular, when elites have reasons to find common ground, bargains can expand and adapt; when national institutions produce more effective leaders, countries are more capable of long-term development; and when countries have more balanced, diversified, and organized business interests, they may be more capable of reforming institutions to adapt to changing economic conditions. Bargains that can adapt to evolving elite interests may nevertheless struggle to adapt to growing citizen demands. Regimes may lose legitimacy when decision-making processes are insufficiently inclusive, even when other developmental outcomes appear successful. For example, even effective growth policies may alienate the population if public voice in the policy process is lacking. Overcoming delegitimization necessitates greater inclusion in the political process.



0.98 A focus on creating conditions, like those discussed in this Report, that prepare societies to adapt as the needs and demands of society change over time, are critical for ensuring inclusive and sustainable development progress.

#### **Key messages**

*Key message 1:* Successful reforms are not about “best practice” or “best fit.” When designing policies, it is important to assess the key constraints to commitment, cooperation and coordination which stand in the way of promoting development.

*Key message 2:* Policy effectiveness can be improved by finding the best ways to strengthen incentives, enhance the contestability of the policy design and implementation process, and to understand and reshape preferences and beliefs.

*Key message 3:* Changes to promote more equitable development can be difficult to achieve, as groups who have less control over resources (such as those at the bottom of the income distribution) systematically have less bargaining power to influence decisions. However, change is possible if elites, citizens, and international actors work together to build pro- development reform coalitions.

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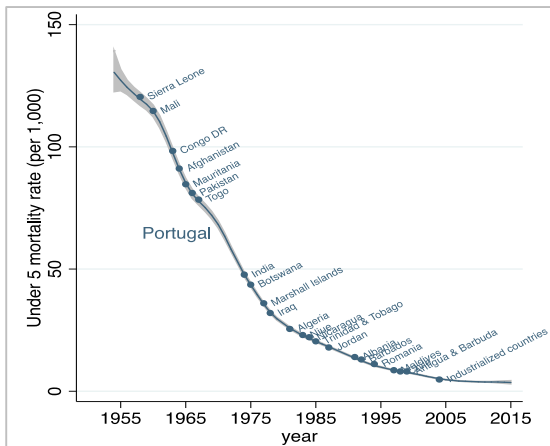
## Motivation

### Explaining variations in development progress: Proximate factors and underlying determinants

1. Societies worldwide have made enormous progress in improving socioeconomic conditions for large groups of people over the last century. Just in the past 20 years, more than 1.2 billion people have been lifted out of poverty (World Bank 2015). Economics Nobel Prize winner Angus Deaton labels this phenomenon “The Great Escape,” as “the story of mankind’s escaping from deprivation and early death, of how people have managed to make their lives better, and led the way for others to follow” (Deaton 2013).
2. Such positive performance hides, however, great variations within and among countries and regions, in terms of important aspects of the quality of life. Extreme poverty is still a reality for about 1 billion people, who make up over 14 percent of the total global population. Inequalities are striking—and increasing in many cases. This persistent disparity in social and economic achievement has concerned policy makers, academics, and development practitioners for a long time, particularly in today’s world, where the links among countries are stronger and technology diffusion can be fast and cheap.
3. Consider, for example, the under-five child mortality rate. This indicator is regarded “as one of the most revealing measures of how well a society is meeting the needs of its people,” given its reflection of the quality and incidence of service provision (Buckley 2003, in Andrews and others 2010). Despite substantial improvements over the last 45 years, developing countries today still lag many years behind the rate in developed countries. For instance, Sierra Leone and India trail, respectively, 45 and 30 years behind the average of industrialized economies (figure 1, panel a). Moreover, within countries, those individuals at the bottom of the income distribution are systematically behind those at the top. For instance, the poorest twenty percent of the population in India lies approximately 20 years behind the wealthiest twenty percent in that same country (figure 1, panel b).
4. Explanations of such differences in development performance typically focus on *proximate factors*, such as the provision of health services, connectivity infrastructure, or access to finance. “The intensive study of the problem of economic development,” Hirschman (1958) noted, almost six decades ago, “has had one discouraging result: it has produced an ever-lengthening list of factors and conditions, of obstacles and prerequisites.” This Report argues that while proximate factors are indeed crucial for development, the success of policies to achieve progress in this area is often associated to deeper *underlying determinants*, related to governance (box 1).

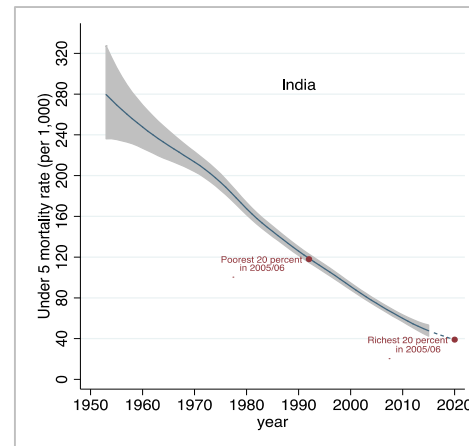
**Figure 1 Despite declining under-five child mortality rates, inequality among and within countries is still sizable**

a. Sierra Leone lags almost 60 years behind Portugal in reducing under five child mortality rates



Source: WDR2017 team on data from the UN Inter-agency Group for Child Mortality Estimation (IGME).

b. The poorest 20 percent in India lag almost 30 years behind the richest 20 percent



Source: WDR2017 team on data from the UN Inter-agency Group for Child Mortality Estimation (IGME) and India Demographic and Health Survey (DHS) for data by quintile.

## Box 1 The basic concepts

### What is governance?

Governance is a broad concept, which can be used in many ways. The term first appeared in the World Bank lexicon in 1991 (Lateef 2016). This is Report is not trying to change the definition of governance, but rather to look specifically at how it can help us to better understand the challenge of policy effectiveness.

Thus, in the context of this Report, *governance* is defined as the process through which state and nonstate actors interact to design and implement policies, within a given set of formal and informal rules that shape and are shaped by power.<sup>a</sup> This Report also defines *power* as the ability of one actor to make others undertake an action that is in that actor’s interest, and that they would not otherwise take (Dahl 1957; Lukes 2004).

Depending on the context, actors may establish a *government*, as a set of formal state *institutions* (organizations and rules) that enforce and implement policies. Also depending on context, *state actors* will play a more or less important role with respect to *nonstate actors*. In addition, governance takes place at different levels, from international bodies, to national state institutions, to local government agencies, to community or business associations. These dimensions often overlap, creating a complex network of actors and interests.

### Governance for what? Achieving the goals of security, growth, and equity

There are many important aspects of governance that are valuable in and of themselves (that is, that they have intrinsic value)—in particular, the notion of freedom. Freedom can be seen in economic terms as an opportunity set, and development can be seen as “the removal of various types of *unfreedoms*” [exclusion from opportunities], where these unfreedoms reduce people’s capacity of “exercising their reasoned agency” (Sen 1999). As essential as such an intrinsic value of freedom is, its *instrumental* value also matters because of the “effectiveness of freedoms of particular kinds to promote freedoms of other kinds” (Sen 1999). These positive relationships are what economists call complementarities. The Report acknowledges the intrinsic value of various dimensions of governance, while also recognizing their instrumental value to achieve equitable development.

The analysis of this Report starts from the normative standpoint that every society cares about freeing its members from the constant threat of violence (*security*), about promoting prosperity (*growth*), and about how such prosperity



is shared (*equity*). It also assumes that societies aspire to achieving these goals in environmentally sustainable ways. The Report assesses governance in terms of its capacity to deliver on these outcomes.

This approach is consistent with the transition from a dialogue based on ideology to a dialogue based on ideals, which has transpired in the global development community over the past few decades. Rather than debating what specific form political and economic systems should take, the focus has increasingly been turning toward the objectives that those systems are aiming to achieve. The establishment of the Millennium Development Goals (MDGs) in 2000 and the recent ratification of the Sustainable Development Goals (SDGs) by member countries at the United Nations are examples of these efforts to set common goals for social and economic advancement. SDG 16 calls for promoting “peace, justice, and strong institutions,” and is explicitly related to governance. Nevertheless, as this Report will argue, beyond the intrinsic value of SDG 16, it also holds important instrumental value, as the attainment of SDG 16 will aid in the attainment of all the other SDGs. Indeed, the achievement of all the development goals will require a solid understanding of governance dynamics in order to enable more effective policies.

*Note:*<sup>a</sup> This general definition is consistent with the World Bank’s corporate definition, which emphasizes formal institutions and the role of state actors.

### ***Governance is fundamental to the study and practice of development***

5. Too often, sensible and well-designed policies fail to meet their objective. The World Bank has called attention to this failure in delivering development dividends in the context of the *science of delivery*: “When a government passes a strong anti-corruption law but little changes in actual practice: that’s a delivery failure. Or when a country invests heavily in primary education but still can’t get all its children in school, or ensure that they’re learning: that’s a delivery failure, too.” While the development community has focused a lot of attention on learning *what* policies and interventions are needed to generate better outcomes, it has focused much less on attention on learning *why* those approaches succeed so well in some contexts, but fail to generate the same results in other places.

6. Consider for example, why some countries get “stuck” at certain levels of development while other continue to grow. With a few exceptions, policy advice for these countries has focused on the proximate causes of transition, such as the efficiency of resource allocation or industrial upgrading. However, the real problem may be political: powerful actors who gained during an earlier or current growth phase (such as the factor-intensive growth phase) may resist the switch to another growth model (such as one based on firm entry, competition, and innovation, in the process of “creative destruction”).

7. Ultimately, the success of policies and the institutions needed to deliver them are inseparable from the underlying structures of power in society. Policy making and policy implementation take place in complex political and social settings, in which individuals and groups, which hold unequal power, interact within changing rules as they pursue conflicting interests. The process of these interactions is what this Report calls governance.

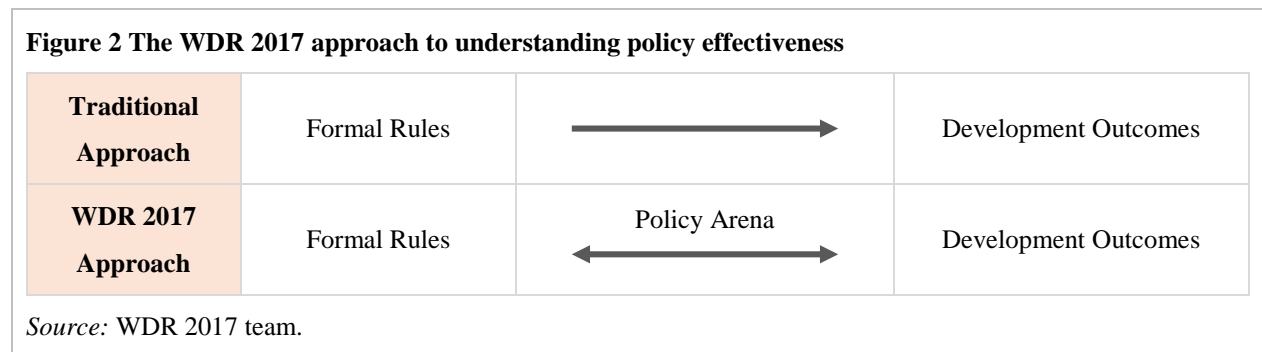
8. Governance is fundamental to the study and practice of development, and must be taken seriously if implementation gaps are to be overcome. Past *World Development Reports* (WDRs) have shed light on how to solve some of the most challenging problems in key areas of development such as jobs, gender equality, or risk management. This WDR, however, is part of a trilogy of recent reports, alongside *Digital Dividends* (2016) and *Mind, Society, and Behavior* (2015) which examine how policymakers can make fuller use of behavioral, technological, and

institutional instruments to improve state effectiveness for development. This WDR starts by acknowledging that policies to strengthen labor markets, overcome gender barriers, or prepare countries for shocks are often difficult to introduce and implement because certain groups in society who gain from the status quo may be powerful enough to resist the reforms needed to break the political equilibrium.

### A brief introduction of the framework

9. The WDR 2017 proposes an analytical framework to answer two fundamental questions: First, how can pro-development policies be achieved within a certain governance setting? Second, how can governance be changed to expand the range of feasible pro-development policies? Answering these two questions requires understanding in more detail the dynamic relationships between the policy-making and policy-implementation processes, the power configurations that shape and constrain these processes, and the resulting development outcomes. It builds on the foundations of applied game theory, and involves identifying the hidden forces of commitment and collective action that underlie all these relationships.

10. The framework contains three key elements: the *policy arena*, where actors bargain over policy design and implementation; the *formal rules* of the game (institutions) which shape the policy arena; and the *development outcomes* at which policies are aimed at influencing positively. Traditional analysis has focused on the interaction of the formal rules and the development outcomes. For example, analyzing how decentralization can improve service delivery at the local level. These assumptions, however, presume that the same policy is expected deliver the same results in another context. As discussed previously in this section—this is often not the case. This report emphasizes that the effectiveness of policies to deliver on outcomes depends on the nature of the policy arena which mediates the interaction between the two (figure 2).



11. The policy arena is where the different bargaining power of actors is manifested. Their relative power comes from the rules themselves (de jure) or from concrete aspects like control over resources (de facto). Ultimately, this means that the effectiveness of policies depends not only on *what* policies are chosen, but also on *how* they are chosen and implemented which depends on the relative distribution of power. For example, decentralization reforms in Maharashtra, India actually ended up reinforcing inequalities rather than improving targeting to beneficiaries as those with more power at the local level were better able to influence the redistributive programs than the poor (Anderson, Francois and Kotwal 2015).

12. The analysis acknowledges that while these power structures tend to be persistent, change is possible. The Report explores how coalitions for change can emerge within the policy arena to break out of a bad equilibrium and change the formal rules. For example, development processes that concentrate wealth may reinforce existing inequalities in the policy making process, leading to a vicious cycle in which inequality is rising (Esteban and Ray 2006). However, if actors— even those who typically have less voice in the decision making process—are able to cooperate and coordinate to overcome their collective problems they can increase their influence in the policy arena.

13. For example, consider the case of Switzerland, where women were not granted the right to vote in federal elections until 1971, even though the country had a tradition of direct democracy for centuries. The existing formal rules in Switzerland required a national referendum to change the constitution, and only men were allowed to vote. Reform coalitions among many actors led the way in bringing about such change, including international influence and domestic action by women’s groups, such as the Swiss Association for Women’s Suffrage. The change in female suffrage in Switzerland made it possible for new actors—women, in this case—to participate in the process of policy design and implementation, changing the incentives of politicians to be responsive to their preferences and interests. This led to further important policy changes over the decade. In 1984 women were finally granted equal rights in marriage to men, eliminating legal requirements such as the wives’ need to have their husbands’ permission to work outside the home, or to initiate legal proceedings, or to open a bank account (World Bank Group 2016).

### ***Governance for the bottom half***

14. The analysis in this Report calls for particular attention to understanding the implications for those groups who tend to have less power to influence the decision making process because of their economic or social circumstances. Groups which are typically marginalized from the policy arena—such as those the bottom of the income distribution—should have the same access to public services as all others. This is an essential pillar of development progress.

15. Think about the differences in the structure of economic activity and public service provision for people in low income versus high income countries. If one travels across a low income country, a commonly observed pattern is homogenous economic activity—for example, where a large group of people rely on agricultural activities—but where the provision of public services is rather heterogeneous—connectivity is uneven, availability and quality of services, such as education and health, vary dramatically from rural to urban sectors. The opposite tends to be true in advanced countries, where one finds a more diversified economic structure and a rather homogeneous coverage and quality of public goods and services. In this sense, the quest for development could be summarized as the transition towards more diversified economic opportunities and a more homogeneous response of public services to all individuals.

16. In order to make sustained progress in development, governance needs to be responsive to all groups in society, regardless of their circumstances. Even though power is unequally distributed in every society—an inevitable fact—promoting *governance for the bottom half* means promoting a process in which development dividends can still be equitably distributed.

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# Part I

## Rethinking Governance for Development



## Part 1 Introduction

### Rethinking governance for development

1. This report is about how to make policies more effective to deliver on development goals by taking governance as a key underlying constraint to explain implementation gaps. The analytical framework proposed by this Report has important implications for a number of well-entrenched development creeds. Traditional development orthodoxy has so far emphasized the centrality of three assumptions in explaining development outcomes: the form of laws and policies, the capacity to implement them, and the impersonal application of the rules. These assumptions have shaped donors' conventional solutions to the problem of policy failure: first, invest in "good" laws and policies on paper; second, build organizational capacity to implement them; and third, strengthen the "rule of law." Part I of this Report revisits these assumptions and illustrates that while these factors are important, they are not enough. It proposes three new principles, which build on these foundations: "Think of functions, not only form"; "Think of power, not only capacity"; and "Think of the role of law, not only the rule of law." Chapters 1, 2, and 3 explore these principles.

2. *Think of function, not only form.* Governance reform often focuses on what "type" of institutions to build and how to build them. However, development progress has been made in places with many different types of institutions, and its progress has been uneven in places with very similar types of institutions. While institutional forms are necessary and important, they only affect security, growth, and equity outcomes insofar as they perform an intended function. Specifically, they need to be able to solve commitment, cooperation, and coordination problems to make policy promises credible and effectively influence behavior.

3. *Think of power, not only capacity.* The capacity of the state is an essential determinant of the effectiveness of the state. Nonetheless, while capacity building has been heavily emphasized by the development community, it is often addressed independently of power. Without considering how the underlying power structure affects the way in which actors reach agreements and invest in capacity over time, these interventions may have limited effects in promoting development. In order to be more effective in enabling commitment, cooperation, and coordination, policies need to take into account three key factors: who can participate in the decision making process ('contestability'), what are the incentives they have to pursue certain goals, and what are their preferences, interests, and beliefs about other actors' actions in response to policies.

4. *Think of the role of law, not only the rule of law.* While the rule of law is often touted as a fundamental condition required to improve development, it is the result of a long historical process, and not a structure that can simply be engineered. In fact, the rule of law may be conceived as an ideal configuration that can be achieved only by strengthening the different *roles* of law in society. The roles of law in shaping the bargaining power of actors, in defining and implementing policies, and in enabling change are fundamental to understanding governance. In addition, formal law does not exist in a vacuum. In order for formal law to be effective in performing its roles, it needs to be understood in the context of many intersecting layers of rules—formal and informal—that jointly shape behavior.





## **Chapter 1 Think of function, not only form**

### **On form and function**

1.1 “Amka and the Three Golden Rules” is a beautifully crafted film about a Mongolian child, Amka, whose life turns into a nightmare after he finds a golden coin and hops onto a path of overspending, abandoning family duties and taking on unmanageable levels of indebtedness. Under pressure to repay his debts, he runs away, through the astounding Mongolian landscape, to settle with an eccentric uncle who teaches him the three golden rules of life.

1.2 A prominent Mongolian newspaper, the UB Post, noted that “the story is in many ways a symbol of how Mongolia must decide its own fate, to manage its growing levels of debt.” Indeed, as the movie was released, the country was going through a third attempt to establish a rainy day fiscal fund, the Future Heritage Fund, to manage the windfall derived from mining revenues—the country’s largest source of revenue. The attempt to transplant the design of a “future generations” fund from international best practices had failed twice already.

1.3 Experts from around the world had visited Mongolia in the previous decade, providing advice on the best existing rules for the distribution and management of revenues from natural resources. Technical solutions were available and political will was palpable among several state actors. Yet since 2007, attempts to establish rules for the use of mining revenues have been thwarted by political pressures. Parliamentary elections have led political parties to promise increased spending on programs like cash allowances, untargeted social benefits, and investments in specific regions in order to garner support. Such promises, could be fulfilled only by depleting the resources going into the reserve funds (Chimeddorj 2015). Thus, no matter how well policy makers designed the “future generations’ fund,” unless the interests of powerful groups in society changed, the commitment to a policy of fiscal prudence would continue to fail and the country would remain in debt. The process to reach and sustain agreements among decision makers with respect to these policies had not created the conditions for people to be willing to cooperate and coordinate actions around specific long-term goals.

1.4 The parallels between the Mongolian situation and the story in the movie was thus not a coincidence. The metaphor in Amka’s tale was a deliberate attempt, supported by opinion leaders and artists, to create awareness in Mongolian society regarding the importance of prudence when it comes to the management of resources (in the case of Amka’s story, the golden coin). The movie was seen as an instrument to reinforce the values of prudential management of wealth in the population in an effort to coordinate support for the pursuit of the necessary long-term goal of fiscal sustainability in Mongolia.

1.5 Policies are not designed and implemented in a vacuum. They are the result of a bargaining process among actors, frequently with diverse and even opposing preferences and interests. More importantly, those actors have very different bargaining power, derived from a variety of sources such as existing formal rules, informal norms, their ability to represent and mobilize other groups in society, or their control over resources. The complex process in which actors bargain to define and implement policies, in a very specific social, historical, and economic context, is what we call *governance*.

1.6 The example of Mongolia, discussed in more detail later in this chapter, illustrates how an understanding of the configuration of actors, interests, and relative differences in power could have led to more effective policy solutions. Effective policy making and implementation requires a process that first establishes a long-term goal in which all actors agree and have the incentives to pursue. While achieving such commitment among actors and inducing the collective action around long-term goals is not straightforward, it is the essential foundation for achieving progress in development.

### ***Moving beyond institutional transplants***

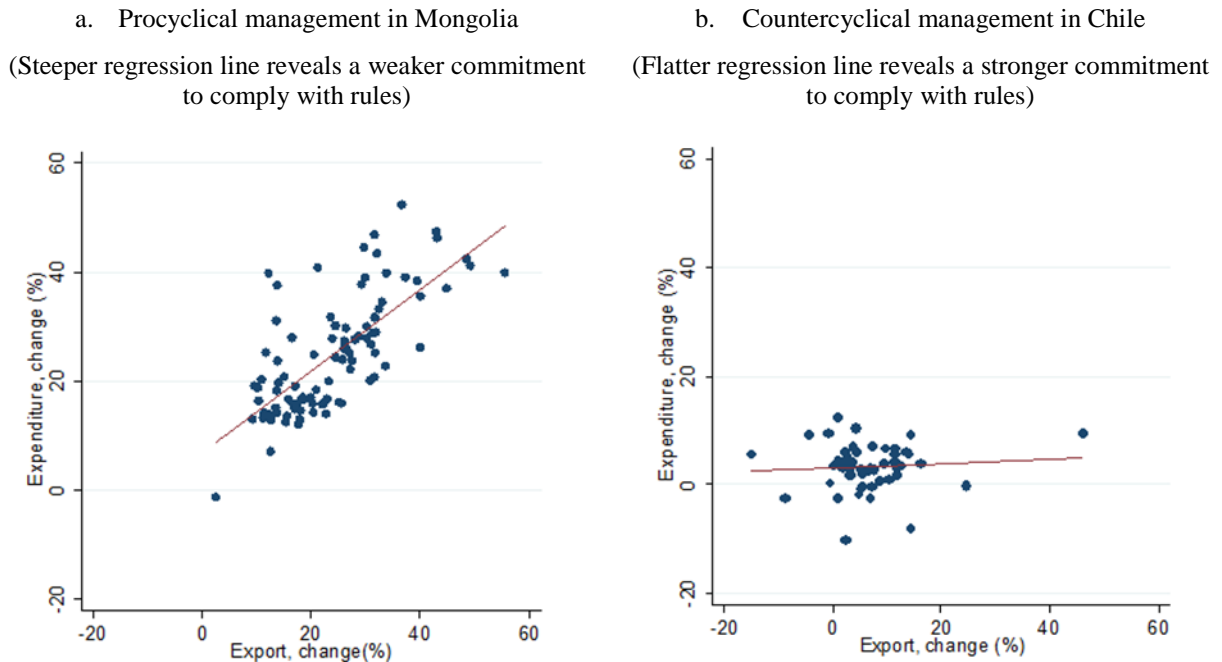
1.7 For decades, academics as well as practitioners have acknowledged the importance of *institutions*—the formal and informal rules of the game—for development. Countries that are more secure, prosperous, and equitable tend to rank higher in terms of existing indicators that emphasize certain institutional forms. This pattern has created a perception that certain types of institutions unambiguously determine higher levels of development, and has led many well-intentioned policy makers and development agencies to promote institutional reforms that aim at achieving those institutional standards—often referred to as institutional transplants. In other words, while acknowledging that governance matters for development, it is implicitly accepted that the effects of governance are determined by the characteristics of formal institutions.

1.8 However, institutional forms are not enough. What are those institutional forms trying to achieve? Consider the challenge Mongolia faced in following its own “golden rules.” The Mongolian government decided to adopt best international practices in order to manage fiscal revenues from natural resource extraction, but failed to administer them with a long-term perspective. While the countercyclical management of fiscal policy to manage volatility has been seen as a key characteristic of institutions to promote long-term development, the form which those institutions took in Mongolia was not enough to change outcomes (Gill and others 2014). Political constraints, pressures from interest groups, existing social beliefs about the need to accelerate progress in specific areas, and historical inertia have eroded the credibility of the commitment to prudent management of mining resources.

1.9 Contrast the case of Mongolia with those of countries seen as examples of effective management of natural resources, such as Chile and the Netherlands. Interestingly, Chile and Mongolia have the same institutional forms for the allocation of revenues from the extractive industry—as Mongolia followed the Chilean example—but very different outcomes. Fiscal spending in Mongolia is considerably more procyclical, in spite of having the same rules (figure 1.1, panel a). Chile and the Netherlands, on the other hand, have very different institutional forms, but are similarly effective in managing resources (figure 1.1, panel b). What do the Chilean and Dutch cases have in common? Many factors determine effectiveness, but certainly the fact that actors are willing to accept and follow the rules, or act collectively, is one of them. In Chile, political agreements after the return to democracy in the 1990s have included a long-term perspective on economic management, principles accepted by all actors in the political spectrum. In the Netherlands, basic principles of fiscal management have been broadly accepted in the Dutch

political culture for many years—reinforced by the experience of going through a period of mismanagement and the so-called Dutch disease in the second half of the twentieth century.<sup>1</sup>

**Figure 1.1 Despite similar rules for the management of natural resource revenue in Chile and Mongolia, Chile’s expenditure patterns reveal a stronger commitment to compliance**



Source: Mongolia (Mongolia Statistical Information Services, monthly data 2005-2015), Chile (World Bank Development Indicators 1960–2014).

1.10 The dynamic interaction between governance and development outcomes is indeed complex, and causality is difficult to establish. The diversity of institutional paths to development suggests a need to look more closely at the underpinnings of the unique and often complicated experiences of governance around the world. While the development community has been focused on what types of institutions matter, perhaps a more relevant starting point is asking what it is those institutional forms are trying to achieve, or what *functions* they are meant to perform.

<sup>1</sup> The importance of fiscal prudence is embedded in the Dutch value system, as much as the importance of an open debate about policies that involve the use of public resources. Nicolaas Gerard Pierson, Dutch Minister of Finance and one of the most respected economists in the world toward the end of the nineteenth century, said more than 120 years ago that taxes should be invested wisely or they would be just unjustified, and that opportunities for investments should be taken when “a concurrence of favorable circumstances generates a temporary budget surplus e.g. abundant harvests leading to extra tax revenues” (Pierson 1890).

## **Institutional functions for development: Commitment, cooperation, and coordination**

1.11 This Report argues that while the form of institutions is certainly important, it only affects development to the extent that it is able to perform an intended function. Three key *institutional functions* that matter for development—as illustrated in the Mongolia example—are ensuring *commitment* (supporting consistent policies over time to make sure promises are delivered), enabling *coordination* (credibly signaling what is the expected behavior among actors), and inducing *cooperation* (changing the incentives of actors to limit opportunistic behavior). In order to improve functional effectiveness, it is necessary to understand the nature of the process that leads to policy design and implementation and the mechanisms that sustain those agreements among actors; these matters will be discussed at length in chapter 2. Box 1.1 discusses the ways in which commitment, coordination, and cooperation interact by referring to the models of game theory (the branch of mathematics that analyzes strategies for dealing with competitive situations where the outcome of a participant's choice of action depends critically on the actions of other participants).

1.12 Think of a case in which a government wants to build a toll road to connect a specific region to other parts of the country and foster growth. This particular government lacks the financial resources needed to construct the road and considers solving this problem by contracting the construction of the road to private investors, who view the road as an opportunity for profit. The construction of the road may have environmental, social, and economic implications that concern members of the local community. People concerned about social and environmental damage and dislocation will demand a credible agreement to reduce damage and compensate the affected groups.

1.13 Investors will require a commitment to guarantee the return on their investment—knowing that once the physical investment has been made, politicians may face political pressures to reduce the tolls below the level at which costs can be recovered and profits made to get votes for the next election. Political and commercial risks must be allocated through a credible commitment device, in the form of a contract and regulations that set the right incentives for the different actors at different stages in the process of designing, building, and maintaining the road (Engel and others 2014).

1.14 While analysts may rightly conclude that the constraint to development refers to poor connectivity, the underlying determinants are related to the commitment capacity of local institutions and the willingness of the actors involved—once the decision is made—to cooperate and coordinate by voluntarily abiding by the rules. Such functions of credibly committing and effectively solving collective action problems can be achieved in different ways and through different contractual forms, depending on the specific context (see spotlight 1 for a more detailed discussion on the implications for public-private partnerships contracting).

**Box 1.1 The microfoundations of commitment and collective action: A perspective from game theory**

The framework of this WDR highlights commitment and collective action (cooperation and coordination) as the key institutional functions that shape the effectiveness of policies for development. Those terms come from game theory and are better explained using its language.<sup>a</sup> Table B1.1.1 presents an example.

**Table B1.1.1 Coordination and cooperation as modeled in game theory**

		Actor 2	
		Take action A (A)	Do not take action A (NA)
Actor 1	Take action A (A)	2, 2 (A, A)	0, x (A, NA)
	Do not take action A (NA)	x, 0 (NA, A)	1, 1 (NA, NA)

The table is read in the following way: the top left-hand corner symbolizes the net benefits (hereafter referred to as the *payoffs*) for actors when both of them decide to take action A (for example, mobilize, pass a law, or monitor a provider). The first number (2) stands for the *payoff*, of actor 1 when he/she decides to take action A and actor 2 does the same. The second number (2) symbolizes actor 2's payoff when he/she decides to take action A when actor 1 does it, as well. In the top right-hand corner, the first number (0) is actor 1's payoff when he decides to take action A although actor 2 decides not to. The second number (x) is actor 2's payoff when he/she decides not to take action A and actor 1 does. The actors' payoff values can be read in the other scenarios in the same way. According to the matrix of payoffs, the value of x will determine whether it is a coordination or a cooperation game. Both are *collective action problems*.

**Coordination**

If  $x < 2$ , the actors are engaged in a coordination game. In this game, the actors' incentives are aligned, but their action depends on their expectations about what the others will do. Both of them prefer to do the same action; both outcomes—(A, A) and (NA, NA)—are *equilibriums* of this game. The problem is how to achieve the equilibrium that is efficient and yields the highest payoff (A, A) because players are unsure about what the other will do. In game theory, this game is known as the *assurance game*, where it is in each player's own interest to take a particular action (y) if there is assurance that everyone else is also taking action y. To achieve coordination, policies need to create common knowledge that everyone will take the desirable action. Sometimes this requires providing incentives for some actors to take the desirable action first so others will follow.

**Cooperation**

If  $x > 2$ , the actors are engaged in a cooperation game. In this game, actors' incentives are not aligned. In equilibrium, both of them do not take action A—(NA, NA)—which is the worst outcome from the point of view of maximizing the group payoff. In game theory, this is referred to as a *prisoner's dilemma game*: where the collective gain would be greater if the actors could cooperate, but each actor individually has a greater incentive to *free-ride* (take action NA). To induce cooperation, policies need to put forth a credible mechanism of conditional reward or penalty to prompt actions yielding the jointly preferred outcome.

**Commitment**

*Commitment* refers to the ability of actors to enforce agreements. For example, if communication were allowed in the cooperation game, actors would have incentives to promise to take the action that maximize the group's payoff. However, as there are no mechanisms to enforce those agreements—hereafter called *commitment devices*—it is still in the interest of the actors to renege on their promises. Commitment devices allow actors to transform the game so their incentives are aligned.

a. Example adapted from Weber (2008) and reprinted in Bardolino (2013).

### ***Ulysses and the sirens: The importance of commitment to achieve development***

1.15 In every society throughout history, decisions that affect the many are made by a few. Institutions are the central means by which human beings purport to maintain social order and reduce uncertainty. Thus, a fundamental function of institutions is to ensure commitment. Contracts are always incomplete, as unforeseen contingencies may arise. Economic and political conditions may change and the incentive for policy makers to deviate from established goal-oriented policies can be strong. It is particularly important to ensure that those in power can credibly deliver on promises made to citizens beyond the political cycle. In this sense, institutions can be thought of as technologies that allow society and individuals to engage in the pursuit of long-term goals, even in the face of changing circumstances.

1.16 Imagine that you would like to save for retirement by contributing funds to a pension. If you do not believe that the government can credibly commit to not expropriating those funds and returning them back to you in the future, you will likely choose not to save. In fact, this type of “credibility crisis” is exactly what has been observed in situations in which governments have defaulted on their commitments (Stein and others 2008). Another common example of institutions as commitment devices is through the enforcement of property rights, which is fundamental for the pursuit of development, in particular for reducing violence and promoting investment.

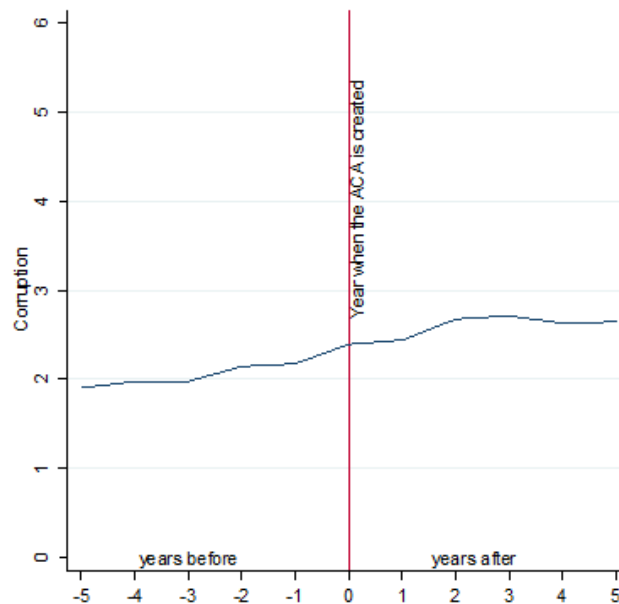
1.17 The *doi moi* (renovation) reforms to legalize private business in Vietnam provide another interesting case study to see how the same institutional “form” can lead to different outcomes if its commitment is not perceived as credible. In 1991 the reform eliminated differences across provinces to register firms. However, there were drastic differences in the share of household businesses which chose to register themselves as firms. What can explain this difference? While registering would provide benefits, such as the ability to operate in other districts, open new branches, or obtain export licenses, there were also costs. Beyond the fees associated with the need to fill out paperwork and taxes, there was also the *possibility* that providing this information to bureaucrats could result in them demanding bribes. Malesky and Taussig (2009) argue that the ability of bureaucrats in each province to commit not to extract unlawful rents from entrepreneurs, was a key factor behind the number of entrepreneurs that decided to comply with the law and register their firms. While the form of the law was exactly the same across provinces, its function differed as bureaucrats in some provinces were unable to credibly commit to not abuse their power, making the policy ineffective.

1.18 What types of institutional arrangements can help ensure credible commitment? How can those in power bind themselves in such a way that their promises become credible even when it is in their short-term interest to break them? Think of the myth of Ulysses in Homer’s *Odyssey*: in order to resist the short-term temptation of the Sirens’ luring song, Ulysses has his sailors bind him to the ship’s mast to remove the option of jumping overboard. In order to understand why powerful actors would “tie their own hands” in this way and whether or not that agreement will be credible, it is necessary to examine the context of a specific set of actors, rules, and potential incentives to break the agreement. For example, granting independence to the central bank is a mechanism that governments use to tie their hands in an attempt to gain credibility that they will not use inflation to finance public expenditure (Cukierman and Lippi 1999). However, if the balance of power in society is such that the outside agency does not have the political capacity to

enforce those arrangements, this type of “form” will fail to perform its function of ensuring commitment (Acemoglu and others 2008).

1.19 Think of the impact of anticorruption agencies. In theory, anticorruption agencies play an important role in constraining the use of public office for private gain. However, those agencies will be ineffective if they are unable to alter the existing incentive structure (which makes it not credible to enforce the new regulations and the underlying contract of the new agency). Figure 1.2 shows how the trend in terms of control of corruption hardly changed after the creation of anticorruption agencies around the world. Does that mean that such agencies do not matter? Not necessarily. What it shows is the *endogeneity problem* that is pervasive when thinking about governance reforms: those places in which the commitment to fight corruption was present would show little effect by creating that specific new agency; in those places where the equilibrium to maintain corruption as a means to sustain deals among actors is stable, the establishment of the agency would make no difference. This is similar to the effect of the reforms aimed to increase central bank independence to control inflation described in Acemoglu and others (2008). See spotlight 2 for a more detailed discussion on corruption as seen from the perspective of the WDR framework.

**Figure 1.2 Control of corruption does not improve when an anticorruption agency is created**



Source: Alina Mungiu-Pippidi. Presentation for WDR 2017 Seminar on Corruption.

1.20 Around the world, different institutional forms have been established in order to make commitment credible. In Guatemala, for instance, in the aftermath of the peace agreements of the 1990s and after an increase in the political violence that raised concern among many actors, an agreement was reached to turn to international actors and create the International Commission against Impunity (CICIG) (box 1.2), which has changed society’s perception about its capacity to hold powerful actors accountable.

**Box 1.2 How an international commission enabled a credible commitment to fight criminals’ impunity in Guatemala**

“If you are watching this message, it is because I was assassinated by President Álvaro Colom, with help from Colom's private secretary Gustavo Alejos.” The release of a YouTube video in 2009, in which Rodrigo Rosenberg makes this statement accusing the president of Guatemala of his murder precipitated a political crisis in the country. Opposition to the president asked for his immediate resignation, and only a rapid and effective independent investigation of the situation prevented an escalation of political instability in Guatemala. The evidence found in the investigation revealed that the hitman who had killed Mr. Rosenberg was not hired by the president, but was in fact hired by Mr. Rosenberg himself: Mr. Rosenberg had ordered his own assassination.

The investigation was conducted by the International Commission against Impunity in Guatemala (CICIG), and provided the credibility needed to resolve this crisis in a peaceful manner. This UN-backed institution was approved in 2007 by the Guatemalan congress and was mandated to help the Guatemalan judiciary authorities in their fight against illegal criminal organizations that had infiltrated security and judicial state institutions. The approval came following a broad wave of homicides that infuriated citizen organizations and the mass media. The growing perception was that national authorities had lost any capacity to credibly prosecute large and powerful criminal networks.

To fight impunity meant to dismantle these criminal organizations and eradicate their corrupting power within state institutions, which protected them from being effectively prosecuted. Three of the greatest strengths of CICIG’s mandate, were its independent capacity for criminal investigation, its prosecution capacity through a specific “fiscalia” of the office of the Attorney General (AG) (which allowed it to investigate even in the face of internal opposition within the AG), and its independent voice in relation to mass media. These arrangements enabled CICIG’s ability to credibly commit to prosecuting impunity.

Since 2007, CICIG has had a deep impact on the Attorney General office’s capacity to credibly prosecute criminal networks, even leading to a peaceful resignation of the president in 2015 after the discovery of his involvement in “La Linea,” a criminal network linked to customs fraud. Moreover, national security forces, judges, and members of congress have been empowered in their public roles and the renewed commitment to prosecution has increased pressure to reduce participation in illegal activities. CICIG’s political power today is well beyond that which was originally thought for an international organization, which raises both concerns and enthusiasm in Guatemala.

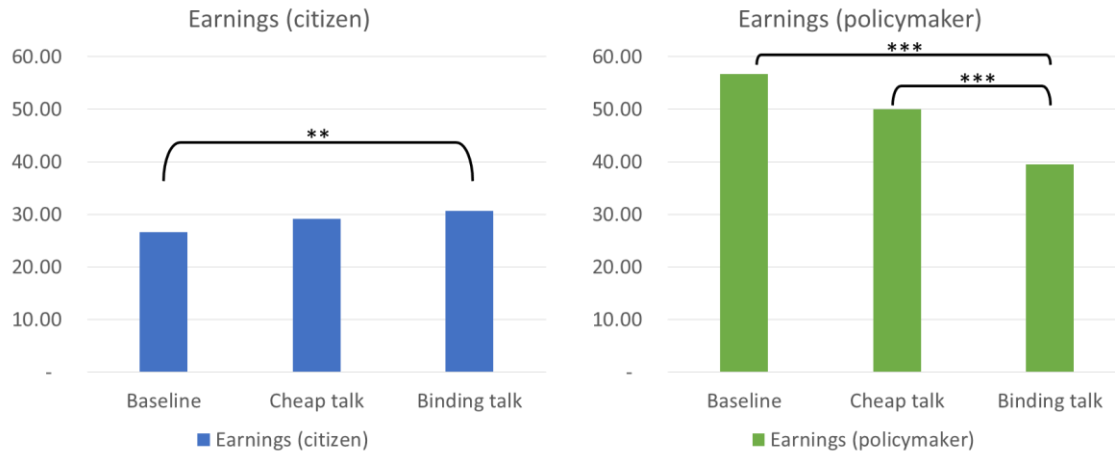
*Source:* Carrera 2015, background paper for the WDR 2017.

1.21 The perception of people about the credibility of commitments enhances also the willingness to cooperate—say, through tax compliance—and coordinate—follow rules as a response to the belief that other will follow as well. In lab experiments carried out for this Report, yielded results that are consistent with these notion, where binding commitments led to higher cooperation and more redistribution (Banuri and others 2016, box 1.3).

**Box 1.3 Commitment, cooperation and coordination: Evidence from Lab Experiments**

As background work for WDR 2017, a series of lab experiments were carried out to explore the behavioral responses of agents in terms of cooperation and redistribution under different protocols. The basic lab game design has three citizens and one policy maker. The citizens provide resources to a group account which the policy maker is in charge of distributing (see annex B). The policy maker observes the total amount in the group account and then can distribute the resources in any manner he chooses. The game is repeated over twenty periods. In the cheap talk treatment the policy maker makes public his intended distribution rule prior to citizens’ contributions, but the rules are not binding and can be modified after citizens make their contributions. In the binding talk treatment, the policy maker again makes public the distribution prior to citizens’ contributions but in this case he cannot amend it after citizens make their contributions. In this case, there is credible commitment as the announcement is binding. The results are shown in figure B1.3.1.



**Figure B1.3.1 Welfare is higher for citizens under commitment in the lab game**

\*\* Significantly higher earnings in Binding talk - compared to baseline ( $p < .05$ ) but not compared to cheap (and cheap not different from baseline).

\*\*\* Significantly lower earnings of policy makers in Binding ( $p < .01$ ) relative to both baseline and cheap ( $p < .01$ ). Cheap not significantly different from baseline ( $p = .133$ ).

Source: Banuri and others (2016) as background work for WDR 2017.

### ***Solving collective action problems: Coordination and cooperation***

1.22 Societies are comprised of many people with diverse preferences and incentives. What makes people choose to coordinate and cooperate to reach socially preferred outcomes? The answer to this question is at the heart of understanding development progress. As Douglass North contends, “The disparity in the performance of economies and the persistence of disparate economies through time have not been satisfactorily explained by development economists.... What has been missing is an understanding of the nature of human coordination and cooperation” (North 1990: 11). Solving these two types of collective action problems (coordination and cooperation) are the second and third key functions that institutions perform.

#### *Coordination: Shaping expectations to enable complementary action*

1.23 By shaping beliefs and coordinating expectations, institutions can push societies on new paths toward better development outcomes. When actors are uncertain about what others will do, they may not make decisions that could induce socially preferred outcomes. Consider a country that wants to invest in green technologies such as electric cars in order to improve the environmental sustainability of its growth process. This requires the complementary investment of car manufacturers, battery producers, electricity providers, and city planners. If each individual actor is unsure whether the others are willing to invest, the electric cars may never be produced. However, if institutions are able to reduce that uncertainty by creating common knowledge that other firms will also invest or by providing incentives to first movers, they can help coordinate investment across firms and push the adoption of greener technologies (World Bank 2012). Infant industry protection and other industrial policies are ways in which governments have provided

these types incentives to avoid being trapped in a situation where everyone waits for the others to invest first.<sup>2</sup>

1.24 Coordination issues arise precisely due to complementarities. Since Rosenstein-Rodan's (1943) classic work on the problems of industrialization in Eastern Europe, and the idea of the "big push" formalized by Murphy and coauthors (1989), the issue has been seen as central both economic and non-economic realms. What kind instruments policy makers have to coordinate expectations and lead societies to socially preferred outcomes will very much depend on the kind of complementarities involved.

1.25 Norms and beliefs play an important role also in the case of coordination. Coordination of beliefs can help to understand phenomena ranging from discrimination to corruption to technological revolutions (Tirole 1996; Mokyr 1997). How societies perceive, for example, the value of entrepreneurship and innovation can lead to different expectations and thus actions on the side of investors and consumers (see box 1.4 on one specific type of coordination failure). When Berlusconi in Italy said publicly that he considered the tax burden and tax enforcement for entrepreneurs to be excessive, he was sending a signal that, as long as he was in charge, tax enforcement would be weaker, actually leading to lower tax compliance by businesses (Raitano and Fantozzi 2015).

**Box 1.4 The importance of coordination: The example of bank runs**

In summer 2015, the spotlight of Europe was pointed at Greece. While the country's government was negotiating with the International Monetary Fund and the European Central Bank for a loan in exchange for a tough package of reforms, fear of financial crises and of the collapse of the bank system brought long lines of people to ATMs all over the country. The value of bank notes in circulation increased 10 percent in the month of June alone.

This is a recent example of a (system-wide) *bank run*, which occurs when a large number of account holders rush to withdraw cash from (all) financial institutions in the economy at the same time because of fear of imminent insolvency. Argentina is an even more dramatic example: in November 2001, the total deposits in the banking system fell by nearly 3 percent on the second day of the run alone (Ennis and Keinster 2009). Other examples include Brazil in 1990 and Ecuador in 1999.

Bank runs are an example of a *coordination failure*. Each depositor's incentive to withdraw funds depends on what he or she expects other depositors to do. There are two self-fulfilling equilibria: in one (efficient) equilibrium, account holders decide to withdraw only when they need liquidity; in the other (inefficient) equilibrium, in an environment of distrust of bank institutions and noncredible state commitment to protect savings, account holders fear that they will not be able to access their funds in the near future, and rush to withdraw their deposit, irrespective of liquidity needs. As a consequence of the bank run, if a large enough number of individuals withdraw cash and if the value of liquid reserves is only a share of total deposits, banks end up being insolvent, hence fulfilling the fears of account holders.

The behavior of account holders in a period of financial crisis depends crucially on how they expect state institutions to react. For instance, if the state can credibly commit to respond to a bank run with an instantaneous freeze of all deposits, the bank run will not occur (see Diamond and Dybvig 1983 for a formal economic modelling). Nevertheless, such crises often occur during periods of political instability, when trust in institutions is generally low. In 2015, the Greek government officially imposed strict capital controls (a shutdown of banks, withdrawals limited to 60 euros per account per day, banning of transfers outside the country), stemming the run, and preventing the bank crises. On the other hand, in Argentina in 2001, the deposit freeze could not be credibly enforced at a moment when two presidents resigned in a period of four weeks.

*Source:* WDR 2017 team based on Diamond and Dybvig 1983, and Ennis and Keister 2009.

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<sup>2</sup> See Hoff and Stiglitz (2001) for several other examples of coordination problems that are key for development.

1.26 Policies to induce coordination can help countries break free from path dependence, and are often needed only as a temporary intervention. Consider the role of temporary policies in combating corruption. It may be possible for a temporary anticorruption program to move an economy from a high-corruption equilibrium (based on expectations of high corruption) to a low-corruption one (based on low-corruption expectations with respect to the behavior of others), as Tirole (1996) discusses. In the case of non-smoking laws, the passing of the laws and the no-smoking signs in buildings increases the probability that non-smokers will complain if a person smokes in the building, and given those beliefs by smokers, they end up changing to a smoke-free equilibrium.

*Cooperation: Avoiding free-riding and opportunism*

1.27 Another basic type of collective action problem that institutions solve is cooperation. Lack of cooperation is a typical cause of segregated outcomes: for instance, differential treatment of different ethnic groups. One group may not be willing to contribute to the provision of public goods if a different group will benefit, which can change if a commitment to public goods provision can be credible—regardless of which group is in control of the resources (constraining the power of those to whom authority is delegated, or sharing power in cabinets). By reducing free-riding and opportunistic behavior, institutions can help build more cohesive societies and turn zero-sum games into positive-sum games (Ostrom 1990). A key notion behind cooperation problems, which differentiates them from coordination problems, is that the preferable action from a social point of view is not necessarily an equilibrium. In the case of coordination problems, multiple equilibria exist, and policy is a matter of helping “make the jump” to the optimal one.

1.28 Perhaps the most well-known example of a cooperation problem is the tragedy of the commons (Hardin 1968). In this example, open grassland—the “commons”—is available for all herdsmen to graze their animals without restrictions. As increasingly more cattle graze in the pasture, the land becomes unable to grow back fast enough, ultimately depleting until it is not useful for anyone. The notion is that rational individuals acting independently according to their own self-interest will deplete a shared resource, even if it is contrary to the best interest of the group. This type of problem is common in situations where agents obtain immediate gain for their action but do not experience the losses from the impact until later. It is often observed in reference to the provision of public goods, as well as in terms of environmental concerns such as climate change (box 1.5).

1.29 Cooperation becomes more difficult to induce as the number of people involved increases, there is less information and greater uncertainty about others, and when the interaction is finite. Inequality may also matter in sustaining cooperation. Theoretically, the relationship between wealth inequality and the successful provision of a common resource pool can be ambiguous. Consider a situation with high wealth inequality. On one hand, a few dominant members may reap enough of the benefits from having the public good so that they have the incentives to provide and maintain it independently, even if other less wealthy individuals free ride on it (Olson 1965). On the other hand, some individuals with better outside options (often the rich) may not want to

contribute to the provision of the good and there may be higher costs to enforce cooperation, thereby nurturing distrust that the other(s) will pay and undermining cooperative behavior.<sup>3</sup>

**Box 1.5 The importance of cooperation: Managing local water resources in Tamil Nadu in India**

Cooperation problems often occur in situations with common pool resources such as fisheries, forests, or irrigation systems. In the southeastern Indian state of Tamil Nadu, cooperation to manage public irrigation systems at the community level is crucial to avoid free-riding and efficient water use.

A large survey conducted in the state was used to study the determinants of cooperation in these communities, looking at institutional, socioeconomic, and topographic factors. Each of the 48 surveyed villages is served by either a canal system or a more traditional tank system. Water users' organizations perform diverse functions, such as pooling resources for the construction and maintenance of field channels, managing water allocation, or monitoring violations of allocation rules. Most organizations are informal community groups. Canal systems fall under the purview of the general administration of the national government, the Public Works Department (PWD), which makes water allocation decisions for canal-based system units more directly in some districts than others.

Bardhan's empirical analysis looks at the effect of these factors on cooperative behavior measured by how well the systems are maintained; the absence of conflict; and the extent of violations of rules. The results indicate that inequality in the landholding of farmers has a negative effect on cooperative behavior—suggesting that economic homogeneity is more conducive to cooperation. Access to urban areas and markets—including access to transport and communications, such as buses and telephones—also has a negative effect on cooperative behavior in villages, as these “exit options” decrease the incentives to cooperation. On the other hand, the duration of access to water (the number of months where there is access to irrigation) increases the likelihood of cooperation—probably because there are higher returns to investing in maintenance when access to the system is longer (that is, when the stakes of not cooperating are higher). The presence of a guard to enforce allocation rules predictably increases cooperative behavior (particularly if the guard was appointed by the community itself).

There is also some evidence that social homogeneity (measured as three-quarters or more of the farmers belonging to the same caste) is conducive to cooperation, as is smaller group size (measured by the number of households using a particular irrigation source). Rules related to cost-sharing that make costs proportional to landholding also increase cooperative behavior, indicating that a perception of fairness counts for cooperation.

Government involvement has a positive significant effect on cooperative behavior for all three indicators of cooperation. A likely explanation is that when the PWD is involved in allocation and maintenance at the higher level, returns to farmers' collective efforts at the lower level are higher. On the other hand, government involvement increases the violation of some notably rigid rules of water allotment, whereby the wealthier farmers get more water than their due. In many of these same units, however, systems are well maintained and there is no incidence of conflict in the last five years. This suggests that the fact that those particularly inflexible rules are coopted does not seem to damage cooperation within villages.

The results highlight the importance of being involved in the crafting of the rules. The study finds that when a farmer believes that rules have been created jointly (along with the elite or government), the farmer is more likely to have a positive perception both about the allocation system and about the compliance of other farmers with the rules. Similarly, elites violate water allocation rules less when they are the ones that crafted the rules.

*Source:* Prepared by WDR 2017 team based on Bardhan 2005.

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<sup>3</sup> Examples of the cohesion and inequality-conflict cycle are found in Esteban and Ray (2011) and Gintis (2000). Bardhan (2005) discusses cooperation in the context of scarcity and conflict.

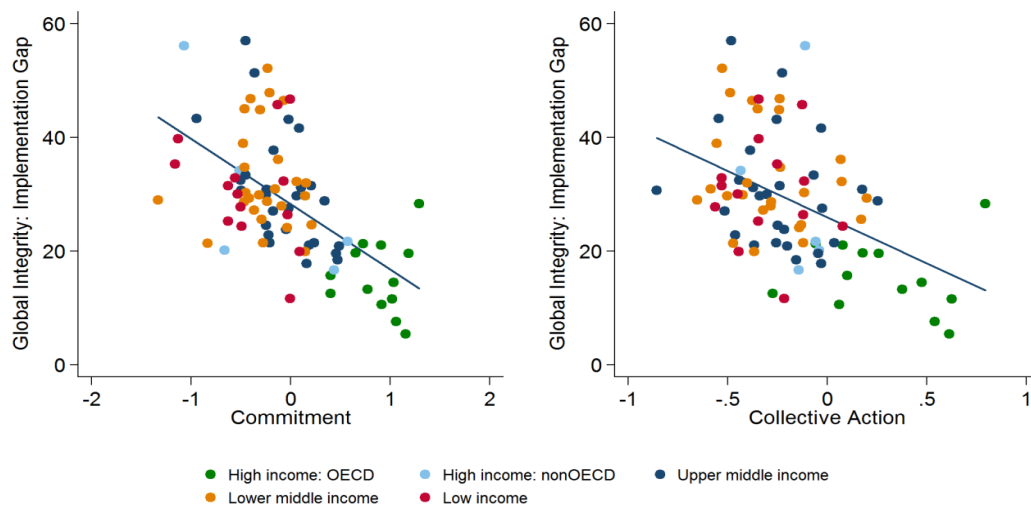
## Closing the gap between policies on paper and policies in practice: Enhancing the effectiveness of institutional functions

1.30 Consider the challenge of improving tax compliance from the perspective of the institutional functions. Why might people choose not to pay their legally owed taxes? First, they may not believe the government will provide the collectively agreed public goods with those resources (lack of commitment). Alternatively, individuals may think everyone else is not paying (lack of coordination). Finally, even if everyone else is paying, but the government does not have the capacity to enforce the law, some individuals may decide not to pay because they individually do not rely on the provision of the public good, such as public education (lack of cooperation).

1.31 The actual functioning of formal institutions plays a key role in providing signals and incentives to all members of society to address these commitment and collective action problems. For example, the effective independence of the bureaucracy as well as the transparency of the use of public funds could make the commitment to provide the collectively agreed public goods more credible and therefore influence people to pay their share of taxes. Alternatively, increasing commitment to prosecute those who evade taxes may limit free-riding and increase compliance. Finally, increasing tax compliance through the mechanisms identified above could be enough to signal to citizens that there is a new environment where everyone pays taxes, shifting the norm.

1.32 Figure 1.3 shows that *implementation gaps*—the difference between the policies on paper and in practice—are negatively correlated with an index of aggregate measures of commitment and collective action (the institutional functions). While these associations alone are not enough to claim a causal link, it shows that the cross-country evidence does not refute the hypothesis documented in well-identified studies that commitment and collective action are crucial to understanding the mismatch between what policies are supposed to do and what they actually do.

**Figure 1.3 Better performance of the institutional functions is associated with smaller implementation gaps**

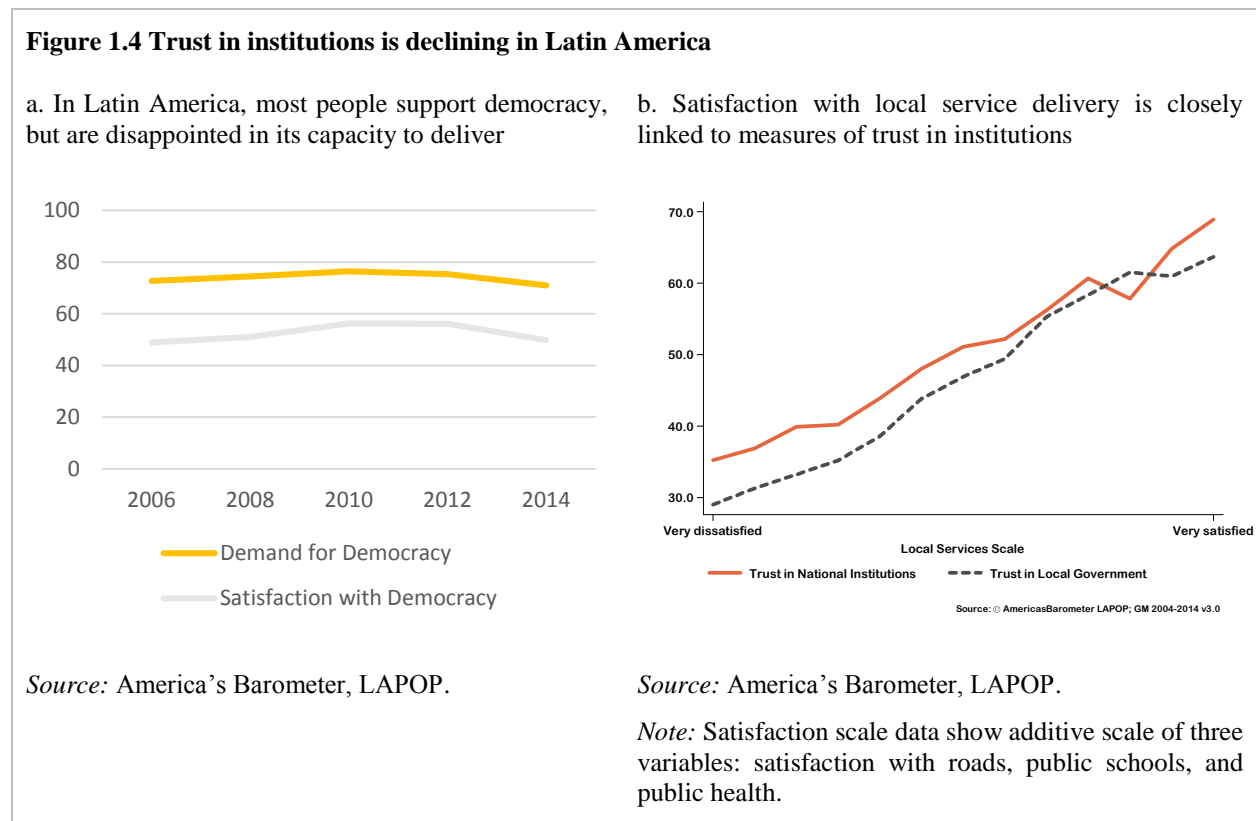


*Source:* WDR 2017 based on Global Integrity dataset and own aggregation of the commitment and collective action indicator. The implementation gap measure is based on an expert survey that checks the difference between the laws in paper and in practice. The aggregation of the commitment indicator uses experts' perceptions of contract enforcement, and whether expropriation occurs without proper compensation. For collective action, indicators of trust in government and tax evasion were used.

**Voluntary compliance: Outcome legitimacy and process legitimacy**

1.33 The previous sections established the importance of commitment, cooperation, and coordination for development, but how are these functions related? What leads people to voluntarily cooperate and coordinate? To answer these questions, we turn back to the understanding of the bargaining arena in which actors reach agreements, and the nature of the mechanisms to sustain those agreements. Cooperation and coordination are expressions of what the literature calls *legitimacy*, related to the voluntary acceptance of an act of authority. There are two principal types of legitimacy which matter for the effectiveness of interventions: outcome legitimacy and process legitimacy.

1.34 *Outcome legitimacy* is derived from delivering on commitments—for example, in providing public services, protecting property rights, or respecting term limits in elections. It is related to the degree in which individuals feel that they can trust institutions (see box 1.6 for an extended discussion on the notion of trust). Consider the large gap between support for democracy and satisfaction with democracy in Latin America over the past few decades, as shown in figure 1.4, which shows declining trust in institutions. Panel b shows that satisfaction with public services is highly correlated with the trust in local government and national institutions.



**Box 1.6 Trust in institutions**

Trust is a central aspect of strengthening governance and delivering on development. Trust is related to positive outcomes in terms of economic growth (Knack and Keefer 1997; Zak and Knack 2001; Whitley 2000), as well as government performance (Putnam 1993; La Porta and others 1997). But what exactly is trust, where does it come from, and why does it matter? This Report defines *trust* as the belief that the other party or parties will act as expected, even when it appears to be contrary to their self-interest, thus allowing actors to solve collective action problems. The literature distinguishes between two key kinds of trust: interpersonal trust and institutional trust.

*Interpersonal trust* refers to trust among individuals. It can arise from their relations such as shared ties, or can be present as a social norm. The notions of “bonding social capital” and “bridging social capital” are relevant to interpersonal trust (Putnam 2000). *Bonding social capital*—the horizontal ties within communities and among organizations—can bring about a sense of purpose and identity, encouraging social cohesion. *Bridging social capital* consists of the cross-cutting ties that breach social divides, such as economic class, ethnicity, and religion. If bridging social capital is missing, it can lead to balkanized societies where strong ties within communities actually work against the collective interest, holding back development (Portes and Landholt 1996).

*Institutional trust* refers to society’s trust in organizations, rules, and the mechanisms to enforce them. Institutional trust can arise from elements based on relationships or as a function of repeated commitment. This Report focuses on institutional trust, built by repeatedly delivering on commitments, such as by enforcing contracts or by not defaulting on pledges and obligations. This type of trust is important, as it strengthens outcome legitimacy, and ultimately enables cooperation and coordination by inducing voluntary compliance.

The importance of trust for enabling collective action can be illustrated in the context of game theory. In the traditional prisoner’s dilemma game, even though it would be in the best interest of both prisoners to cooperate—refusing to confess—the inability to trust that the other party will indeed cooperate means that the outcome for purely rational prisoners is to defect, betraying each other (in a one-off game). Game theory predicts that cooperation comes into play in repeated games. Axelrod (1984) finds that the most successful strategies in the basic prisoner’s dilemma game have to do with mutual trust, engendered from paying support with support and defection with defection.

**Table B1.6.1 Sources of trust**

		Types of trust	
		Institutional trust	Interpersonal trust
Sources of trust	Relationships	Relationships	Relationships
	Commitment	Commitment	Norms

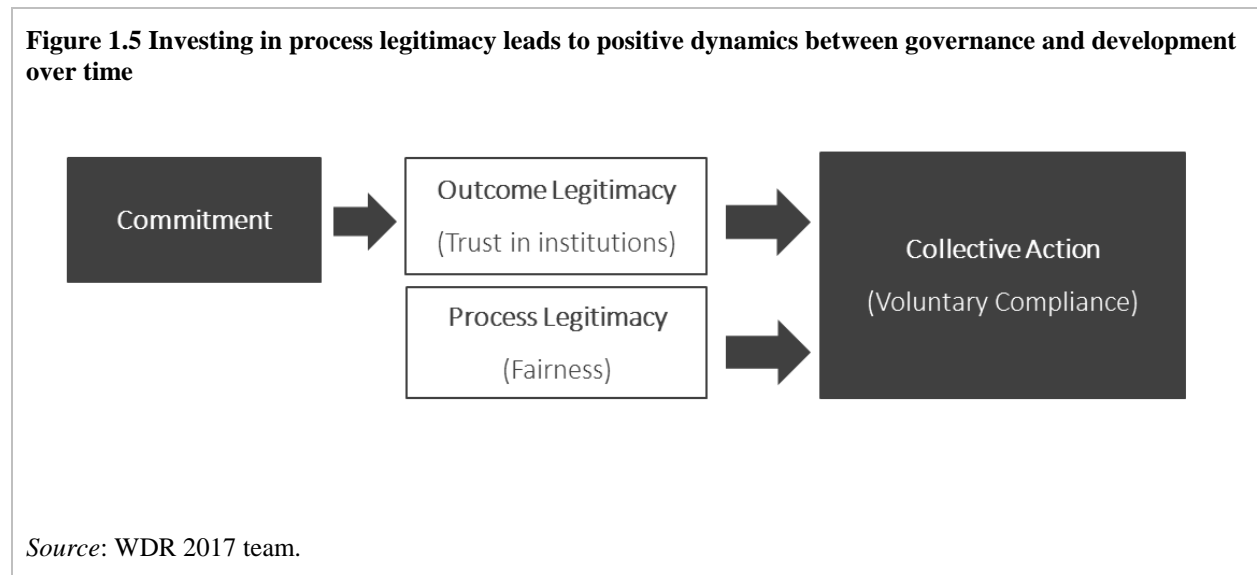
Source: WDR 2017 team, based on Lach and Lopez-Calva 2016. Background paper for WDR 2017.

1.35 *Process legitimacy* is derived from a perception of fairness in the way that decisions, policies, or laws are designed and implemented. It is related to the degree to which individuals feel represented in the policy arena.<sup>4</sup> In Tyler’s classic study, individuals abide in the law primarily not out of fear of punishment (deterrence) but because they believe it to be fair (Tyler 1990). Tyler and Huo (2002) look at the role that being treated fairly plays in individuals’ acceptance of the legal system. Based on a survey of citizens in Los Angeles and Oakland, California who have been in contact with judges, prosecutors, or the police, they find that members of minority groups who perceive that they have been treated unfairly are less likely to trust subsequent decision of law enforcement authorities, and to cooperate. Being treated with respect and dignity, and the belief

<sup>4</sup> The importance of process legitimacy is captured by Levi (1998): “...citizens are willing to go along with a policy they do not prefer as long as it is made according to a process they deem legitimate, and they are less willing to comply with a policy they like if the process was problematic.”

that the process has followed the rules lead to higher compliance with the law, even if the outcomes are not always those that favor individuals.

1.36 Ultimately, legitimacy is a function of both outcome legitimacy *and* process legitimacy. However, while governments cannot always control outcomes directly, they can control processes. Investing in strengthening process legitimacy may induce more voluntarily compliance and enable governments to deliver more effectively. As discussed, delivering on commitments in turn feeds back into building trust in institutions and strengthening outcome legitimacy. Thus investing in process legitimacy is an important foundation of igniting positive dynamics between governance and development over time, as shown in figure 1.5.



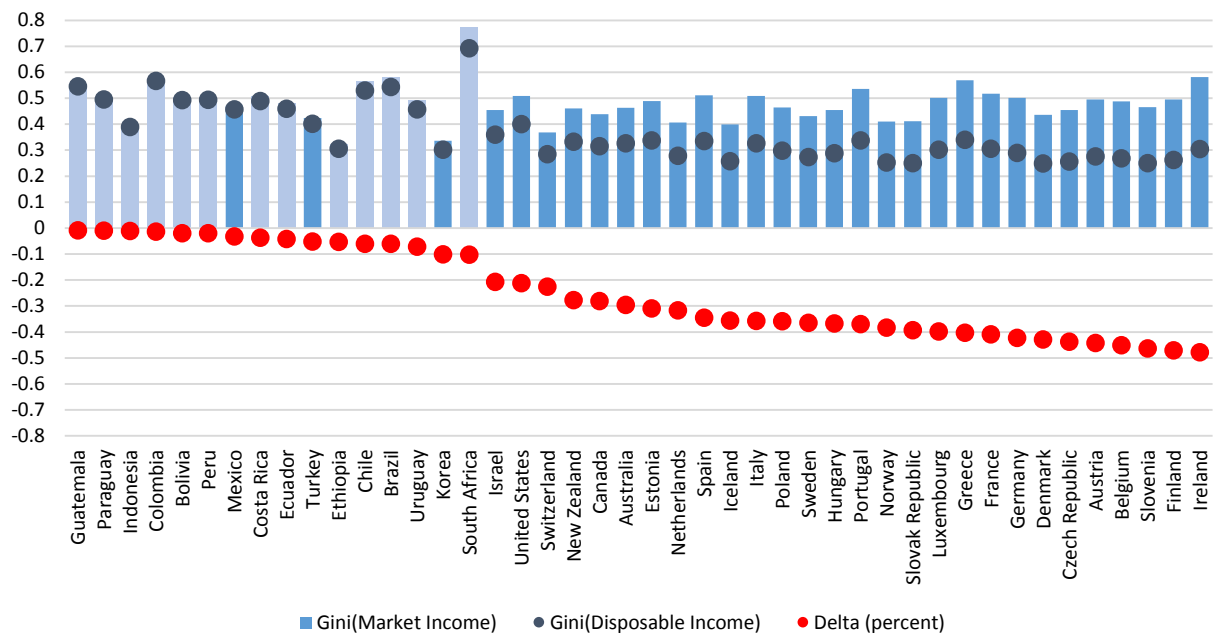
***Governance for the bottom half: Responsiveness and relative bargaining power***

1.37 While strengthening legitimacy is a fundamental building block for enhancing the functional effectiveness of institutions, it requires a deeper understanding of how power relations shape the way that policies are designed and implemented. Policy design and implementation are the outcome of a bargaining process among actors with different degrees of influence. How these different actors reach and sustain agreements is central to understanding how effective the functions will be in delivering on development.

1.38 Think of how countries are more or less effective at redistributing income through the fiscal system. The average measure of inequality (as captured by the Gini coefficient) computed on market incomes is, respectively 0.47 for developed countries and 0.52 for developing countries (shown in figure 1.6). After considering the effect of taxes and transfers, the corresponding coefficients are 0.31 and 0.50. If the effect of publicly provided services (in particular, education and health—not shown in the figure) were also included, inequality would be further reduced to 0.22 in developed countries and to 0.42 in developing countries.<sup>5</sup>

<sup>5</sup> See Aaberge and others 2010; Lustig 2015.



**Figure 1.6 The effectiveness of the fiscal system to reduce inequality varies across income levels**

Source: WDR2017 Team elaboration on Commitment to Equity (CEQ) and OECD data.

Note: CEQ for Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Ethiopia, Guatemala, Indonesia, Paraguay, Peru, South Africa, Uruguay (bars with lighter color); OECD for other countries. Inequality is measured by the Gini coefficient. Delta (percent) stands for the percentage decrease in the Gini coefficient by computing it on market income (pre-tax income) as opposed to disposable income (post-tax income). The definition of income and the unit of analysis are not directly comparable for CEQ and OECD countries. The analysis refers in both sources to the distribution among individuals, while keeping the household as the unit within which income sources are pooled and equally shared. Household incomes are normalized by the square root of the household size for OECD countries, and by the household size for CEQ countries. Disposable income includes imputed components of income, such as imputed rents, only in CEQ countries.

1.39 The measurable redistributive capacity of these countries can be interpreted in different ways. It can be interpreted as the relative ability of actors to influence and contest decisions over the distribution of resources in a given country. It can be interpreted as the incentives of governments to commit to the collection of taxes and allocation of spending; as Besley and Persson (2014) find, more constraints on power are associated with more redistribution. Or it can be interpreted as the preferences for redistribution in a given country. As the following chapter discusses, all three of these elements play a role in determining which policies are selected and how they are implemented.

1.40 This has especially significant implications for households at the bottom of the income distribution and other marginalized groups, as their bargaining power tends to be more limited. Consequently, governance particularly fails to respond to their interests and needs. Chapter 2 will look more closely at the nature of this bargaining process among actors and explore the importance of how the contestability of that process, the incentives of actors, and their preferences influence how governance can be oriented toward designing more pro-development policies and how policy implementation to achieve those goals can be more effective.

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## Spotlight 1 Public-private partnerships

S1.1 In 318 BCE, the ancient Greek city of Eretria signed a contract with a wealthy citizen, Chairephanes, to drain a lake in its territory in an effort to create more useable land for agriculture. According to the contract, Chairephanes was responsible for financing and managing the drainage operation. In return, he was granted the right to use the land for 10 years and exemption from tax duties on the imported materials for the project. The contract foresaw a four-year construction schedule, renegotiable in case of war, and binding heirs in case of the contractor's death. Anyone attempting to rescind the contract was subject to extreme sanctions. The contract was carved in marble and placed on public display (Bresson 2015: 165). Similar contracts may date as far back as the Achaemenid (First Persian) empire (sixth to fourth century BCE), when by royal decree, all individuals who dug a *quanat* (a subterranean gallery used to intercept water sources for irrigation) had the right to retain all profits for up to five generations (Goldsmith 2014: 11).

S1.2 Contracts such as these are examples of what today are referred to as public-private partnerships (PPPs). A public entity contracts the construction and maintenance of public infrastructure to private entities, in exchange for the exclusive rights to profit for a fixed period of time. More specifically, PPPs are defined as “long-term contracts between a private party and a government entity, for providing a public asset or service, in which the private party bears significant risk and management responsibility, and remuneration is linked to performance” (World Bank, ADB, and IDB 2014). PPPs are considered an alternative to both public provision and private provision. Unlike public provision, where a private firm is responsible only for building the infrastructure, under PPPs the concessionaire builds, manages, maintains, and retains control over the assets for the duration of the contract, which can last more than thirty years. Unlike private provision, in PPPs the private firm has only a temporary and partial ownership of the asset. PPPs have been adopted for the provision of different services, mainly infrastructure in network industries such as electricity, telecommunication, water, and transport. PPPs have also been used for delivering other services traditionally connected to public provision, such as health and education, garbage collection, agriculture extension services, and social housing.

S1.3 PPPs were recognized as playing a key role in infrastructure financing at the recent Addis Ababa International Conference on Financing for Development (UN 2015, paragraph 48). While the participation of the private sector in infrastructure projects has grown considerably in the last 25 years in developing countries, especially in the energy sector (figure S1.1), private financing still remains a limited share of aggregate infrastructure investment. In developing countries, it remains less than 25 percent (IMF 2014; World Bank 2014).

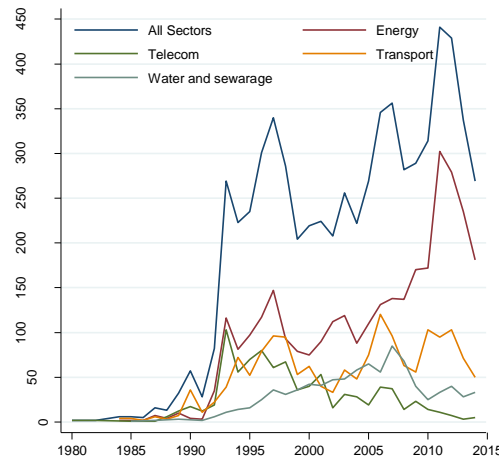
S1.4 The most common argument in favor of PPPs is that they free up resources in budget-constrained governments for other projects.<sup>1</sup> If the country is too poor to collect enough resources domestically, or if the government cannot credibly commit to use revenues for providing public services or to repay investors in the long term, it might be difficult to collect enough funds to finance the initial investment, either in the form of taxes or public debt. Another reason PPPs may be appealing is that they can increase efficiency in providing public services because private firms

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<sup>1</sup> Economic theory also predicts that the present value of all the user fees that the government could have been collecting under public provision of the service equals the initial saving under PPPs. For a formal discussion, see Engel, Fisher, and Galetovic (2014).

obey the rules of financial markets. In contrast to state officials, who obey political considerations, they introduce competition in markets characterized by the features of natural monopolies, and they prevent investment in projects with negative social values because the profitability of the investment depends on the demand for the service.

**Figure S1.1 Private participation in infrastructure projects**



Source: WDR2017 team based on data from World Bank Private Participation in Infrastructure Database.

**S1.5** A key challenge for PPPs to provide public services efficiently is designing them in a way that takes into account the incentives of both the public and private entities, given that PPPs allocate risks between the contracting parties over a long period of time, when circumstances often change. Actors will likely fail to reach an agreement or the PPP may be ineffective if there is no mechanism to allocate the risk in a credible way. Auction bids are based on long-term forecasts of the expected demand for the service. In reality, however, the demand may vary from the forecast. For example, forecasts may fail to accurately take into account the impact of service fees on user demand or the service may become obsolete as technology advances. Similarly, because the government agenda may change with the political cycle and pressures for reelection, private firms may worry that the profitability of their investment could be undermined.

**S1.6** For this reason, many PPPs have not resulted in the expected efficiency gains. For example, without credible commitment to enforce the terms of the agreement, contracts are frequently renegotiated in favor of the private contractor, with considerable outlays for the government often supplied in questionable noncompetitive ways. Renegotiation often occurs as a consequence of an aggressive bid strategy at the time of auction. After having been awarded the contract, the concessionaries can lobby the government to renegotiate the terms, voiding the potential efficiency gains of the auction. For instance, 68 percent of the 1,700 PPP projects financed in Latin America from 1990 to 2013 (and 78 percent in the transport sector) were renegotiated on average one year after the contract award, according to Guash and others (2014).

**S1.7** Taking into account actors' incentives and making sure that the contract's terms are consistent over time may reduce the likelihood of opportunistic behavior, as in the case of renegotiation. However, depending on the circumstances, the form in which this commitment is credibly reached may vary. In the case of the ancient Greek city of Eretria, a contract carved in

marble made it very difficult to renegotiate the terms. The publicity of the contract in a public square also helped bind the contracting parties by increasing scrutiny. This clearly may not be the best solution for PPPs today. The optimal contract may depend on whether or not it is possible to collect user fees, whether or not there is high demand, and whether or not the quality of the service is easily contracted. For example, the commitment device needed to effectively deliver on highway infrastructure may be very different from that needed for health services.

S1.8 Take the case of financing a new highway, where demand is high, user fees can be collected, and quality is easily contactable. However, returns on investment depend on future demand, which cannot be controlled by the concessionary. If the contract is fixed term, the risk is borne by the private contractor, which will internalize the volatility linked to traffic forecasts, and ask for a higher subsidy *ex ante*, or renegotiate the terms of the contract once the bid is won. In turn, the higher state subsidy will blunt the role of PPPs in ruling out bad investments, and renegotiation will undermine the competitive benefits of the auction. In such a context, it would be better for the planner to bear the demand risk.<sup>2</sup>

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<sup>2</sup> For instance, the tender could specify a discount rate and a user fee schedule, and the bids could be made on the present value of revenue. The contract term would then last until the winning contractor collects all the fees demanded in the bid, hence deterring any form of re-negotiation and chances for the government to subsidize with transfers the private firm (see Engel, Fisher, and Galetovic 2014).





## **Chapter 2 Think of power, not only capacity**

### **Why good policies fail and bad policies endure**

2.1 Like many developing countries, Kenya's public education system faces serious issues of teacher performance. A study conducted in 2012 found that approximately 40 percent of teachers were not in the classroom during regular school hours (Bold and others 2016). Based on rigorous evidence on best practices (Duflo and others 2015), the government introduced a new policy in 2009 to allow 18,000 contract teachers to be hired. It was thought that contract teachers, as opposed to civil servant teachers, would have greater incentives to perform well because they were on short-term contracts that—in principle—would be renewed only if performance was satisfactory. Yet experimental evidence from 64 government-run schools showed that learning outcomes did not improve (Bold and others 2015).

2.2 A central explanation for why the policy failed is that that despite the introduction of short-term contracts on the books, there was no credible commitment in practice to sanction underperforming teachers. Once the newly contracted teachers were in place, leaders of the teachers' union successfully mobilized to convert those new teachers into civil servants under permanent contracts, thereby undermining the reform. The children attending those schools and their families—who had little say and found it more difficult to organize and demand better service—were left with the same low-quality education. In the end, the government spent scarce budget resources on a policy that did not improve learning outcomes.

2.3 This example illustrates this Report's definition of governance in action. Policy design and implementation reflects not only the choices made by the policymaker; rather, it is the result of a bargaining process among several actors that often have different degrees of influence, different incentives, and different preferences. The failure of good policies on paper to perform their intended function and the persistence of bad ones is often not the result of policy makers' lack of resources or knowledge. Rather it is the result of actions by powerful actors to block the adoption or undermine the implementation of policies that enhance welfare, for fear that such new policies might reduce their relative power now or in the future.<sup>1</sup>

2.4 Chapter 1 stressed that formal and informal institutions in poor and middle income countries are vital for supporting economic growth, more efficient redistribution, a legal system that works to protect both the rich and the poor and help avoid violent conflict. The way institutions enable commitment and collective action to achieve these outcomes is inseparable from the structures of power within a society. Designing policies to improve security, growth and equity requires understanding this balance of power among different actors. This chapter attempts to improve the way policy makers and the development community thinks about designing

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<sup>1</sup> This is usually referred to as the social conflict view. It emphasizes that policies arise not because they are efficient but because of their distinct distributional consequences (Bardhan 1989; Knight 1993; Acemoglu and Robinson 2006). This chapter builds upon the work of these as well as others scholars, including Buchanan and Tullock 1962; Weingast and Marshall 1988; Dixit 1996; Spiller and Tommasi 2003; Acemoglu 2003; IDB 2005; Stein and others 2007; North, Wallis, and Weingast 2009; Besley and Persson 2011.

interventions to improve development in this context by identifying key entry points for reshaping the policy arena.

### ***Moving beyond best practices and capacity building***

2.5 The development community has largely focused its reform attempts on designing best practice solutions and building state capacity to implement them. In this sense, capacity is often considered a prerequisite for policy effectiveness. While capacity<sup>2</sup> is certainly important at a given point in time and can explain differences in performance across countries (Fukuyama 2014), capacity interacts with—and can be explained by—power (box 2.1). Thus, when thinking about governance and development, it is important to *think of power, not only capacity*.

2.6 *Power* is defined as the ability of one actor to make others behave in alignment with that actor’s interest. It is the “production of intended effects.”<sup>3</sup> Actors can exercise their power by setting the agenda, by vetoing specific options, or by influencing the other actors’ preferences. Agenda-setting power refers to actors’ ability to influence the alternatives over which decisions are made (Person and Tabellini 2000). Veto power, on the other hand, refers to the ability of actors have to block a change from the status quo (Tsebelis 2002). In all cases, it is about restricting the effective choices of other actors.<sup>4</sup>

2.7 In the presence of powerful actors who can block or undermine the policy, optimal policies from a strict economic standpoint (*first-best policies*) may not be the optimal implementable policies (*second-best*, but feasible) as the Kenya example shows. Even when feasible, implementing first-best economic policies can lead to worse outcomes for society because it affects the dynamics of power. For example, in cases where governments are captured by firms and there is high inequality, unions may be the only way for workers to solve their collective action problem, even if representation is not perfect. If so, passing a law that makes labor contracts more flexible undermines unions’ membership and may lead to more inequality, which, in turn, can perpetuate the power of the wealthy (Acemoglu and Robinson 2013).

2.8 The fact that actors will evaluate all policy alternatives based on their expected effect on actors’ political and economic power is what the Report refers to as the *power constraint* to policy effectiveness.<sup>5,6</sup> This chapter zooms in on the policy arena where actors bargain over the design and implementation of policies to unpack three key entry points for overcoming this constraint.

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<sup>2</sup> This includes material (physical and financial) resources and technical ability.

<sup>3</sup> Russell 1938.

<sup>4</sup> Lukes 1986 presents an extensive discussion of the concept of power from different perspectives, summarized in the definition used in this Report.

<sup>5</sup> This can be understood more traditionally as a political incentive-compatibility constraint. This Report, however, emphasizes that such incentives are shaped by the relative ability of actors to influence other actors; thus the use of the term “power.”

<sup>6</sup> While there has been agreement in the academic literature on the importance of power for development for some time, the development community is only now beginning to catch up. For example, the United Kingdom’s Department of International Development (DFID), the Overseas Development Institute (ODI), and the *thinking and working politically* community of practice have pioneered this movement by using this knowledge as an explicit tool that informs their operational activities. This Report attempts to build on this and clarify the mechanisms that make power important and discuss how to design more effective policies in the presence of the power constraint.

For policies to be effective, it really matters: who can participate in the decision making process (the *contestability*<sup>7</sup> of the policy arena); what are the incentives they have to pursue certain goals; and what are their preferences and interests. For instance, in the Kenya example, the reform may have had a greater chance of being effective if the teachers' unions had been given a voice in the design phase. In Chile, a more effective education reform involved both increases in wages and the introduction of incentives for performance for teachers. This reform received the support from all stakeholders, including the teachers' union (Mizala and Schneider 2014).

### **Box 2.1 State capacity is determined by power**

#### ***Case 1: Historical power asymmetries and state capacity today in Peru***

The provinces of Calca and Acomayo in Peru provide an example of how capacity is shaped by power. They are similar in terms of geography and population; both are in the mountains and are inhabited by Quechua-speaking descendant of the Incas. Yet development outcomes are strikingly different. Habitants in Acomayo consume less and have less access to economic opportunities and to health care and education (Acemoglu and Robinson 2012; INEI 2016). While on paper the policies in schools and hospitals are the same, the capacity to actually implement them—given the stock of resources, such as adequate infrastructure—varies considerably, leading to very different outcomes. The question is then what explains these differences in state capacity among otherwise similar provinces in Peru?

The difference in state capacity today is the result of different historical power dynamics in these two provinces introduced by the fact that Acomayo was part of the catchment area of the colonial forced labor system (*mita*) for the nearby Potosí silver mines, while Calca was not (Dell 2010). *Mita*, which means “a turn,” was originally used by the Incas and was revived and adapted by the Spanish Crown. The system required that communities supply one-seventh of their adult male population to work in the silver mines of Potosí and mercury mines of Huancavelica. Communities inside the *mita* were forced to provide this labor, while those outside were exempt. The system was instituted in Peru and Bolivia in 1573 and lasted through the entire colonial period until 1825.

What happened outside the *mita* that helped societies like Calca develop their state capacity? Dell (2010) illustrates the point that elites are not monolithic. While inside the *mita*, the Spanish Crown extracted the country's wealth using forced labor, outside the *mita*, owners of large landholdings wanted to increase their wealth and power by increasing agricultural production. As a result, large landowners (*haciendas*) shielded the population from exploitation, provided conditions for farmers to increase their productivity and lobby the Crown for investments in public goods such as roads. This *critical juncture* allowed Calca to develop institutions that were marginally better for supporting development than those in Acomayo.

This example is another illustration that first best economic policy may backfire in the presence of the power constraint. In this case, inefficient economic policy, such as having large *haciendas*, was crucial to shield farmers from exploitation from the Crown and provide security of property rights.

#### ***Case 2: Statistical capacity is shaped by political will<sup>a</sup>***

For years the development community has invested heavily in developing statistical capacity in Africa. It has done this through economic resources as well as technical expertise. However, the results are disappointing. Lack of good quality data continue to be the rule rather than the exception. Many countries in the region still lack the data to monitor socioeconomic conditions such as poverty, inequality, and service delivery. Many voices are now demanding more money and more capacity building to bridge this gap. However, this view neglects the fact that in order for countries to develop statistical capacity there is a need for political will. Without political will all efforts to build capacity will be in vain.

Countries with low statistical capacity often lack political will to invest in capacity. Many elites in African countries consider high quality data systems as a tool the opposition could use to audit their performance. As a result, they

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<sup>7</sup> In the theory of industrial organization, contestability refers to a market where there are no entry or exit costs. As a result, even if there is a single firm, it cannot earn profits above normal because this would encourage new firms to enter into the market (Baumol, Panzar and Willig 1982). By extension, this Report refers to enhancing the contestability of the policy arena as reducing the barriers of entry to participate.

have incentives to either establish weak statistical offices or partisan ones, staffed with supporters rather than with technical experts. This is, of course, not unique to Africa. In Argentina, for example, after decades of having a statistical office (INDEC) who was the model in the region for production of high quality data, in 2007 president Kirchner decided to replace the technical experts with supporters who first manipulated the data to reduce the poverty estimates and then stopped measuring poverty altogether (Noriega, 2012; Roitberg and others, 2016).

Source: WDR 2017 team.

Note: <sup>a</sup>This case draws on Beegle and others (2016) and Hoogeveen and Nguyen (2016).

## The policy arena

2.9 The Report's framework highlights the dynamic interaction between power and development, and the role that governance plays in mediating this interaction. At its center is the *policy arena*, the space where actors bargain over policy design and implementation. Policy arenas may be more formal, such as the legislature or the cabinet, or informal, such as backrooms, the news media or protests on the street.<sup>8</sup>

2.10 The policy arena is shaped by both de jure and de facto power. De jure power refers to power that it is conferred to the actors by the formal rules. For example, what are the electoral rules, whether there is a presidential or a parliamentary system, whether there is an independent judiciary, or whether the central bank is autonomous are all formal rules that confer de jure power to different actors. De jure power can shift over time as actors form coalitions to change these rules to give de jure power to new actors. For example, voting rights for women in the United States allow them to increase their influence in the policy arena and lead to the adoption of policies to increase health care spending (Miller, 2008).

2.11 De facto power refers to the actual power to influence other actors. Actors' de facto power can come from many sources, including control over resources, control over coercive instruments, societies' shared beliefs (norms), or the capacity to mobilize. De facto power can shift over time as changes in development outcomes feed back into the policy arena by redistributing resources and reshaping ideas and norms. For example, in Bangladesh, a society with a long history of a hierarchical division between men and women, gender roles have changed in the past 30 years as a result of the growth of the export-oriented garment industry, which has increased the de facto power of women (Heath and Mobarak 2015).

### *Policy effectiveness in the presence of power asymmetries*

2.12 Power is always unequally distributed within societies. This Report refers to this unequal distribution of power as *power asymmetries*. Governance is what mediates these power asymmetries. In this context, the effectiveness of policies hinges on the ability of a wide set of actors to reach and sustain agreements. *Agreements* are situations where the actors reach policy compromises that can be *enforced*, meaning that actors can make sure that the other actors will

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<sup>8</sup> Stein and others 2007; and Scartascini and Tommasi 2012a.

fulfill their part of the agreement. However, in the presence of *transaction costs* to reach political agreements,<sup>9</sup> it becomes increasingly difficult to mediate power asymmetries effectively (box 2.2).

**Box 2.2 Transaction costs, incomplete contracts, and political agreements: The reasons why land redistribution policies often fail**

Land distribution schemes have been tried—and have failed—repeatedly around the world. This box attempt to explain the reason. Consider the case of Surekha, a farmer who owns a large plot of land and must decide whether to lease it to smaller farmers or buy the necessary equipment and hire employees to farm the land herself. If economies of scale are not significant and there are no transaction costs,<sup>a</sup> Surekha would be better off dividing the land and leasing it to famers, who would be willing to pay more than if she farms it by herself, as they would be more productive. This is a classic problem in economics. In the absence of transaction costs, the initial allocation of property rights should have no effect upon the efficient operation of an economy (Coase 1960).

However, in the real world, transaction costs abound because institutions do not always allow parties to effectively commit, coordinate, and cooperate. Because transaction costs exist—and because individuals have limited cognitive capacity (bounded rationality)—contracts are always incomplete and will not specify what to do under every potential contingency. When there is room for interpretation—and renegotiation—the nature of the relationship changes because the parties need to cooperate over time to enforce the contract. The process of bargaining, then, never really ends because parties to a contract will be continuously adjusting their actions in response to changing circumstances (Epstein and O’Halloran 1999).

In the presence of high transaction costs, Surekha would rather hire labor and buy her own equipment to farm the land.<sup>b</sup> Owning the land will not only increase Surekha’s control over contingencies but it may also give her special social status or political power to control other transactions (Bardhan 2005). For example, Surekha could threaten her employees, telling them that if they do not accept her conditions, she will influence the village merchants not to trade with them (Basu 1986).

Suppose a local leader in Surekha’s country proposes to redistribute land holdings—including compensating current landowners for the value of the land—to increase overall productivity in the economy. Why has this type of policy failed so often and in so many places? Because in the presence of transaction costs and incomplete contracts, the economic and political value of the land for Surekha is higher than the fair compensation. Surekha’s bargaining power would be reduced if land were redistributed. As a result, she will have an incentive to block or undermine the policy.

Like economic agreements, political agreements are not independent of the distribution of power and are the result of a bargaining process among a wide set of actors. For example, state institutions emerged in history not as a voluntary contract between society members (such as producers willing to pay taxes in exchange for protection from *stationary bandits*), but rather because some groups imposed their coercive power on others (see chapter 4). As a result, institutions and the outcomes of the bargain within those institutions, policies, reflect the power structure in a given society.<sup>c</sup>

Source: WDR 2017 team.

Note: <sup>a</sup>. A world of no transaction costs is one in which there is no costs to specify, monitor, or enforce contracts between the parties (Dixit 1996). In this case, it means that the owner and the renters can foresee all possible contingencies, such as the probability of a drought or a war. It also means that a third party can observe and verify that both parties are honoring the contract and can act to enforce the contract in case of a dispute.

<sup>b</sup>. When transactions cost are high Surekha would rather do the work internally, buying the machines and hiring employees because ownership over the assets gives her more bargaining power over the employee in case of disputes than if she just leases the land (Hart and Moore 1990).

<sup>c</sup>. See Carneiro 1970; Tilly 1985; Boix 2015; De la Sierra 2015. See also Boix 2016, WDR 2017 background paper on state origins and state consolidation.

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<sup>9</sup> The problem of sustaining cooperation in transactions or agreements is known in the economics and political science as transactions costs. The term originated with Coase 1960 and Williamson 1989, and was later expanded to politics by North 1990 and Dixit 1996.

2.13 Reaching and sustaining agreements is difficult because policies are not spot transactions like buying a book or using a taxi; they require cooperation over time. Policies are not just one law or decree, but are often the result of multiple laws and decrees drafted over time by different policy makers. Because the decision-making power of different actors fluctuates constantly, policies may lose coherence and consistency without intertemporal cooperation among actors. Furthermore, shocks such as economic recessions and natural disasters may require policy adaptations. If those actors that take decision over time do not cooperate to produce consistent policies it will be very difficult for societies to achieve sustained progress toward their goals.

2.14 Ultimately, who bargains in the policy arena, their preferences and incentives are crucial to understand whether actors will be able to reach agreements to design and implement welfare-enhancing policies. Depending on the functional challenge, the entry point may be different (table 2.1). The mechanisms and incentives actors have to enforce those agreements are fundamental for enabling credible commitment as this challenge requires consistency in the face of changing circumstances. The barriers of entry to participate in the arena—the contestability of the arena—which determine who is included and who is excluded from the bargain are fundamental for enabling cooperation as this challenge requires voluntary compliance from actors. The different preferences and beliefs of those actors which shape their policy goals are fundamental for enabling coordination as this challenge requires changing actors’ expectations. As these functional challenges are interdependent, these entry points are complementary.

**Table 2.1 Entry points to enhance effectiveness of policies**

Entry points to enhance effectiveness of policies			
Functional challenge	Incentives	Contestability	Preferences
Commitment	•		
Cooperation	•	•	
Coordination	•	•	•

Source: WDR 2017 team.

***Contestability: Who can bargain?***

2.15 The relative bargaining power between groups as well as within groups is key to understand who is included in the decision making process. Actors in society can be classified into three general groups depending on their relative power: those that are directly involved in decision making and formally select and implement laws and policies (*state elites* such as policy makers and bureaucrats); those elites outside of the state that can influence the selection or implementation of policies (*nonstate elites* such as interest groups); and *citizens*, who affect policies through their ability to influence the state or nonstate elites. None of these groups is monolithic; rather, each is a reflection of the ongoing bargains within groups.

2.16 The classification of citizens and elites is not intended to be a strict dichotomy, but rather a spectrum in which different actors have different degrees of influence.<sup>10,11</sup> Often the formal de jure rules that confer power to actors in the policy arena do not always translate into de facto power relations (box 2.3). The relative degree of power of actors to influence policy design or policy implementation may vary by issue. For example, while large export firms in some societies may have power to influence trade policy and thus are an elite in this area, they may not be an elite in the areas of security or health policy.

2.17 The extent to which citizens are able to influence policy will depend on whether they are able to work together to hold elites accountable. For example, when citizens are fragmented, lack information about the consequences of alternative policies, or believe they are powerless against elites, they may fail to act together to hold politicians accountable.<sup>12</sup> Ultimately, those actors marginalized from the policy arena will have fewer incentives to comply with the policy. For example, citizens who believe that they cannot influence government expenditure pay fewer taxes (Torgler 2005).

**Box 2.3 Who is who in the policy arena: The case of Bolivia’s social policy**

The divergence between the formal rules and actual practice of formulating and implementing social policy is clearly illustrated in this example. Officially, ministries are designated as the policy initiators, since ideas and information flow from them to CONAPES (the National Council of Economic and Social Policy), to the Council of Ministers, and to the president (figure B2.3.1, panel a). However, studies of the actual process of social policymaking in Bolivia based on social network analysis reveal a strikingly different picture (panel b). In the actual policy-making network, coordination is vertically exercised by the president, ministries interact very little, and grassroots organizations are key actors in the arena. Ideas and information for policy formulation flow not from the ministries to the Council and the president, but from the grassroots organizations that constitute the electoral bases of the government party to the president, and only then to the ministries and their deputies. In the figure, the size of each circle represents the importance of the actor in the policy-making process.

The policymaking dynamics uncovered by social network analysis reveal two main effects that significantly shape the features of social policies. One is that social policy-making units are technically weak: they are typically staffed not by specialists but by political supporters who are subject to frequent turnover and do not necessarily possess adequate skills. For example, the average tenure of the interviewees in the study was 14 months and 22 percent of them had no prior experience in any social policymaking capacity. The other effect is that the actors do not have incentives to coordinate and cooperate with each other. Rather, they compete to influence policymaking hurting the coherence and coordination of policy design as well as the quality of implementation.

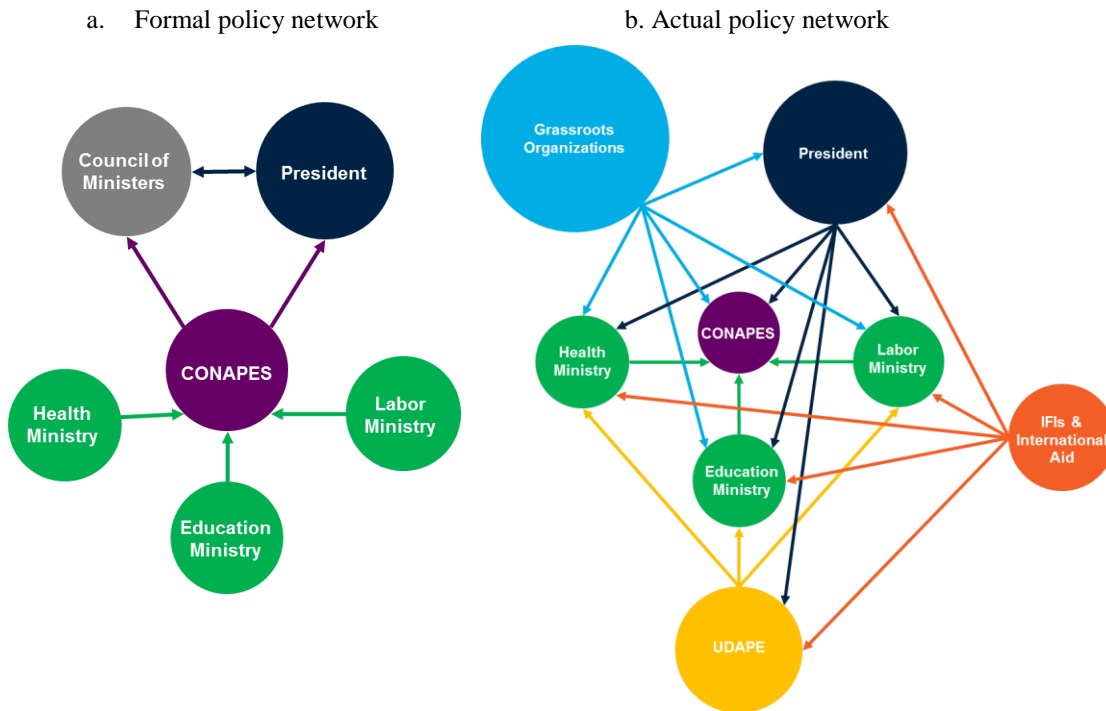
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<sup>10</sup> While the term “elite” is often used in popular writing and in academic literature, it is not often defined. A search of the word “elite” returned 913,000 results in Google Scholar, while a search in the writings rarely finds a clear definition.

<sup>11</sup> As Gould 1987 notes, dichotomies are either “useful or misleading, not true or false” as they “are simplifying models for organizing thought, not ways of the world.”

<sup>12</sup> This is a *civil society failure*, in the language of Devarajan and Kanbur 2005, and Mansuri and Rao 2013.

**Figure B2.3.1 Formal and actual policy networks in Bolivia, 2010**



Source: WDR 2017 team based on Bonvecchi 2016.

Note: CONAPES (National Council for Economic and Social Policy); UDAPE (Analytical Unit for Social and Economic Policies); Grassroots Organizations (CSUTCB, Unified Central Union of Peasant Workers of Bolivia; CONALCAM, National Coordination for Change and MAS, Movement Toward Socialism); IFIs and International Aid: World Bank, Inter-American Development Bank, UNICEF; Cooperation agencies from several industrialized countries.

Source: WDR 2017 team based on Bonvecchi and others 2015. See also Bonvecchi 2016, background paper prepared for the WDR 2017.

### ***What are their preferences?***

2.18 Actors in the policy arena do not always seek to promote the common good. Policy makers and bureaucrats are not necessarily benevolent public servants who reliably carry out the “will of the people.” Elites are not necessarily opposed to promoting the welfare of others. Nor are citizens necessarily a unified group which supports the welfare of all. They act as people do in all other spheres of life: understanding their motivations matters to anticipate their conduct.<sup>13</sup>

2.19 Societies’ shared beliefs, ideas, and norms shape their policy preferences. For example, even in societies with similar configurations of relative power, policies may vary as a result of diverse preferences. Arguably the difference in redistributive policies in Europe and United States are not due to differences in actors’ relative power but rather in actors’ beliefs. While in the United States people believe individual effort is mostly responsible for determining income and market outcomes are relatively fair, in Europe people believe luck and connections play a larger role and

<sup>13</sup> In the literature of public choice tradition this has been described as “politics without romance”. See Buchanan and Tullock 1962; and Muller 2003.



the state should correct market outcomes using redistributive policy (Alesina and Angeletos, 2005). Norms not only shape policy preferences but also shape day to day interactions among society members. As a result, norms can reinforce power asymmetries in society. Box 2.4 describes the case of an intervention in a small-scale fishery in Ghana which was intended to improve women's livelihoods but actually lead to worse outcomes for women by not taking into account entrenched gender norms.

**Box 2.4 Norms reinforce power asymmetries**

A salient example of how norms reinforce existing power asymmetries—and can constrain the effectiveness of interventions—comes from Ghana's small-scale fisheries. Men, (often referred to as *Fish Papas*) and women (often referred to as *Fish Mamas*) have historically had different roles in fishing. Because women are forbidden from fishing at sea—a norm that has been in place for over 200 years and is respected to this day—men fish while women smoke, dry, and cook the fish for sale. *Fish Mamas* buy the fish directly from the men and exercise control over the local market by setting prices and selling the day's catch.

A well-intentioned project by the government of Ghana supported by the World Bank attempted to improve women's livelihoods by making the harvesting and processing of fish more sanitary and efficient. In particular, they built a facility where all fish can be processed and sold. However, by pooling together the catch in one place and making it easier to process the fish, the project undermined the *Fish Mamas'* power to set the price because it made it easier for men to do both the fishing and selling of the catch.

As a result, men began selling the fish themselves and thus reducing women's engagement in fisheries management. This project, which aimed at improving women's role in the value chain, ended up undermining their livelihood.

*Source:* WDR 2017 team based on Bezeredi (2016).

2.20 Actors' self-interest is also reflected in their policy preferences. For example, if a powerful interest group derives its power from being the most productive firm, it will advocate for policies that allow it to continue to be productive and reach new markets. On the other hand, if those groups with power have coercive power to cause economic and social disruption and are in the least productive sector of the economy, they will advocate for policies to protect their economic power and will block competition. When the polarization of preferences among powerful groups grows, the costs of losing power becomes higher, raising the likelihood of violence and instability.

***What mechanisms and incentives do actors have to reach and sustain agreements?***

2.21 The mechanisms and incentives actors have to reach and sustain agreements are crucial to predict whether the policy arena will produce welfare enhancing policies or not. It will be more difficult to reach lasting agreements in contexts where societies are very heterogeneous; the relative bargaining power of actors shifts often causing a high turnover of actors entering and exiting the policy arena; and the short-term benefits of renegeing on promises are high compared to the benefits of maintaining a reputation for honoring the agreements. Box 2.5 describes factors that make sustaining cooperation more likely.<sup>14</sup>

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<sup>14</sup> See Ivaldi and others 2003; and Spiller and Tommasi (2003, 2007).

### **Box 2.5 Factors that make sustaining cooperation over time more likely**

*Stability of actors' bargaining power.* When the actors that interact in the policy arena change frequently, it is more difficult to sustain cooperation. The reason is twofold: actors will be less able to *punish* those that deviate from the agreement; and building a reputation for honoring agreements becomes less valuable when the interactions with the same actors are not frequent.

*Low probability of shocks.* In cases where there is a high frequency of shocks that requires continued policy adaptations, cooperation will be harder to reach. For example, it is easier to sustain cooperation on regulating a commodities market than a technology market. The rapid innovation in the technology market requires regulation to constantly adapt to obtain the desired objective. Moreover, shocks may create losers and winners, thereby creating competing and shifting interests that make intertemporal cooperation more difficult to sustain.

*Transparency.* Inability to observe or verify whether actors have honored or will honor the agreement make cooperation more difficult to sustain (Stigler 1964; Green and Porter 1984). For example, in the case of agreements between voters and politicians, if citizens cannot observe politicians' efforts and must rely on outcomes to infer their actions, cooperation will be more difficult to sustain.

*Actors' certainty about the distributional effect of policies.* When there is uncertainty about the distributional effects of policy, it is more difficult to sustain cooperation. It is more difficult to know who the winners and losers of the policy are; as a result, actors cannot establish a compensation mechanism (Fernandez and Rodrik 1991).

*Actors' structural links.* Bargaining for many different policy issues allows actors to have repeated interactions, which facilitate cooperation in two ways: first, by increasing the likelihood that there will be some overlapping interest over a set of policies; and second, by reducing the cost of punishment because actors can use bargains over different policies to punish those that deviate in any one of the agreements.

*Enforcement technologies.* Some policy issues have multiple enforcement technologies; this allows actors to choose the one they trust the most and increase the set of issues over which they can cooperate. The recent experience in Guatemala shows that importing a court, the International Commission Against Impunity in Guatemala (CICIG), can be a way to increase commitment to enforce the rules, and as a result, increase cooperation of potential witnesses, at least in the short term (see chapter 1).

Source: WDR 2017 team.

2.22 For example, societies that are homogenous in terms of material conditions and social status can use personal relations to enforce agreements. *Relation-based* or *deal-based mechanisms* can take a range of forms, from gossip and stigmatization to informal threats, physical injury, and even execution (Boix 2015). When the size of the community and its heterogeneity increases, it becomes more difficult to use relation-based mechanisms to enforce agreements and hold actors accountable. Thus as social distance increases, there is a need to move toward *rule-based mechanisms* such as courts, legislatures, and political parties to enforce agreements. Therefore, while relation-based mechanisms may function well for smaller and more homogenous groups, rule-based mechanisms may be necessary to facilitating cooperation in larger and more heterogeneous groups. (Li 1999; Dixit 2003, 2004).

2.23 However, rule-based mechanisms may differ in their capacity to absorb and process conflict, which may lead actors to use more deal-based mechanisms to influence decision making (Scartascini and Tommasi 2012a). For example, while in Costa Rica disagreements on policies are disciplined by political parties and processed through formal political institutions, in Argentina, disagreements on policies finds thousands of people on the street, burning tires and blocking roads (Przeworski 2010).

2.24 Countries with ongoing violent conflict where groups fight for control over territory, such as in South Sudan, present a compelling illustration of why power gets in the way of using rule-

based mechanisms to sustain mutually beneficial agreements. The outlook for the groups involved in such violent conflict is not rosy: at best, a costly victory, only to inherit a shattered economy. An agreement to put a stop to such violent conflict, encourage productive investment and share its benefits in proportion to the power each group currently holds is mutually desirable. But why are such agreement rarely seen? The reason, as explained below, is a commitment problem that is known as the *political hold-up problem*.

2.25 Suppose the groups that have the power to commit violence and are in control of different territories were to allow those with business skills (but no power) to make efficient investments in their territories, in exchange for a “fee”. Such an agreement could maximize the size of the benefits while redistributing them in proportion to the strength of these violent groups. But for this policy to be credible to potential investors, the violent groups need to give up power and establish, among other things, a system of impartial courts. Such a rules-based mechanism of investment and redistribution would unavoidably transfer some power to investors. There is no guarantee that the investors will abide with the agreement to pay fees once they have gained power relative to the violent groups. Anticipating this, the groups with power will decide not to pursue this policy in the first place<sup>15</sup>

2.26 It is more likely that such violence will be tempered by economically inefficient, unstable *deals* between violent groups.<sup>16</sup> These deals provide a way for these violent groups to divide power, i.e. granting monopoly power over natural resources extraction for some and monopoly power over telecommunication for others, while at the same time supplying the “glue” that provides the necessary enforcement mechanism to sustain cooperation and avoid violent conflict. Because these unproductive rents are reduced if violence erupts, it offers the incentives for groups to cooperate in making sure violence does not break out. Box 2.6 provide the cases of Ghana in 1971 and Sierra Leone in 1979 to illustrate the general point that inefficient policies may be the best possible solution in a world of power constraints.

2.27 How can societies pursue policies to reduce economic inefficiency and corruption given that they are, as explained above, a built-in feature of governance interactions? How can societies transition from deals to rules? Spotlight 2 argues that societies have only managed to do it when political will was aligned with this goal and not just as a consequence of passing anticorruption legislation.

**Box 2.6 In the presence of power constraints implementing first best economic policy can backfire**

In the case of Ghana, Kofi Busia, prime minister of in 1971, used price controls and an overvalued exchange rate to distribute rents to powerful groups in society and reduce the potential of violence. The economic advice was to stop price controls and devalue its currency by 44 percent. Once this policy was enacted, riots and discontent took the streets by storm. Two weeks later, Busia was overthrown by a military coup that reversed all his policies (Acemoglu and Robinson 2013).

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<sup>15</sup> Klein, Crawford, and Alchian 1978 note that the level of specific investments in a contractual relationship depends upon the expectation of obtaining a fair rate of return on that investment. In this case, the investment refers to the fact that violent groups will need to give up power to pursue growth enhancing policies. However, once they give up power they fear not obtaining a fair return on their investment. Dixit 1996 extended the reasoning to political transactions.

<sup>16</sup> (North, Wallis, and Weingast 2009; North and others 2013). In the context of this Report, rents refer to earnings that arise not as normal return to a factor of production, but rather are artificially created by market distortions potentially driven by influencing the political environment

Something similar happened in Sierra Leone. In 1979, the country had many economic problems: a large fiscal deficit, overvalued exchange rate, poor infrastructure and low productivity. Again, the economic advice was to put an end to economic distortions. However, it did not take into account the political scenario. Without those resources, the president of Sierra Leone at the time, Momoh, was forced to change strategies from buying support to using violence to coerce the opposition (Acemoglu and Robinson 2013).

In both these cases power asymmetries are crucial to understand the persistence of inefficient institutions as well as individual policies. Many policies that would increase the size of the economic or social “pie” will not be adopted if they increase the probability of reducing the political or economic power of those in power.<sup>17</sup> In other words, the political hold-up problem prevents agreements to make the transition to better policies.

Source: WDR 2017 team.

### ***Coalitions: Configuration of agreements in the policy arena***

2.28 There are two types of agreements in the policy arena that are important to differentiate: *vertical agreements* (between citizens and elites), and *horizontal agreements* (within elites and within citizens).<sup>18</sup>

2.29 In *vertical agreements*, citizens indirectly influence policy makers and bureaucrats. They do this through formal mechanisms (such as voting and political parties) or through informal mechanisms (such as social movements to express their views on a policy issue). In both cases, to be effective citizens need to generate horizontal agreements among themselves that will enable them to cooperate to influence policy makers.

2.30 In *elite horizontal agreements*, interest groups influence policy makers and bureaucrats to tilt the design and implementation of policies in their favor. For example, politically connected firms may exchange campaign contributions for fewer regulations in their industry. Taken together, horizontal and vertical agreements help determine whether policies will be effective in changing individuals’ behavior and in turn will have the desired impact on development outcomes.

2.31 Figure 2.1 presents a visual representation of four stylized cases of actors’ coalitions in the policy arena. The colored figures represent different actors, the distance from the center illustrates their relative power, and the oval outlines represent agreements among the actors grouped inside of them. Policy arenas and agreements are issue specific. For example, the policy arena and the agreements for defense policy may not be the same as those for health or infrastructure policy because who can bargain, their preferences, and what are the mechanisms and incentives actors have to reach and sustain agreements are different. Note that in all cases presented in which agreements are reached, state elites (represented by the yellow figures) play a role because they hold decision-making power; however, their decision is never isolated from the influence of others.

2.32 In the first case, some citizens are able to work together (horizontal citizen agreement) to effectively hold politicians accountable (vertical agreement). At the same time, those politicians are able to work together with other politicians, bureaucrats, and interest groups (horizontal elite agreement) that have agenda-setting or veto power to propose a policy that is supported by all of

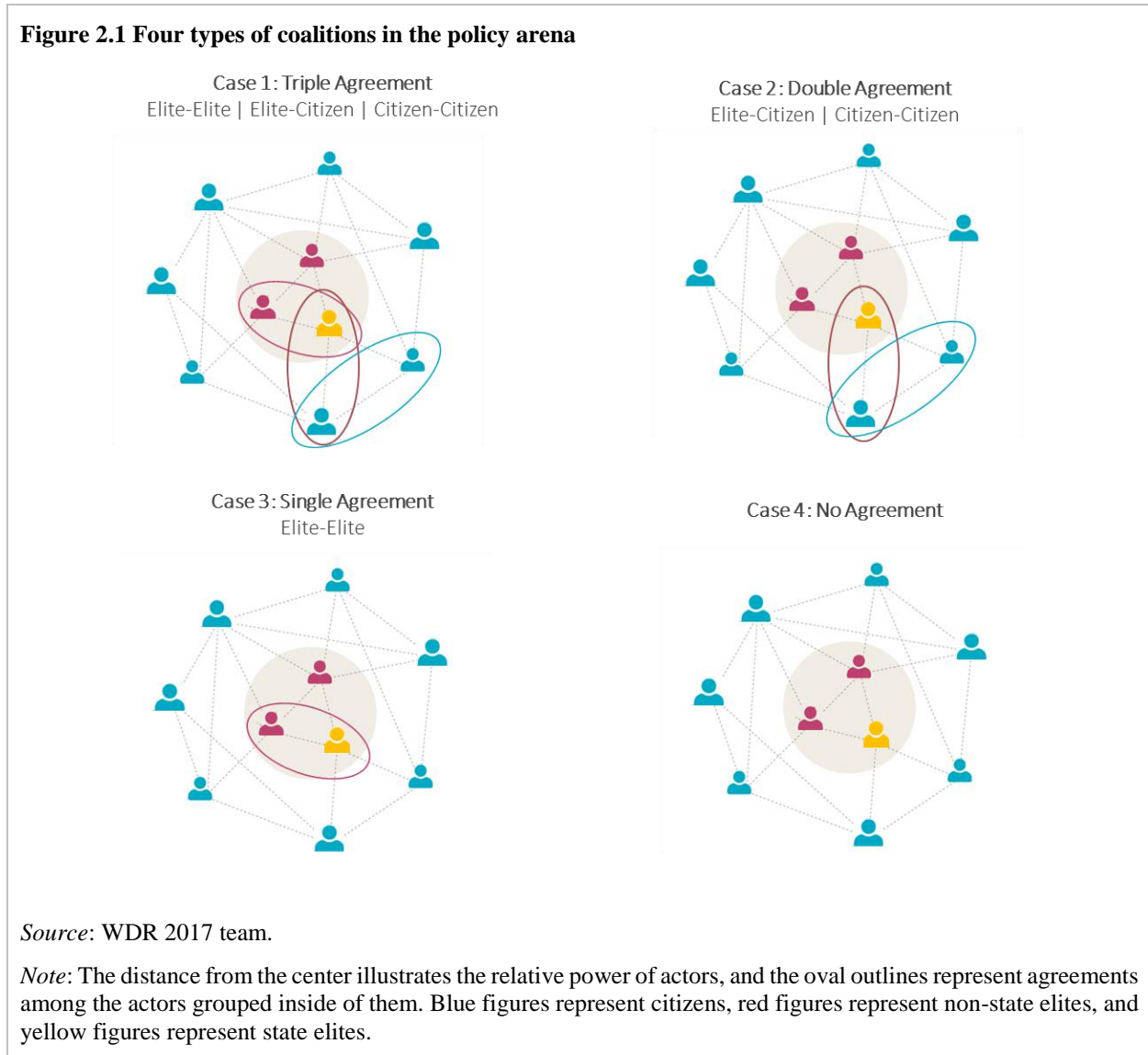
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<sup>17</sup> Those in power will evaluate all policy alternatives based on their probability of reducing their political power in the future. In particular, they will be interested in relative rather than absolute gains in these exchanges (Bardhan 2005).

<sup>18</sup> Note that the literature often refers to this as vertical and horizontal accountability.

the parties to the agreement. This means that the actual policy that gets implemented is a compromise that reflects the preferences of the citizens, politicians, bureaucrats, and interest groups that were part of the agreement. Because all of the powerful actors that can undermine the policy are included, the policy has a greater chance of being effective.

**Figure 2.1 Four types of coalitions in the policy arena**



2.33 In the second case, some citizens are able to hold politicians accountable, but politicians, bureaucrats and interest groups are not able to reach an agreement on a policy compromise. As a result, the selected policy and the implemented policy may differ because interest groups and politicians that are not part of the agreement will potentially undermine the policy. For example, while in the United States opinion polls show that both a majority of citizens and the sitting president would like more restrictions on gun ownership, the National Rifle Association (NRA) has been able to block nearly all policies in this issue.

2.34 In the third case, some politicians, bureaucrats, and interest groups strike a policy compromise. In this case, citizens are not able to influence policy. There are many reasons why

this can happen. For example, elites may prevent citizens from organizing and solving their collective action problem by limiting civil liberties, such as freedom of assembly or freedom of expression. Even in cases where those civil liberties exist, political market imperfections such as politicians' inability to make credible commitments and citizens' inability to solve their collective action problems to punish or reward politicians can result in citizens being unable to influence policy. Elites in this policy arena can choose to ignore citizens' preferences when designing and implementing policies. However, when citizens or some elite groups are not part of the agreement, they may decide not to comply with the policies if they believe the policies are not legitimate. Even if there is no participation in the decision-making process (*process legitimacy*), elites can choose policies that provide benefits for the people outside the elite group in power, such as providing high quality service delivery in health and education (*outcome legitimacy*), which increase voluntary compliance and thus policy effectiveness.

2.35 In the final case, no agreement is feasible among any actor in the policy arena. In these cases, actors use informal mechanisms to sustain short-term transactions among themselves, but are unable to achieve long-lasting agreements. Policies will not be consistent or coherent over time, but rather will reflect which group has more power at a given point in time, deeply undermining the institutional function of commitment. The switch to privatization, and the subsequent switch to nationalization of social security in Argentina is a case in point. Those that supported privatization paid off the opposition at the time to get the policy through congress. Once new elites got into power, they repealed the policy. Citizens anticipated the high probability of a change in the rules of the game. As a result, privatization did not incentivize them to contribute to their retirement fund beyond the bare minimum. The reason for this low contribution was citizens' perceptions that those retirement accounts had a high risk of being expropriated by the government, as it ended up being the case in 2008 (Scartascini and Tommasi, 2012b).

### **Reshaping the policy arena: Building coalitions for change**

2.36 Most challenging problems developing societies face today cannot be successfully addressed without understanding the deeper determinants related to power asymmetries. More often than not, the development community and well-intentioned policy makers rely on best practices to reform policies. However, these policies often fail. In order to design more effective policies, it is important to understand what agreements are feasible in the policy arena and how the policy arena can be reshaped to expand the set of policies which can be implemented.

#### ***How change happens***

2.37 The process of development is uneven and constantly reallocates resources, conferring new de facto power to actors and shifting norms over time.<sup>19</sup> These process include external (exogenous) shocks (such as a regional or worldwide financial crisis), and internal (endogenous) structural changes (such as a demographic shifts) or norms-based changes (such as changes in gender roles). This in turn affects the ability of different groups of citizens and elites to solve their collective action problems and influence the policy arena. These triggers provide opportunities for actors to change the system, as they alter the distribution of power.

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<sup>19</sup> Hirschman 1958; Streeten 1959; Ray 2010.

2.38 The feedback process from development to governance have been widely acknowledged by the literature, but academics and practitioners are still debating their implications for policy reform. Can societies improve security, growth, and equity despite having an initial power asymmetry among actors?

2.39 This Report argues that relaxing the power constraint and changing the policy arena is difficult because those currently in power have incentives not to introduce reforms that would limit their power. Moreover, even dramatic shifts in who has power in the policy arena may not be enough, if the new elites, once in power, have incentives to use the same mechanisms to extract rents from society used by the previous elites (Acemoglu and Robinson, 2008). However, despite the difficulties, history has shown that change can happen; many societies where power at a point in time was in the hands of a few have managed to develop into more open, more prosperous, and more secure societies (Deaton 2013; Boix 2015).

2.40 Political pressure for reform can come from the top down (elite bargains) or from the bottom up (citizen engagement). While in many cases, *elite bargains* may lead to worse outcomes for society, in other cases elites may impose constraints on their own power (tie their own hands, as discussed in chapter 1) to be able to credibly cooperate with other elite groups to stay in power.<sup>20</sup> For example, divisions within elites in Britain was key for the enactment of voting rights which restricted the power of the elite. The reason for this was that one faction supported the enfranchisement to move the other faction away from their reliance on patronage and special interest group politics which only benefited the latter (Lizzeri and Persico, 2004).

2.41 Top down reforms can also be the result of elites' strategies to reduce the cost from losing power (*political insurance*). For example as new actors enter into the policy arena and the elite face more credible competition for power, they may choose to enact reforms such as transparency and accountability measures that restrict not only their power, but also that of their potential successor. This was the case in Mexico, where as political competition increased, states were more likely to pass Right to Information legislation. Chapter 7 discusses the reasons why elites will choose to restrict their own power and the mechanisms they use at greater length.

2.42 Through *citizen engagement*, individuals can solve their collective action problems and put pressure on elites to reform either through voting (box 2.7), through organizations (political parties, civil society organizations, social movements), or through other deliberative public spaces. For example, in India, elites were not the drivers of change behind the Right to Information legislation as in Mexico. Rather it originated from a rural-based social movement of workers in Rajasthan that demanded access to information on their attendance records. Because employers paid workers less than the actual number of days worked, the workers sought access to the records to be able to sue their employers. The movement built alliances with journalists, lawyers, and human rights activists and spread nationwide eventually succeeding in pressuring policy makers to adopt the Right to Information Act in 2005 (Bari, Chand, and Singh 2015). Chapter 8 explores citizen engagement strategies at greater length.

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<sup>20</sup> Bueno de Mesquita and others 2003; North, Wallis, and Weingast 2009; Svobik 2012.

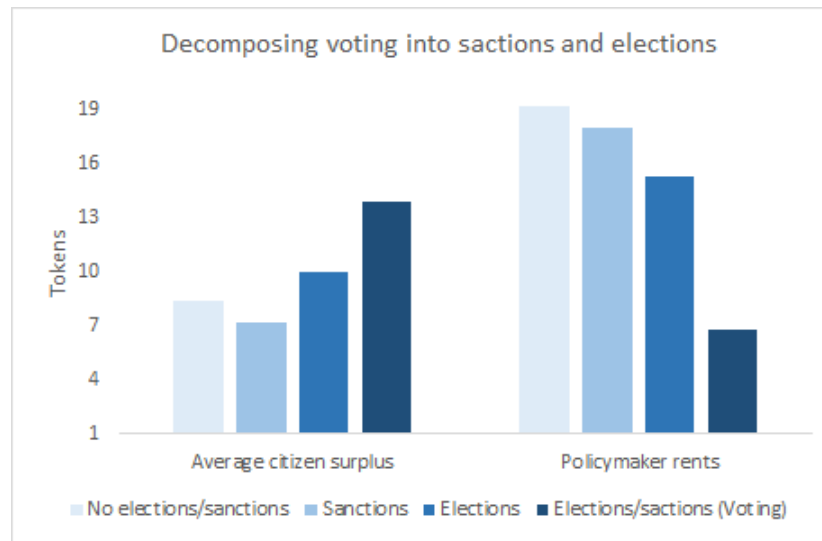
**Box 2.7 When does voting work?**

How can societies adapt in a way that moves them on a more sustainable path toward development? Political philosopher David Hume’s classic statement about the “easiness with which the many are governed by the few” encapsulates the dynamic that sustains commitment and voluntary compliance in the context of delegated power. In the language of this Report, the “many” can be understood as citizens, and “the few” can be understood as elites. What makes the “few” willing to incorporate the interests and needs of the “many,” or willing to pass laws that would restrict their own power?

This box focuses on the relative merits of different tools citizens can use to make elites accountable. To measure this, the WDR 2017 team used a laboratory game where three individuals (the citizens) decide how much to contribute to a group account where resources are doubled, and one randomly selected individual (the policymaker) decides how to allocate the resources among all players. Then, the WDR 2017 team compared the citizens’ surplus—the difference between initial and final earnings—and policy maker’s rents in four scenarios. First, citizens cannot elect or sanction the policymaker. Second, citizens need to use their own resources and coordinate to sanction the policymaker. Third, there are elections, but citizens are not pivotal and cannot affect the outcome. Fourth, there are elections and citizens are pivotal. Thus, if they coordinate, they can remove policy makers from office.

Figure B2.7.1 presents the results for citizen surplus and policy maker rents, as measured by tokens. The results show that sanctions or elections alone do not improve citizens’ surplus or reduce policy makers’ rents substantially over the baseline case where neither election nor sanction are present. However, when both instruments are present at the same time, citizens’ surplus is significantly higher and policymaker rents go down to less than half the other cases.

**Figure B2.7.1 Voting improves citizens’ surplus and reduce policymaker rents**



Source: WDR 2017 team based on a laboratory game designed for this report. See appendix b for more information.

2.43 Citizens and elites are also influenced by international factors, which can play a role in influencing the local bargaining dynamics. While external actors cannot engineer domestic development, they can play a role in strengthening or weakening the relative power of different actors. In particular, the flow of private and public capital (through foreign direct investment and aid) and ideas (such as human rights, environmental protection, or the Sustainable Development Goals) can have a powerful influence on the domestic policy arena. Chapter 9 explores the potential positive and negative impacts of these flows of capital and ideas.



2.44 This Report emphasizes that these bottom-up and top-down pressures can overcome the power constraint by changing the policy arena by lowering the barriers of entry for new actors to bargain; reshaping actors’ preferences; and changing actors’ mechanisms and incentives to reach and sustain agreements. For example, consider how the enfranchisement of previously illiterate voters in Brazil—through the introduction of electronic ballots—reducing the entry barriers for their participation, and ultimately affected spending in healthcare (box 2.8).

**Box 2.8 Reshaping the policy arena: The introduction of electronic voting in Brazil**

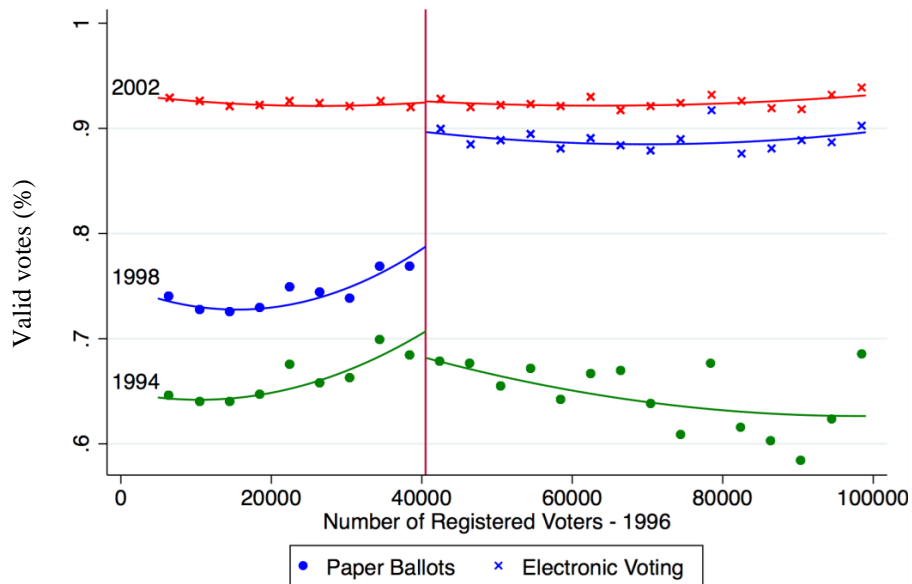
In developed countries, filling in a ballot is a trivial task; one reason is the level of education of the average citizen. The same might not be true of many illiterate or poorly educated citizens in rural and other areas in the developing world. This was the case for Brazil, which until the mid-1990s used a complex paper ballot. Given the country’s electoral rules, it is common for hundreds of candidates to run for state legislatures, making it impossible to list candidates in paper ballots. Voters were thus asked to write the name (or number) of the candidate on the ballot.

**Figure B2.8.1 An electronic ballot made it much easier for those with little or no education to cast their vote than the paper ballot**



Source: Fujiwara 2015.

At the time, roughly one-quarter of Brazilians were not functionally literate. These complex paper ballots led to the de facto disenfranchisement of a large fraction of voters. It was common for more than a quarter of the votes to be deemed invalid and not counted. However, that changed by the late 1990s with the introduction of electronic voting devices. Their simple interface allowed voters to select the number of their candidate, and a picture of the candidate appeared on the screen before the voters validated their vote. This simplification of the voting procedures greatly reduced the number of invalid votes effectively enfranchised more than 10 percent of the Brazilian electorate, whose votes previously had not been counted.

**Figure B2.8.2 Electronic voting reduces the number of invalid votes**

Source: Fujiwara (2015).

Figure B2.8.2 shows the effect of electronic voting on valid votes. The analysis exploits the fact that in 1994, all Brazilian municipalities used paper ballots. In 1998, municipalities with more than 40,500 voters used electronic voting, while smaller towns used paper ballots. By the 2002 election, electronic voting was the sole method of voting in Brazil.

For example, compare the towns of Altamira and Paracatu, which were otherwise similar. Because Altamira had 40,461 registered voters, 39 less than the threshold of 40,500 for electronic voting, the municipality used paper ballots for the 1998 election, while Paracatu, with 40,917 registered voters, used electronic voting. This led to a significant difference in valid votes, from 79 percent in Altamira to 90 percent of Paracatu's registered voters. Multiplied across many towns in Brazil this de facto enfranchisement of millions of previously excluded voters had substantial consequences on policymaking and development outcomes.

This newly enfranchised voters chose more progressive legislators for the state assemblies, which then increased spending in public health care by 34 percent from 1998 to 2006. In Brazil, public health care is largely a pro-poor policy, given that better-off citizens rely on private health services. This additional spending then increased access to prenatal health care, and had an impact on health outcomes. Fujiwara (2015) estimates that electronic voting was responsible for lowering the prevalence of low-birth weights (a common measure of infant health) among mothers without primary schooling by 6.8 percent.

Source: WDR 2017 team based on Fujiwara 2016.

### Taking power seriously in policy design

2.45 This chapter has emphasized that the development community has largely focused its reform efforts on attempting to implement first-best economic policies (often called best practices) and on building capacity to design and implement these best practices. However, this ignores the fact that actors who can block or undermine the policy will evaluate policy alternatives not on their technical merits to improve development but on the probability that these policies will reduce their political or economic power today or in the future. In order to improve policy effectiveness and expand the set of possible implementable policies, there is a need to reshape policy arena in a way such that powerful actors do not have incentives to block or undermine policies, more actors are

able to participate in the arena, or new preferences can influence the agenda. To achieve these changes, citizens, elites and international actors will need to overcome collective action challenges and create coalitions for reform.

2.46 Chapter 3 will explore the different roles that law and legal institutions play in this process: specifically, by in converting policies into outcomes (ordering behavior), establishing authority among all relevant actors in the policymaking arena (ordering power) and shifting preexisting dynamics of power to arrive at new outcomes (ordering contestation).

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## **Spotlight 2 Corruption**

S2.1 Corruption is often defined as the use of public office for private gain. In the WDR 2017 framework, corruption is a deals-based way to sustain agreements among certain individuals or groups. While in the short term corruption may be able to “grease the wheels of the economy,” in the long term it negatively affects growth by diverting resources from more productive uses and negatively affects equity by disproportionately benefiting those in power. Moreover, it undermines legitimacy because it affects public perceptions of the fairness of the decision-making process (Ackerman 2016).

S2.2 The first generation of high-income OECD states has achieved a high control of corruption through development processes and institutional forms that many other countries around the world have since tried to replicate without achieving the desired results. This has led to many reform efforts including designing better recruitment and compensation schemes in public agencies, instituting anti-corruption commissions, and developing monitoring mechanisms such as websites like [www.ipaidabribe.com](http://www.ipaidabribe.com).

S2.3 However, success of these strategies across and within countries has been mixed. From the perspective of this Report, replicating these forms may be ineffective if approaches do not also tackle the underlying reasons why they are not performing their intended function: credible commitment of those in power not to abuse that power for private gain. These underlying reasons are related to systemic features in the policy arena such as entrenched power structures or social norms. Consequently, corruption is less about individual transactions and more about networks of actors. Thus changes in formal rules and anti-corruption strategies are only likely to be effectively enforced when they set the right incentives for powerful actors in a country.

### **Corruption and social order**

S2.4 The first step in rethinking corruption is to recognize that corruption is not a social “malady” or “disease” to be eradicated, but rather a built-in feature of governance interactions. All societies started from being “owned” by a few individuals who control all resources. Through long historical processes, some countries have managed to reach a stage where the state provides members of society with equal opportunities for representation and shares public resources more equitably (Fukuyama 2011). Countries today are on a continuum of governance between a system in which rules are applied by virtue of personal status, and one in which they are applied impersonally. Unfortunately, presuming that a particularistic system is the exception and an impersonal system is the norm is not historically accurate. In fact, the public-private separation in public affairs and the complete autonomy of state from private interests are relatively recent. Moreover, social norms can reinforce these existing dynamics. For example, entrenched corruption may lead to a higher tolerance for corrupt behavior. In this sense corruption can become an equilibrium, as corrupt systems make it very costly for individuals to behave honestly.

### **Is corruption inescapable?**

S2.5 The role for collective action and broad reform coalitions is paramount for escaping corruption. If the demand for control of corruption is poor because spoils are used efficiently to buy off certain strategic groups, then collective action becomes impossible to achieve and the

equilibrium remains with particularism as the norm. Development plays an important role in this context, as growth and equity outcomes can generate different socioeconomic classes and strengthen coalitions that demand better governance. For example, larger middle classes have historically played an important role in pressuring governments to deliver better public services, such as education and health care. Moreover, in more developed countries, many elites have an interest in the enforcement of the formal rules required to conduct complex business and transactions.

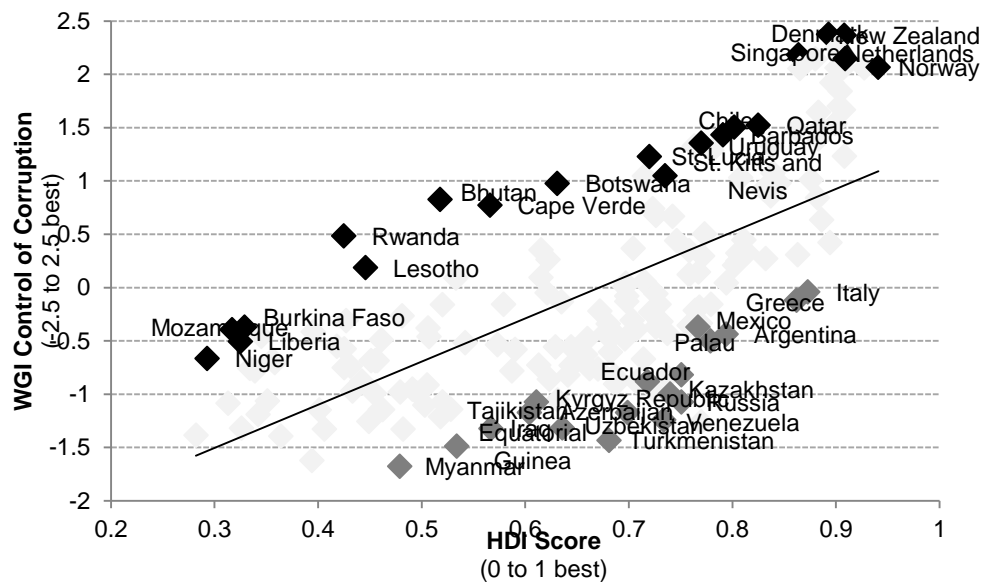
S2.6 In contrast, powerful groups in less developed societies are fewer in number and less dependent on competitiveness and market transactions for their revenues. They can feasibly interact with each other in informal or deals-based ways and generate rents through political connections. If the most powerful groups in a country do not want the enforcement of formal rules, it is unlikely that the rule of law will emerge through enforcement efforts from above. Policymakers and political parties in these countries may only be able to raise significant revenues in informal and deals-based ways as powerful groups prevent formal rules to raise taxation from being implemented. As a result, the most feasible way of rewarding their supporters for political parties is to allow them to violate rules. For example, when parties buy political support in exchange of jobs in the public sector they hold supporters accountable for their political success in the voting booth not for their performance on the job. In general it is difficult for political leaders to exercise ‘political will’ to enforce rules when their tenure depends on doing otherwise.

S2.7 However, development, as measured by the Human Development Index, explains only about half the variation in control of corruption (Mungiu-Pippidi 2015). A large sample of countries shows how some countries overperform and others underperform in their expected levels of controlling corruption, given their levels of development (figure S2.1). This heterogeneity in progress can help reveal important underlying factors. What did overperforming countries with relatively low levels of development when they started their transformation—such as Botswana, Chile, Georgia, and the Republic of Korea—have in common?

S2.8 Evidence from most of these cases suggests that control of corruption is achieved when the right balance between resources and constraints is struck, and not when some anticorruption tool is adopted. There is no silver bullet. Countries that have adopted anticorruption agencies, restrictive party finance legislation, or whistleblower protection acts do not necessarily progress more than countries that have not. For example, mandatory asset disclosure for officials may work only in the presence of a free press; fiscal transparency may help curb corruption only when an active civil society exists.

**Figure S2.1 Development accounts for only about half the variation in control of corruption**

*Predicted control of corruption scores based on Human Development Scores*



Source: Mungiu-Pippid 2015.

Note: Dots show the values for the Control of Corruption indicator (World Bank) and the Human Development Index (United Nation Development Program). Only outliers are shown.

HDI = Human Development Index; WGI = [World Governance Indicators].

### What can be done?

S2.9 How can countries identify and achieve the right balance between resources and constraints? In contexts where levels of development and political arrangements do not yet allow the effective enforcement of formal rules, anti-corruption strategies should sequentially attack corruption at critical points where anti-corruption is both feasible and has a high impact on development. A common error is to equate the impact of corruption with the magnitude of bribes. An activity with relatively small bribes can have a high development impact, for instance if bribes prevent the enforcement of regulations on food adulteration. Other activities with significant bribes may be profit-sharing transfers to politicians with a lower impact on development if the corruption does not distort policy. The high-impact anti-corruption approach therefore has to assess anti-corruption priorities but it also has to be feasible. It has to assess if strategies can be designed to make enforcement easier by aligning with the interests of important stakeholders, or developing new coalitions.

S2.10 While this way of looking at corruption control does not allow for rigid, straightforward policy prescriptions, it is possible to identify a series of key strategies in countries that have managed to get make progress in controlling corruption in recent times. In order to reduce opportunities for corruption and increase constraints, reform coalitions will need to change incentives to limit the payoff of corrupt officials through increased accountability of elites and enhancing contestability by engaging actors in civil society and the media. One particularly

promising avenue of action is to take advantage of technology. Digitalization helps transparency and rationalization of fiscal management on the government side, and creates empowered citizens on the society side. Internet media in general and social networks in particular are now indispensable components of citizen empowerment and collective action.

S2.11 International actors, such aid donors, also play a key role in local fight against corruption and should take care that they do not increase resources for corruption themselves. Meaningful international anticorruption efforts should coordinate and engage with actors outside the state, including local communities, nongovernmental organizations (NGOs), and multinational businesses to support domestic anticorruption reforms through tools such as the provision of information (reform evaluations and cross-country data) or legal mechanisms (international treaties and arbitration) (Ackerman 2016).

\* \* \*

*This spotlight is based on special contributions to the WDR 2017 from Alina Mungiu-Pippidi, Mushtaq H. Khan, and Martin Schmidt.*

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## Chapter 3 Think of the *role* of law, not only the *rule* of law

### Three core roles of law in governance

3.1 The third implication of this Report’s conceptual framework calls for an understanding of the role that law plays in governance dynamics. Like the first two components, it moves away from a consideration of ideal forms and end states—here, the notion of the rule of the law—in order to focus on the underlying determinants of policies and outcomes. It has long been established that the *rule of law* at its core, requiring that government officials and citizens are bound by and act consistently with the law—is the very basis of good governance needed to realize full social and economic potential. But it is also recognized that rule of law is not a technology that can be engineered; it is rather a particular governance arrangement that is the product of broad power dynamics, which are themselves determined by historical processes. While the *rule* of law remains an important aspiration, unpacking the *role of law* can improve understanding of how law actually works to shape governance arrangements and improve policy effectiveness in practice. It is the aim of this chapter to unpack the mechanics through which law, in its multiple roles, can serve this purpose.

3.2 Long before the Code of Hammurabi set the rules for ancient Mesopotamian society, people subjected themselves—sometimes by cooperative agreement, sometimes due to brute force—to rules to enable social and economic activities to be ordered.<sup>1</sup> All states today are *creatures of law* (constitutions and other founding legal instruments), *subjects of law* (international law, treaties), and *makers of law* (statutes, regulations, decrees). It is through law and legal institutions that states regulate social and economic activity, allocate and limit power, and define the rights and entitlements of citizens.<sup>2</sup> Law is also a critical instrument of transnational activity, both enabling and regulating flows of capital, goods, people, and ideas. Law can be an important tool to hold authorities accountable and to promote change. Empirical studies have shown the importance of law and legal institutions to improving the functioning of specific institutions, enhancing growth, promoting secure property rights, improving access to credit, and delivering justice in society.<sup>3</sup> In short, law is ubiquitous in all aspects of governance.

3.3 But, as everyday experience makes clear, the mere existence of formal laws by no means leads to their intended effects. In many developing countries, laws on the books are just that; they remain unimplemented, selectively implemented, and sometimes are impossible to implement. Laws may also lead to unintended or adverse effects. Yet, law is also an important instrument for challenging these types of sub-optimal outcomes. Law and governance have a complex relationship, simultaneously shaping and being shaped by the other. Understanding how law is used instrumentally and what accounts for its success or failure in implementing policy and shaping behavior is an important aspect of understanding governance.

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<sup>1</sup> Fukuyama (2011, 2014) traces the evolution of law and governance as society moved from hunter gatherer groups to more complex societies.

<sup>2</sup> Dixit (2004) notes: “There seems universal agreement [even] in traditional economics that the framework of law is a necessary condition for a market economy to succeed.” Platteau (2000) discusses all the implicit assumptions related to law for the basic results of welfare economics to hold with respect to markets and efficiency.

<sup>3</sup> Acemoglu 2003; Besley and Persson 2014; Galiani and Shargdrosky 2010.

3.4 This chapter builds on the implications of this Report’s conceptual framework laid out in chapters 1 and 2 to examine how law interacts with the underlying power dynamics in order to enable commitment, cooperation, and coordination—and ultimately, shape development outcomes. It examines two key questions:

1. Given that law is often the accepted means of implementing policies as well as allocating de jure power, how can implementation gaps be understood, and how can they be avoided? What are the mechanisms through which law as “words on paper” convert into the functions of commitment, cooperation, and coordination that are necessary to produce desired development outcomes?
2. Looking beyond law as an authoritative statement of state policy, what is the role that law plays in structuring the bargains that lie at the core of governance itself? How does law serve as an important means through which government, elites, citizens, and external actors project, reinforce, contest, and institutionalize the allocation of power and shift norms?

3.5 *The role of law.* This chapter analyzes these questions across three core *roles of law* that accord with the main elements of the Report’s framework:

- *Ordering behavior (the command role of law).* The role of law in converting policies into outcomes. This covers a wide variety of legislation governing social and economic activity, ranging from laws prohibiting bribery, to establishing licensing fees and business registration, to banning child marriage, and the means of enforcement of these rules. Here law is the form that emerges from the policy-making arena. How does the form relate to the functions of commitment and collective action needed to produce development outcomes?
- *Ordering power (the constitutive role of law).* The role of law in establishing and distributing authority and power among government actors and between the state and citizens. This is most commonly done through constitutions that set out the roles and authorities of political institutions, checks and balances, and citizen rights. Here law determines the de jure allocation of power and its limitations, which together with de facto power shape the nature of the policy-making and implementation space. What accounts for the success or failure of legal constraints on power to shape governance?
- *Ordering contestation (the change role of law).* The role of law in contesting preexisting dynamics of power and norms to arrive at new outcomes. Here law serves as a tool, usually in conjunction with other collective action strategies, to promote accountability, change the rules of the game, or both. This category includes, for example: advocacy to adopt right to information laws; litigation to demand that government provide services and fulfill its obligations in line with the law; using the language of rights and appealing to authoritative standards and norms in the demand for better outcomes; changing procedural rules so as to reshape the nature of the policy arena.

## What is law?

3.6 The task of defining law has captured the minds of legal scholars, philosophers, and sociologists for centuries. H. L. A. Hart (1961: 1) observed that “few questions concerning human society have been asked with such persistence and answered by serious thinkers in so many diverse, strange and even paradoxical ways as the question ‘What is law?’” Theorists have debated the essence of law for centuries, including the extent to which law refers to custom and social ordering, requires state-backed coercion, and encompasses notions of justice (box 3.1).

### Box 3.1 Three conceptions of law

Countless theorists have attempted to define law. The answers generally fall into one of three categories, which were initially set forth two millennia ago in the Platonic dialogue *Minos*: law involves principles of justice and right; law is an institutionalized rule system established by governments; law is fundamental customs and usages that order social life. Adherents of the first category are natural lawyers, like Thomas Aquinas, who assert that the defining characteristic of law is its morality, justice, and fairness. Evil legal systems or evil laws are disqualified as law in this view. The second category aligns with H. L. A. Hart and other legal positivists, who base their definition on the existence of a legal system that consists of substantive laws (primary rules), and laws governing how those rules are made (secondary rules), without regard to the justness of the law. Under this approach, evil legal systems count as law, but customary law and international law, which lack centralized enforcement systems, are not considered fully legal. The third category is represented by anthropologists and sociologists like Eugen Ehrlich and Bronislaw Malinowski, who focus on customary law or living law, rejecting the notion that law must consist of an organized legal system, instead recognizing that the central rules that individuals within groups abide by in social intercourse count as law. Three key fault lines run across these conceptions of law: one regarding the normative value of law, the second concerning the systematic form of law, and the third concerning the function of law.

Source: Brian Tamanaha, *Washington University in St. Louis*.

3.7 This Report sidesteps these philosophical debates and uses the term *law* or *formal law* in its most conventional sense to mean positive state law—that is, laws that are officially on the books of a given state—at the national or subnational level, whether they were passed by a legislature, enacted by fiat, or otherwise formalized. Law here means the *de jure* arrangements. The operation of law requires a *legal system*, which includes a broad set of state institutions whose function it is to make, enforce, and interpret the law, such as legislatures, judicial and law enforcement institutions, and administrative agencies, as well as those actors and institutions that represent and empower users of the system, including the legal profession, informal providers of justice such as mediators and traditional systems and civil society groups.

3.8 Two further clarifications about this Report’s use of the term *law* are necessary. The first distinguishes the *role of law* from the concept of the *rule of law*. The second acknowledges that state law always exists simultaneously with multiple other rule systems (the phenomenon of legal and normative pluralism). Both are important to unpacking the relationship of law to capacity, norms, and power when considering their functional roles.

## ***The rule of law***

*“In establishing the Rule of Law, the first five centuries are always the hardest.”*  
—Gordon Brown<sup>4</sup>

3.9 The *rule of law* is widely recognized as necessary to the achievement of stable, equitable development. Over the past few decades, no other governance ideal has been as universally endorsed.<sup>5</sup> There is far less agreement, however, on what it means. At a minimum, the rule of law requires that government officials and citizens are bound by and act consistent with the law (Fukuyama 2014; Tamanaha 2004). This, in turn, requires certain characteristics: namely, that law is clear, certain, and public; and that it is applied equally to all through effective legal institutions.<sup>6</sup> As such, the rule of law generates credible commitment to facilitate economic and social activity by imposing restraints on government, maintaining order, and coordinating behavior and transactions among citizens. Safeguarding property rights from arbitrary expropriation and guaranteeing contract enforceability—as underpinned by the rule of law—have long been regarded as a precondition for investment and thus growth. Clear rules and predictable enforcement mechanisms enable peaceful resolution of disputes. Two elements are common to various notions of the rule of law: first, that law is applied impersonally, independently of the actors involved; and second, that the rulers are also bound by the law. The lack of the latter is seen as rule *by* law. “To my friends, anything. To my enemies, the law,” is a popular quote attributed to some Latin American political leaders.

3.10 “Thin” versions of the rule of law have largely given way to “thicker” versions that move beyond the focus on procedure to a focus on substance requiring adherence to normative standards of rights, fairness, and equity.<sup>7</sup> The United Nations exemplifies this normative stance, defining the rule of law as “a principle of governance in which all persons, institutions and entities, public and private, including the State itself, are accountable to laws that are publicly promulgated, equally enforced and independently adjudicated, and which are consistent with international human rights norms and a principle of standards.”<sup>8</sup>

3.11 Correlations between indicators of the rule of law and income levels are strong (figure 3.1). But the direction of causality and the mechanisms that determine this association are less well understood. Indeed, the attainment of the rule of law has proven exceedingly elusive, leading to an extensive literature on the challenges faced by several waves of efforts to promote the rule of law in transition and developing countries.<sup>9</sup> “It is a bit strange...that relatively little analytical work

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<sup>4</sup> Cited in OECD 2014: 178.

<sup>5</sup> Tamanaha 2004; Carothers 2006; Desai and Woolcock 2015.

<sup>6</sup> Hadfield and Weingast (2014) model how these characteristics are necessary to achieve an equilibrium of behavior in line with the rule of law.

<sup>7</sup> This aligns with the views of legal and moral philosophers such as Lon Fuller and John Rawls who define law in terms of natural justice and fairness.

<sup>8</sup> The definition continues: “It requires, as well, measures to ensure adherence to the principles of supremacy of law, equality before the law, accountability to the law, fairness in the application of the law, separation of powers, participation in decision-making, legal certainty, avoidance of arbitrariness and procedural and legal transparency” (UN 2004: 4).

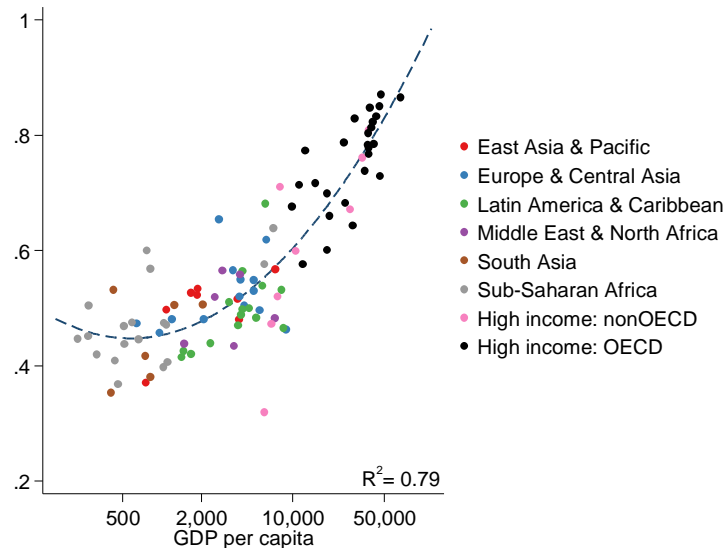
<sup>9</sup> There is an extensive literature on the challenges of modern efforts to promote the rule of law, beginning most famously with the self-reflection of Trubek and Galanter (1974) on the law and development movement of the 1960s. Other key studies include Carothers 2006, Humphreys 2010, Trubek and Santos 2006.



has been done on transitions to the rule of law that is comparable to what has been done on transitions to democracy,” Fukuyama (2010) notes.

**Figure 3.1 Rule of law is strongly correlated with high-income**

*Rule of law index versus GDP per capita*



*Sources:* WDR 2017 team with data from the World Justice Program 2015 and World Development Index 2015.

3.12 At its essence, the rule of law is about formal limitations on power—and in thick versions, about particular normative commitments. This is not something that can be engineered from outside the political and social system, but rather is a function of historical and structural contingencies that shape contests and outcomes over power. Historical accounts of the emergence of elements of rule of law in the Middle Ages describe it as an outcome of the struggle between religious and political authorities, and alliances between the growing merchant class and monarchies against landed nobles. Stable and effective legal institutions to ensure these arrangements developed over centuries as societies came to embrace the principles of the rule of law as a necessary and fundamental aspect of their socioeconomic and political system (Fukuyama 2014; Tamanaha 2004). New Institutional Economics accounts explain why the rule of law is anathema to the natural state of most developing countries, as it undercuts the mechanisms through which a stable order is kept. The credible commitments required to maintain the rule of law are difficult for government to provide, given the importance of deal making and rent distribution in most developing societies (Weingast 2014; North and others 2013).

3.13 Indeed, efforts to transplant elements of the rule of law—such as the top-down promulgation of laws modeled on other countries, or technical support to legal institutions—have largely failed, especially in contexts that lack a widely shared orientation about the authority and effectiveness of state law. This includes societies where the citizenry is divided in its adherence to alternative authorities and systems of social ordering, such as religious and traditional laws, and where the reach of the state—in terms of authority, capacity and legitimacy—is weak. But even while the forms and functions of the rule of law have not yet taken hold in many countries, the

global spread of rule of law as an idea is influencing the parameters of the policy agenda and the nature of the bargaining arena in profound ways. The rule of law thus has a dual nature: it is both the outcome of governance contests shaped by power, cultural schema and the social practices that undergird them, and an idea that can serve to shape those very contests. Box 3.2 discusses the challenging process of transitioning to the rule of law.

### **Box 3.2 Transitions to the Rule of Law**

Compared to the extensive literature on transitions to democracy, a surprisingly small amount of systematic work has been done on transitions to a modern rule of law. There are actually three separate transitions to consider: first, the shift from a customary, informal, and often highly pluralistic system of law to a unified modern one; second, how powerful elites come to accept legal constraints on their power; and third, how countries successfully adapt foreign legal systems to their own purposes.

The shift from a customary and/or pluralistic system to a codified modern one is usually motivated, at base, by actors who see a single formal system as better serving their interests, particularly economic interests in expanded trade and investment. Scale matters: at a certain point, the personal connections that characterize customary systems become inadequate to support transactions between strangers at great remove. However, transition costs are high, and customary rules are often preferred by existing stakeholders. This means that political power is critical in bringing the transition about.

Formal law is usually applied first to non-elites (“rule *by* law”); we shift to “rule *of* law” when the elites themselves accept the law’s limitations. North and Weingast have argued that constitutional constraints become self-reinforcing when power in the system is distributed evenly and elites realize that they have more to gain in the long run through constitutional rules. What this theory doesn’t explain, however, is why these same elites stick to these constraints when the power balance subsequently changes and one group is able to triumph over the others. Similarly, independent courts are always a threat to elite power; why do rulers come to tolerate them when they have the power to manipulate or eliminate them? This suggests that constitutionalism needs to be underpinned by a powerful normative framework that makes elites respect the law as such. Subsequent respect for law depended heavily on the degree independence maintained by legal institutions—the judiciaries, bars, law schools, and other structures that persisted even after their religious foundations disappeared.

Finally, with regard to the import of foreign legal systems, perhaps the most important variable determining success is the degree to which indigenous elites remained in control of the process, and could tailor it to their society’s own traditions. Thus Japan experimented with a variety of European systems before settling on the German civil code and Bismarck constitution. Later in the 20th century, China, Korea, and other Asian countries similarly adapted Western legal systems to their own purposes. In other cases like Hong Kong, Singapore, and India, the colonial power (Britain) stayed for a long time and was able to shape the local legal norms in its own image. Even so, India today practices a far higher degree of legal pluralism than Britain itself, as part of the process of local adaptation. Less successful were cases in sub-Saharan Africa where customary systems were undermined by colonial authorities, but not replaced by well-institutionalized modern systems.

Much more research is needed into the question of legal transitions. It is clear that a fully modern legal system is *not* a precondition for rapid economic growth; legal systems themselves develop in tandem with modern economies. It may be that the necessary point of transition from a customary to a formal legal system occurs later in this process than many Western observers have thought. But we know relatively little about the historical dynamics of that transition, and thus have too little by way of theory to guide contemporary developing countries as they seek to implement a rule of law.

*Source:* Prepared by Francis Fukuyama for the WDR 2017.

## *The role of law*

*“It is not wisdom but Authority that makes a law.”*  
—Thomas Hobbes

3.14 In contrast to the ideal of rule of law, the *role of law* implies no particular configuration or normative claim. It is fundamental to governance because it plays an instrumental role in ordering behavior, allocating power, and regulating contestation. An implication of the instrumental view of law is that groups and individuals within society will use the law as a means of promoting, enforcing, and institutionalizing interests or objectives. Importantly, law is only one tool in the box; it in turn competes with an array of other means of asserting power and interests, including persuasion, market forces, and physical force.

3.15 Thus, laws generally reflect the interests of those actors with greater bargaining power, whether derived from control over resources, from de jure context, or from existing norms. For instance, for decades, South Africa sustained a brutal system of apartheid rooted in law. It has become common for political leaders in illiberal regimes to legitimize nondemocratic rule through changes to the constitution, such as referendums on extending term limits. Every day, actions that exert power over others, such as displacing the poor from their land, detaining dissidents, and denying equal opportunities to women and minorities, are taken within the authority of the law. In well-documented cases, laws intended to secure property rights have served to privilege powerful actors by allowing them to seize land and register it at the expense of rural farmers, or to perpetuate class systems and power relations.<sup>10</sup> Law can be used to confer and legitimate discriminatory identity and status, for example, by defining who has rights and under what conditions. And law expresses power relations when it determines, for example, what is a private or a public matter. It was not until the 1970s that laws in the United States recognized domestic violence as a public criminal offense, as opposed to a private matter in which the state should not intervene. Legal institutions such as courts and police may also be used in the service of narrow interests, as an instrument of, rather than a check on, power.

3.16 But law has also proven to be an important instrument for challenge and change, due to its unique role in legitimating authority and structuring spaces to contest the status quo. Scholars have long emphasized the double-edged nature of law: while law predominantly serves to reinforce prevailing social and economic relations, it can also be a powerful tool of those seeking to resist, challenge, and transform those relations.<sup>11</sup> By its nature, law is a device that provides a particular language, structure, and formality for ordering things, and this characteristic gives it the potential to become a force independent of the initial powers and intentions behind it.

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<sup>10</sup> See, for example, Thompson 1975; Lund 2012; Mattei and Nader 2008.

<sup>11</sup> Thompson 1975; McCann 2004; Rodriguez-Garavito 2011; Epp 1998.

### ***State law in perspective: The reality of legal and normative pluralism***

*A woman in Liberia is raped; the formal law requires that the case be tried in the Circuit Court, which applies a western-style penal code focused on retributive justice. The woman's family prefers to have the case mediated by a local chief in the hopes of being awarded compensation and restoring communal harmony.*<sup>12</sup>

*Closed range ordinances in California establish liability rules for trespassing cattle. These rules, however, have been at variance with the social norms developed and practiced by farmers and herdsman to regulate their respective rights, leading to confusion and social conflict.*<sup>13</sup>

*Nari adalats (women's courts) were established in India's Gujarat and Uttar Pradesh states to provide a new legal avenue for women in situations of domestic violence. These informal courts enabled women to draw on community norms, state law and international human rights.*<sup>14</sup>

3.17 Although this Report defines law as state law, it is essential to place state law within the context of broader realities of legal and normative pluralism (box 3.3).<sup>15</sup> Traditions of positivism, socio-legal studies, and the vast literature on social norms have long recognized that formal law is only one of multiple rule systems and normative orders operating in any given state that may determine behavior and outcomes. All societies have multiple normative systems, which can be broadly categorized as state law, customary and religious law, functional normative systems (rules systems developed for the common pursuit of particular aims such as sports leagues or universities), cultural and social norms, and economic transactional normative systems (Tamanaha 2008). As illustrated in the preceding vignettes, several of these systems might apply simultaneously in a single social arena or around a particular issue.

#### **Box 3.3 Legal and normative pluralism**

The phenomenon of “legal pluralism”—the coexistence of multiple legal systems within a given community or sociopolitical space—has existed throughout history and continues today in developing and developed countries alike. Modern forms of legal pluralism have their roots in colonialism, through which Western legal systems were created for elites, while traditional systems were maintained for the indigenous population. That traditional or customary law still dominates social regulation, dispute resolution, and land governance in Africa and other parts of the developing world is well documented. In some cases, customary law, including a variety of traditional and hybrid institutional forms of dispute resolution, are formally recognized and incorporated into the legal system, such as in Ghana, South Africa, South Sudan, the Republic of Yemen, and several Pacific Islands states. In others, such forms continue to provide the primary means of social ordering and dispute resolution in the absence of access to state systems that are perceived as legitimate and effective, such as in Afghanistan, Liberia, and Somalia. Customary legal systems reflect the dominant (yet evolving, not static) values and power structures of the societies in which they are embedded. Such systems are often perceived to fall short of basic standards of nondiscrimination, rights, and due process, but it is important to understand the importance and effectiveness of the social and economic role they play in solving collective actions problems, relative to the existing state law system.

<sup>12</sup> Lubkemann, Isser and Banks 2011.

<sup>13</sup> Ellickson 1991.

<sup>14</sup> Merry 2012.

<sup>15</sup> Legal pluralism refers to the multiplicity of legal orders in any given social space. Scholars have long debated the boundaries between what is considered a legal order and other forms of social ordering (Tamanaha 2008). For our purposes we use the term legal and normative pluralism to include a wide range of norms that serve the function of ordering behavior and authority in ways that may compete with state law.

A further source of normative pluralism comes from the less visible, but highly influential role of social norms—generally accepted rules of behavior and social attitudes within a given social grouping. A vast literature documents how social norms derived from communal and identity groups, professional associations, business practices, and the like govern the vast majority of human behavior.<sup>a</sup> Social norms—as generally known, socially accepted rules of behavior—are a fundamental way of enabling social and economic transactions as a means of coordinating peoples’ expectations about how others will act. Social sanctions, such as shame and loss of reputation, or, in some cases, socially sanctioned violence, are a powerful means of inducing cooperation to prevent what is regarded as antisocial and deviant behavior (Platteau 2000).

In other words, social norms can serve to make people act in certain ways—such as to adhere to contractual transactions in the absence of centralized enforcement (Greif 2006), to allocate and manage the productive use of land in the absence of formal property rights, or to practice female genital mutilation, permit child marriage, or engage in corruption and clientelism. Social norms can complement formal rules (such as when concerns about reputation provide informal means of enforcing contracts) or compete (such as when expectations of preferences for kinship relations undermine formal rules of meritocracy).

Yet another source of normative pluralism is generated by today’s globally interconnected world, in which a multitude of international, regional, and multilateral organizations, as well as professional and industry associations, diffuse rules about a wide range of transactions and conduct. Increasingly, local experiences of law are informed by broader interactions of national, international, and global law. Among the topics subject to such rules are trade, labor, environment, natural resources, financial institutions, public financial management, intellectual property, procurement, utility regulation, and human rights. These broader influences can take the form of binding international law to which countries accede by treaty, voluntary standards or guiding principles, or even the rules required by donors for the implementation of particular development projects. These rules may reinforce, complement, and/or compete with state law to govern public and private spaces. (Braithwaite and Drahos 2000).

Finally, the spread of transnational commercial activities has generated a broad range of informal and formal norms, standards, codes of conduct, and private lawmaking and regulatory instruments. The global reach of private multinational companies subjects large tracts of land, labor, and even security to these norms and the provisions of private contracts (Tamanaha 2008).

Notes: <sup>a</sup> Sunstein 1996; Ellickson 1991; Basu 2000; Acemoglu and Jackson 2016; Dixit 2004.

3.18 Legal and normative pluralism is neither inherently good nor bad: it can pose challenges, but it can also generate opportunities. Alternative normative systems can complement state laws by providing order where the state is absent, or by alleviating the burden on state institutions for a particular set of issues. For example, informal mediation of land and contract disputes and customary or religious determination of personal and family matters complement state law in many countries. In other cases, state laws may differ sharply from the content of other social norms and rule systems, posing the risk of confusion, rejection and lack of adherence, or resentment and perverse outcomes. This has been the case where state laws are at odds with socially embedded practices, as in the Liberia and California vignettes above. In West Africa, violent communal land conflict is 200 percent to 350 percent more likely where there are competing legal authorities because the lack of certainty reduces incentives to solve disputes peacefully (Eck 2014).

3.19 But pluralism can also enable constructive pathways to development outcomes. Throughout history, social entrepreneurs and clever intermediaries have proven to be deft at opportunistically selecting from among legal and normative claims and authorities to advance their aims.<sup>16</sup> Thus legal pluralism can serve to expand the languages and sites in which contests over power are made. The preceding example of *nari adalats* demonstrates how legal pluralism can be used to contest unequal power relations and to actively shape emerging norms. Across the three

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<sup>16</sup> See, for example, Benton 2001; Belmessous 2011; Yannakakis 2015.

roles of law, which are discussed next, it is the complex and shifting interplay between these multiple and often overlapping orders and their related power structures that ultimately determines behavior and consequent development outcomes.

### **Ordering behavior (the command role of law)**

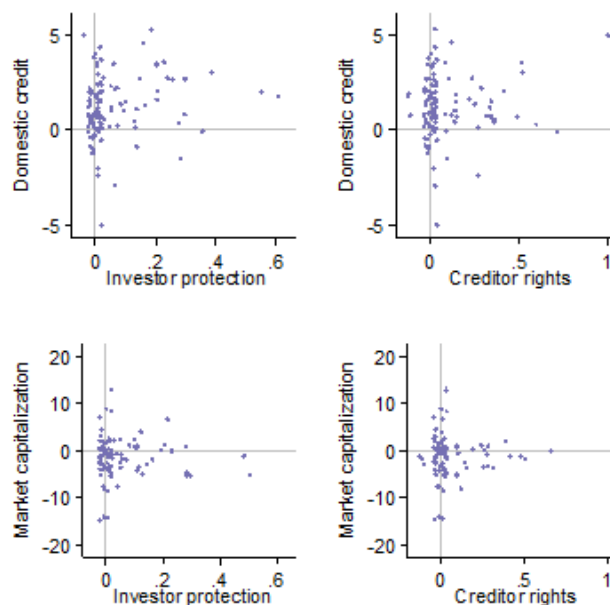
3.20 In this role, law is an instrument of policy. It is the means by which government codifies rules about how individuals and firms are to behave so as to achieve economic and social policy outcomes, including in the criminal, civil, and regulatory domains. The existence of particular formal laws is often used as a measure of a country's commitment to, or compliance with, particular policies. For example, the World Bank's Doing Business and Women Business and the Law (WBL) programs track formal law regarding investment climate, and women's entrepreneurship and employment, respectively. But empirical studies of the correlations between law on the books and outcomes show vast heterogeneity, reflecting the multiplicity of factors that mediate the ways that laws serve to order behavior (box 3.4).

3.21 What makes these laws—essentially words on paper—lead to the expected outcomes, or not? How do laws interact with power, norms, and capacity to underpin the necessary functions of? This section will draw on legal, sociological, and economic scholarship to look at three interrelated ways that law serves to induce particular behavior, and why these may fail. These are the *coercive power of law*; *the coordination power of law*, and *the legitimating power of law*. While operating with distinct logics, these three mechanisms rarely work alone but rather in combined ways that interact with power, norms and capacity to provide commitment and collective action needed to produce results.

#### **Box 3.4 Legal origins: Theory and practice**

One of the most influential explanations of why some countries have legal systems that support more dynamic market economies than others is the Legal Origins Theory put forward by La Porta, Lopez-de-Silanes and Shleifer (1998, 2008, 2013). The theory posits that countries that inherited a common law rather than civil law system from their colonial occupiers have stronger investor and creditor rights, lower legal formalism, more efficiency of contract and debt enforcement and higher judicial independence. This is attributed to the strong role of private property as well as the adaptability of the case law system that characterize British common law.

The Legal Origins Theory sparked a significant effort to reform laws and regulations to imitate common law rules (Besley 2015). Yet, empirical analysis shows that there is no clear relationship between changes in legal rules and changes in economic outcomes. This is further backed by evidence finding only weak correlations between changes in Doing Business indicators and firm level enterprise surveys. (Hallward-Driemeier and Pritchett 2011).

**Figure B3.3.1 Changes in investor protection and creditor rights have little impact on financial outcomes***Changes in legal indexes versus changes in financial indicators*

*Source:* WDR 2017 team with data from Oto-Peralías and Romero-Avila (2017), background paper for WDR 2017.

*Note:* Domestic credit to the private sector by banks and market capitalization of listed domestic companies expressed as the percentage of GDP.

These findings are in line with this Report’s argument that the effect of laws and policies is endogenous to governance dynamics. The extent to which particular laws are able to facilitate commitment and collective action in light of existing power, capacity and norm constraints is far more predictive of economic outcomes than the content of the rules themselves. As critics of the Legal Origin Theory have argued, the manner in which legal systems were transplanted and adapted over time—that is, whether colonial law became embedded in and responsive to local context and demand or remained superficial—is more indicative of any path dependencies than the origin of the law. (Oto-Peralías and Romero-Ávila 2014; Berkowitz, Pistor and Richard 2003). As Besley has argued, indicators such as Doing Business can not necessarily point the way to improved economic outcomes, but they can be an important tool to inspire local debate over context based policy change. (Besley 2015).

*Source:* WDR 2017 team, based on Daniel Oto-Peralías and Diego Romero-Avila, “Legal Reforms and Economic Performance: Revisiting the Evidence,” background paper for the WDR 2017.

### ***The coercive power of law: Incentivizing behavior change through coercion/sanctions***

3.22 Perhaps the most conventional reason that people obey the law is out of fear of sanction.<sup>17</sup> If people, acting according to their narrow self-interest, would not behave in the socially desirable way, sanctions can be used to induce cooperation by changing incentives. Another way of explaining this is to say that the coercive power of law shapes the options available to people by making some actions unfeasible or just too costly. The traditional law and economics approach thus uses a cost-benefit analysis: people will obey the law as long as the costs of being caught (factoring in the likelihood of being caught) are higher than compliance. Thus, state bureaucrats

<sup>17</sup> See Schauer (2015) for an extensive argument about the importance of the role of force in law.

will refrain from accepting bribes if the cost and likelihood of being caught are higher than the benefit of accepting the bribe. Manufacturing companies will comply with environmental regulations if there is a high likelihood of being fined an amount greater than their profit margin gained from noncompliance. Families can be induced to send their girl children to school if the consequence of noncompliance is sufficiently severe. The converse holds true as well, as in the case of a law that generates a credible reward for compliance—for example, a law requiring people to register for an identity card in order to get access to welfare benefits. In the case of a state entity, compliance with the regulations of the European Union, World Trade Organization, or the World Bank Group depends on the belief that the rewards of membership will outweigh the alternative.

3.23 The coercive power of law depends on the existence of a credible threat of being caught and punished, or a credible commitment to obtaining the reward for compliance. This requires three conditions directly related to the three constraints discussed in the chapter 2. First, the state needs the technical, physical, and human *capacity* to carry through with consistency. Second, the law must provide strong enough incentives to overcome the gains from noncompliance (taking into account that many people may not exhibit “rational behavior” (World Bank, WDR 2015), as well as adherence to any alternative conflicting *normative* order. Third, the law needs to be in line with the incentives of those with enough *power* to obstruct implementation, so they will go along with it (unless truly effective restraints on such power exist). Together, these conditions will create a credible commitment so as to induce rational compliance. Basu (2015) argues that the existence of the law itself does not change the payoff, but rather serves to coordinate people’s beliefs and expectations about what the others—fellow citizens and the officials who implement and enforce the law—will do.<sup>18</sup>

3.24 Take, for example, a law prohibiting bribery. First people need to believe that the state has the capacity to detect and punish those engaged in the practice, meaning it needs effective administrative and law enforcement institutions. Even if the state does not have adequate reach to detect violations everywhere, it could be aided by private enforcement to the extent the law (in combination with a broader range of related laws) incentivizes whistleblowing by those in a position to do so. And finally, the sanction for violation must leave the perpetrator worse off than any benefits from engaging in bribery. Getting this formula right is complicated and costly. For example, too low a sanction will be absorbed as part of the cost of doing business, while too high a sanction for the behavior of potential whistle blowers will reduce the number of people who will engage in private enforcement.<sup>19</sup>

3.25 But even with the “right formula,” the law must contend with powerful interests; to the extent they benefit from bribery, enforcement will likely be blocked, or in any case, not consistent or credible. Norms may also compete in ways that undermine implementation. Several studies have looked at the effect of “practical norms” or “culture” on the impact of laws. Laws establishing meritocratic civil service have gone unimplemented in Cameroon and Niger because of an overpowering norm that people should not be sanctioned for breaking the rules unless it is an egregious violation. The importance of social networks and neo-patrimonial logic also undercuts the willingness of officials to sanction workers. As Olivier de Sardan (2015: 3) notes, “[t]he gap

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<sup>18</sup> See also Mailath, Morris, and Postlewaite 2001.

<sup>19</sup> Quoted in d’Iribane and Henry 2015. See Acemoglu and Jackson 2014; for a debate on legalizing bribe-giving, see Basu 2011 and Dufwenberg and Spagnolo 2014.



between official rules and actual behavior is, per hypothesis, not a space where norms are forgotten or missing, but a space where alternative norms are in use.”<sup>20</sup>

3.26 Competing normative orders can lead to perverse effects. Rigorous prosecution of domestic violence in Timor-Leste during the time of the United Nations administration resulted in a significant reduction in the reporting of domestic violence because of the devastating social stigma and economic consequences for women (Chopra, Ranheim, and Nixon 2011). Similarly, stricter mandatory arrest laws for crimes related to domestic violence in the United States were found to be associated with higher murder rates of intimate partners because reporting to the police of episodes of escalating violence decreased (Iyengar 2009; Goldfarb 2013). In India, a recent law providing the death penalty for convicted rapists is expected to have similar effects because of the heightened pressure faced by women not to report the rape (Pande 2015). India has had strong laws on the books prohibiting a range of gender-based violence, including child marriage, sex selective abortion, dowry payment, and domestic violence, but these have barely made a dent in behavior, as the social sanctions associated with abandoning customary practice to follow the law are far stronger (Pistor, Holder, and Amirapu 2010). Here the norm is likely operating at several levels. It undercuts the incentive created by the legal sanction, and it also likely undermines credible commitment, as powerful interests (and individuals in the legal institutions) may also adhere to such norms.

3.27 Social norms that are not based on deep rooted attitudes can also serve to undercut the intended outcome of a law. As Ellickson (1991) famously documented in a study called *Law without Order*, laws that conflicted with the social norms developed to regulate cattle herding in a California county confused cattlemen and led to increased conflict. A law introduced by the British in colonial India allowing agricultural lenders to enforce debts in court was intended to make credit markets more competitive to the benefit of farmers. However, in practice, the law had the opposite effect, as it undercut the incentives that lenders had under an informal enforcement regime to lend at favorable interest rates (Kranton and Swamy 1998).

3.28 An effective system of legal compliance based on sanctions is therefore quite difficult to achieve. It requires significant investment in capacity and infrastructure, and careful analysis of the types of incentives most likely to work. However, even those measures will not suffice in the face of power and norm constraints. These considerations lead to the second and third mechanisms through which law affects behavior, which do not rely on force.

### ***The coordination power of law: A focal point for change***

3.29 The second way that law leads to outcomes is by serving as a focal point to coordinate behavior. This is also known as the expressive power of law (Cooter 1998; McAdams 2015). Here law acts as a sign post—an expression—to guide people as to how to act when they have several options, or, in economic terms, when there are multiple equilibria (Basu 2015; McAdams 2015). People comply with the law because doing so facilitates social and economic activities.

3.30 The easy case is when law establishes rules about a neutral activity, to which citizens have no particular normative attachments. Thus, when the law mandates driving on the right or the left

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<sup>20</sup> See also d’Iribane and Henry 2015.

side of the road, people generally comply, not because they fear punishment, but because it facilitates road safety. The harder question is whether law in its expressive role can coordinate behavior around more highly charged issues, where alternative norms and preferences are strong. In such cases the law would need to shift norms and preferences away from alternative options in such a way that the law becomes the salient focal point.

3.31 Consider the astonishing success of the ban on smoking in public places in many parts of the world even in the absence of rigorous state enforcement. Here scholars have demonstrated that the law served to empower those who adhered to its substantive point—nonsmokers—to pressure smokers to refrain. In a short period of time, this shifted societal norms so that the wrong of smoking in public places became internalized (McAdams 2015). In other words, the law served to change the balance of power and norms in the policy implementation arena by legitimizing the claims of some over others. Cass Sunstein (1996) explains this phenomenon as a *norm bandwagon*—when the lowered cost of new norms leads an increasing number of people to reject old norms until a tipping point is reached, at which the old norm elicits social disapproval.

3.32 For this process to work, a critical mass of supporters of the new norm is needed, who are able to engage in collective action to push toward the tipping point. “When there are contestations in local norms, formal law can strengthen the stance of those whose norms are most closely aligned with the legal rule” (Shell-Duncan and others 2013). The more deeply held the old norm, and more weak the supporting coalition for the new norm, the more care is needed to introduce a new norm through law, so that it does not backfire. Gradual or partial enforcement, coupled with education, awareness, and coaxing campaigns, allow time for norms to shift. (Acemoglu and Jackson 2016). This process of norm shifting has been analyzed and documented by legal anthropologists as a process of “translation” or “vernacularization” involving intermediaries who act as bridges between the world of formal law and the real experiences of local people (Merry 2006).

3.33 For instance, the introduction of an inheritance law in Ghana that was not in line with customary systems resulted in slow evolution of custom and social change. The formal law was not enforced through coercion, but rather served as a “magnet” to provide people with an alternative to custom (Aldashev and others 2012). Similarly, legal prohibition of female genital mutilation in Senegal provided an “enabling environment” for those who wished to abandon the practice. Together with a robust education and awareness campaign, it shifted more people to this category. However, among those who adhered strongly to the practice, the fear of prosecution (even though not a sanction carried out) drove the practice underground, seriously impairing the health of some young women. (Shell-Duncan and others 2013).

3.34 This is not to overstate the expressive power of law. Law does not do the work of norm shifting by itself, but rather depends on the incentives it provides to those who already accept the new law, as well as a range of support programs that drive the process of internalizing the new norm more broadly. While rigorous enforcement can backfire, sometimes enforcement is needed to kick-start the process of norm shifting and internalization. For example, the first term in which a constitutional amendment was implemented that mandated gender quotas in village councils in India, voter attitudes to women were generally negative. After two terms of repeated exposure to women candidates, however, men’s perceptions about the ability of women to be leaders significantly improved (Beaman and others 2009). Aspirations of parents and their adolescent daughters for education were positively affected (Beaman and others 2012), and women’s

entrepreneurship in the manufacturing sector increased (Ghani and others 2014). In the United States, racial desegregation laws required significant coercive force to implement in the face of mass and even violent resistance, but over time they contributed to internalizing the norm change (Schauer 2015).

3.35 One way in which development affects governance is by changing norms. Certain norms are more responsive to a higher level of development. As income grows, for example, people start being more concerned about the sustainability of the growth pattern and may demand better environmental standards. This demand-driven change in standards may come from a change in people's norms with respect to the value of environmental goods. The introduction and effectiveness of child labor regulations has been shown to be related to income levels; as households rely less on children's incomes, the impact of formal regulations increases (Basu 1999). In India, however, child labor regulations led to a decline in child wages and a shift to greater child labor among poorer families (Bharadwaj and Lkdawala 2013). Some norms are much more persistent and less responsive to change, such as those founded on some religious or philosophical principles.

### ***The legitimizing power of law: Creating a culture of compliance***

3.36 While sanctions can be used to control deviant behavior, and law can, under the right conditions, gradually shift certain norms, these are extremely costly and ad hoc ways of inducing behavior change. Ultimately a culture of voluntary compliance with the law depends on its legitimacy. Scholars point to two kinds of legitimacy. *Substantive legitimacy* refers to a situation where the content of the law reflects people's own social norms and views of morality. In such cases, law is largely irrelevant, as people would comply for reasons independent of the existence of the law. While the threat of sanctions lurks in the background, it is primarily there to handle the exceptional cases of deviance (Schauer 2015).

3.37 In heterogeneous societies, substantive legitimacy requires the law to strike a balance between recognizing differences in world views while enabling society to function as a cohesive entity (Singer 2006). Thus, debates over how states formally take account of religious law or customary law are deeply political issues, with significant implications for legitimacy. For example, in Bolivia, Colombia, and Ecuador, constitutional recognition of communal rights and indigenous law was critical in expanding state legitimacy through a sense of shared citizenship (Yashar 2005). Formal incorporation of Islamic law is at the heart of contests to define national identity in states and regions with large Muslim populations from Libya to Mindanao. And official recognition of forms of traditional or customary law remains an important issue in defining state-citizen relations in much of Sub-Saharan Africa.

3.38 *Procedural legitimacy* refers to a situation in which law is respected and observed to the extent it emerges from a system deemed fair and trustworthy. Max Weber argued that rational legal authority (in contrast to traditional or charismatic authority) depends on society's belief in the legitimacy of the order. In his seminal study, Tom Tyler offers empirical support for the argument that people obey the law for reasons other than for fear of punishment when they believe the laws are the product of a system they believe legitimate. Legitimacy here refers to procedural regularity, opportunity for citizen input, and the respectful treatment of citizens by those in authority (Tyler 2006). This encompasses both ex ante procedure (which relates to the means by which law is made,

and the extent to which it is participatory and transparent) and ex post procedure (the extent to which it is applied consistently and fairly). These findings were confirmed in a study of cross-country survey data in Africa. People’s compliance with the law was found to be related to their normative judgment about the legitimacy of government, based on assessments of government competence and performance, but particularly on perceptions that government is procedurally just (Levi, Tyler, and Sacks 2012).

3.39 Substantive and procedural legitimacy leads to voluntary compliance because it enables credible commitment and coordination of expectations. Inequality in the distribution of power affects the social legitimacy of law because it can lead to narrow interests controlling the process or large gaps between law on the books and in practice, in turn creating uncertainty of expectations. (Bardhan 2008). It can also decrease perceptions of the legitimacy of the political, social, and economic system.

3.40 Transplanting laws from one country to another can also suffer from defects in legitimacy. Based on an econometric study of 49 countries that were recipients of foreign law, Berkowitz, Pistor, and Richard (2003) found that countries that have adapted the transplanted law to meet their particular socioeconomic conditions, or had a population that was already familiar with basic principles of the transplanted law, or both, have more effective legality than countries that received foreign law without any similar predispositions. Similarly, legal transplants in the context of integration into the European Union were more successful to the extent that they were accompanied by efforts to empower a variety of domestic state and nonstate actors through multiple methods of assistance and monitoring, and their ability to merge monitoring and learning at both the national and supranational levels (Bruszt and McDermott 2014). By contrast, the transplantation of judicial reform and anticorruption laws into southeastern Europe, which bypassed legislative processes and other forms of adaptation, did not produce the desired effects (Mendelski 2015).

3.41 Finally, it is important to recognize that perceptions of legitimacy can be based on false consciousness “with members of subordinate groups adopting the legitimating myths put forward by the dominant class” (Tyler 2006, 284). Thus, people might subject themselves to laws that lead to bad outcomes based on embedded narratives that legitimate discrimination and other treatments that diminish and disempower them. This phenomenon can explain the continued adherence to caste rules by low-caste members in India (Hoff and Pandey 2006).

### **Ordering power (the constitutive role of law)**

#### ***Rules about making rules***

3.42 In this second role, law plays the more foundational constitutive role of defining the de jure governance process. It is through law—generally constitutions<sup>21</sup>—that states establish and confer power to state actors, defining the authorities and responsibilities of different agencies and branches of government and their role in the policy-making and implementation process, as well as formal constraints on their power. This is typically done through provisions that set out a range

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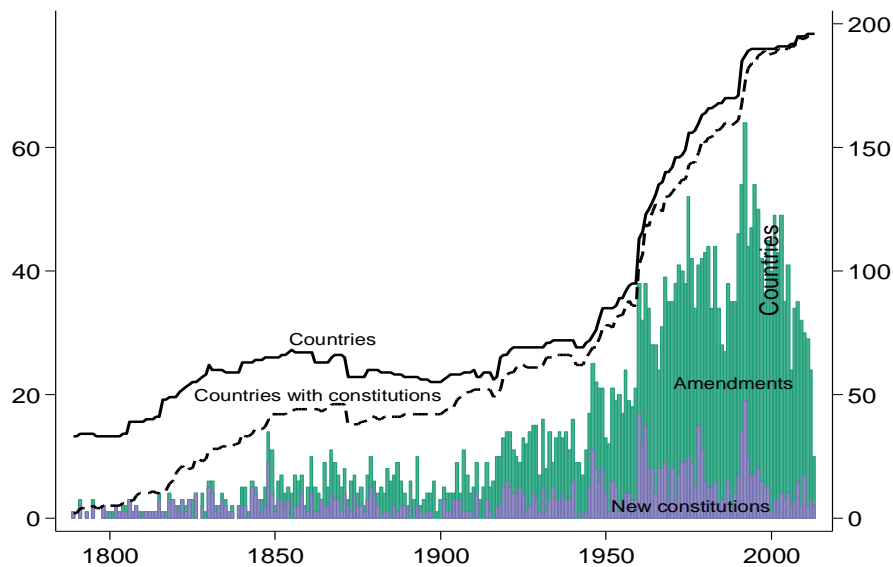
<sup>21</sup> Constitutions are certainly not the only instrument that set out rules about power, but they are the most visible ones and the most systematically studied. A range of other laws that confer authority and define responsibilities and limitations on power, such as local governance laws and enabling laws for various state agencies, are also relevant.

of checks and balances, including through horizontal allocation and separation of powers between different branches; by requiring special procedures for amendment; the establishment of independent supervisory and review bodies; and increasingly, bills of rights. These formal *de jure* arrangements, as modified by informal and *de facto* arrangements, are what establish the nature of the policy arena. In this way, constitutions are effectively rules about making rules. This section addresses the question of why and when the formal rules in fact determine the allocation and limits on power, or when they act only as ‘parchment barriers,’ and what other roles constitutive laws play in shaping the dynamics of governance.

3.43 Constitutions are proliferating (figure 3.2). The increase corresponds to both an increase in the number of independent states as well as the mass transition of Central and Eastern European countries in the post-Soviet era. It also reflects the fact that constitutions are generally short lived. The average life span of a constitution is 19 years, and in Latin America and Eastern Europe, it is a mere 8 years (Elkins, Ginsburg, and Melton 2009; Negretto 2008). Constitutions are thus an important site of political bargaining and ordering, with significant energies invested in designing and adopting them. This is true across all types of political regimes (Ginsburg and Simpser 2014).

**Figure 3.2 Constitutions have become ubiquitous, but are often replaced or amended**

*Number of countries with constitutions and constitutional events, 1789–2013*

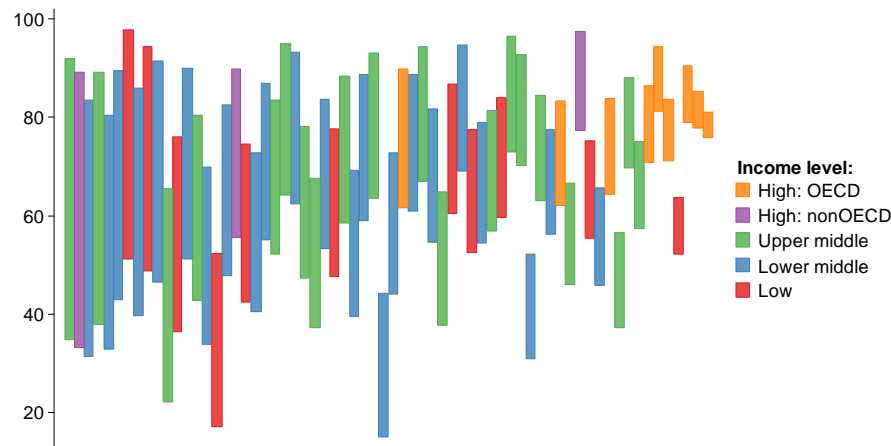


*Source: WDR 2017 team with data from Comparative Constitutional Project 2015.*

3.44 Yet their effectiveness in constraining power through rules is mixed, leading to two kinds of governance failures. The first—as reflected in their short life span—is when the bargain itself fails. The second is when the words on paper persist, but the rules are ignored in the face of power and deal making. In the former case, the result could be positive, to the extent that it leads to a new, more stable bargain. But it could also be detrimental to development outcomes if conflict ensues, and if chronic failure undermines the credible commitments needed to support investment and pro-poor policies—as has been the case in the Dominican Republic and Haiti, which together account for 7 percent of the world’s constitutions. (Elkins, Ginsburg, and Melton 2009). Empirical

evidence regarding the extent to which constitutional endurance matters is mixed. Elkins, Ginsburg, and Melton (2009) demonstrate significant associations between longer-lived constitutions and various social and political goods, including protection of rights, democracy, wealth, and stability, but establishing causality is problematic. In any event, the entrenchment of fundamental principles and its positive impact on credible commitment and coordination generally strengthens as constitutions age.

**Figure 3.3 In every country, there is a gap between laws on the books and the laws implemented, but high-income OECD countries generally do better than low- and middle-income countries**



Source: WDR 2017 team with data from WDI 2015 and Global Integrity 2012.

Note: Global Integrity’s legal index measures the quality of laws “on the books” in six categories: nongovernmental organizations, public information and media; elections; government conflict of interests, safeguards and checks and balances; public administration and professionalism; government oversight and controls; anticorruption legal framework, judicial impartiality, and law enforcement professionalism. The implementation index measures actual practice. The implementation gap is the difference between the two indexes, and thus the length of the bar.

3.45 The second type of failure—widespread divergence between constitutional limitations on power and actual practice—is more directly associated with poorer development outcomes (see figure 3.3). As will be explored in chapters 5 and 6, failure to uphold security of property rights and basic civil, political, and economic rights has negative impacts on both growth and equity. More generally, failure to enforce rule-based limits on power skews the bargaining process in favor of elite interests. Nonetheless, divergence from the rules may also represent an important means of holding together elite bargains. To understand what accounts for divergence between the rules and practice, it is helpful to first examine the conditions under which rules stick.

### *Constitutions as a commitment and coordination device*

3.46 Why would rulers adhere to constitutional rules on the limits of power? Unlike regular laws that have organized institutions of enforcement, constitutions pose the ultimate question of who

guards the guardians.<sup>22</sup> The answer is that effective constitutions need to be self-enforcing. Constitutions are essentially bargains among major interest groups about how to allocate power. As long as these groups feel that they are better off with the rules than without them, the rules will stick. Thus an effective constitution establishes an equilibrium by addressing problems of coordination and commitment (Weingast 2005). Constitutions facilitate elite cohesion by coordinating what institutions play which role, thereby minimizing costs of renegotiation and conflict. The so-called “entrenchment of provisions,” requiring a high standard for change in the form of amendment, provides credibility over time by guarding against shifts in preference, thus enhancing the credibility of commitments (Ginsburg 2009; Ginsburg and Simpser 2013). Once entrenched, the rules become “sticky” as institutionalized arrangements develop around them, and it is far less easy for major interest groups to exit if they become unhappy with the allocation of power. Significantly, constitutions also serve as a coordinating device to enable collective action by citizens in the event of transgression by those in power.

3.47 Analysis of a dataset of every constitution since 1789 finds that enduring constitutions generally have certain common characteristics. They need to be sufficiently inclusive to give potential spoilers an adequate payoff for staying inside the bargain. (How to do so is explored further in chapter 4). They need to be flexible and adaptive so as to be resilient in the face of shocks that can change the balance of power among interest groups. And the degree of specificity also appears to correlate positively with endurance, perhaps because it reduces the scope for subsequent disagreement and requires more investment in negotiation, giving people a bigger stake in success. (Elkins, Ginsburg, and Melton 2009). They are more effective in facilitating monitoring and information, so as to enable citizen collective action for enforcement. Constitutional “bright lines” and clarity of rules are particularly useful in this regard, Weingast (2005) suggests.

3.48 This latter point relates to the way that constitutions act as a focal point. Even when there is little intention to adhere to constitutional provisions—as in the case where constraints on power and rights are adopted as aspirational or rhetorical appeasement—the words on paper can matter to the extent that they enable collective action. This is particularly important during times of conflict among elites, where constitutions can serve as devices of horizontal accountability. Thus, for example, Tunisia’s adoption of international human rights treaties by the prior regime was largely seen as an empty gesture. Yet during the transition, these provisions were seized upon by opposition forces and used to structure the new government. In China and Vietnam, the language of constitutional protection has also been used as a basis for mobilization for politics within elites (Ginsburg and Simpser 2013). As will be discussed more fully, constitutions also serve as an important device of vertical accountability, as the special status accorded to constitutional rights can enable citizen collective action for their fulfillment.

### ***Explaining divergence between law and practice***

3.49 A number of studies have sought to demonstrate empirically how different institutional designs optimize coordination and commitment for different configurations of elite interests. In theory, different political institutions—such as presidential versus parliamentary, or majority vote versus proportional representation—create different incentives that favor certain outcomes.<sup>23</sup>

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<sup>22</sup> Regular laws are also plagued by this same question. It is for this reason that Basu (2015) emphasizes that laws work only to the extent that they establish credible expectations about what others will do.

<sup>23</sup> See, for example, Buchanan and Tullock 1962; Persson and Tabellini 2003; Voigt 2011.

Actual outcomes, however, depend on the extent to which these de jure rules are in fact used as the main locus of political activity: that is, whether or to what extent political actors choose to invest in these institutions, such that they become a self-reinforcing equilibrium (Caruso, Scartascini, and Tommasi 2015).<sup>24</sup>

3.50 In many developing countries—and to a certain extent, in developed ones as well—power is often exercised through means other than those prescribed by law, sometimes referred to as “alternative political technologies” (Caruso, Scartascini, and Tommasi 2015), or “informal institutions” (Helmke and Levitsky 2004; Khan 2010). These include a variety of means of making bargains and deals outside the rules, including conventions for brokering power; clientelism; and purchasing favor (bribery, vote buying); as well as through nonstate authority structures, such as traditional or religious mechanisms. In some cases, the use of means of exercising power not based on law is simply a matter of deviance and abuse. But often it is serving the purpose of solving commitment and collective action problems in ways more in line with elite incentives and the de facto distribution of power. In such cases, as Mushtaq Khan (2010) explains, “[i]nformal institutions like patron-client allocative rules, and informal adaptations to the ways in which particular formal institutions work play a critical role in bringing the distribution of benefits supported by the institutional structure into line with the distribution of power.” In other words, divergence between the law and practice is rarely an absence of rules, but rather a replacement of law with rules that may be better suited—under the circumstances—to generate and meet shared expectations so as to uphold basic stability through elite bargains (North and others 2013). The conditions under which deals-based elite bargains evolve into rule-based governance constrained by law is the subject of chapter 7.

3.51 Divergence between the laws on paper and actual practice can also be an unintended consequence of laws that conflict with existing power structures, such as when local governance laws fail to take into account local contexts of power and norms. The impact of a land law in Senegal shows how the complex interaction of law, norms, and power yields different results even in the same country. The law sought to constitute rural councils and endow them with authority to allocate land according to productivity. While the law met with some success, it also yielded three unintended results. In some cases, rural councils were never established and land governance continued to be exercised by customary authorities. In other cases, rural councils became a vehicle for patronage and elite capture, leading to land grabs by elites. Finally, in some areas, land governance became dysfunctional as preexisting customary systems, rural councils, and district government authorities overlapped, with inconsistent outcomes (Hesseling 2009).

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<sup>24</sup> This discussion draws on Aoki 2001 and Greif 2006.



### Ordering contest: The change role of law

*It is true that in history the law can be seen to mediate and to legitimize existent class relations. Its forms and procedures may crystallize those relations and mask ulterior injustice. But this mediation, through the forms of law, is something quite distinct from the exercise of unmediated force. The forms and rhetoric of law acquire distinct identity which may, on occasion, inhibit power and afford some protections to the powerless.*

—E. P. Thompson (1975)

3.52 Law’s role in ordering behavior and ordering power is primarily about how elites use law to implement policies and to exercise authority. The third role of law examines how citizens—non-elites—use law to challenge and contest the exercise of power. As the preceding quotation by the historian E. P. Thompson shows, law is simultaneously a product of social and power relations, and a tool for challenging and reshaping those relations. This section will examine how law, often in combination with other social and political strategies, can be used as a commitment and coordination device to promote accountability, and also to change the rules of the game to foster more equitable bargaining spaces.

3.53 In well-developed legal systems, it is the role of legal institutions to promote accountability through horizontal checks on authorities and by providing a forum for vertical claims by citizens. These legal institutions include courts and associated agencies such as prosecutors and police; special purpose adjudicative and oversight bodies, such as ombudsmen, auditors, and anticorruption or human rights commissions; and the public administrative law functions of executive agencies: for instance, those involved in property allocation and registration, the issuance of identity documents, or the provision of health, education, and sanitation services. The extent to which these institutions are accessible and effective forums for citizens to challenge the more powerful varies considerably from country to country, as a function of historical circumstances as well as political calculus of elites. The Spotlight on Effective Legal Institutions discusses this in depth.

3.54 Even while legal systems in many countries continue to lack effectiveness and autonomy, there has been a marked trend toward juridification of social and political contest across the globe. As Rodriguez-Garavito (2011: 274–275) has noted, “the planetary expansion of the law is palpable everywhere, from the avalanche of constitutions in the Global South in the growing power of judiciaries around the world; in the proliferation of ‘law and order’ programs and the ‘culture of legality’ in cities; in the judicialization of policy through anticorruption programs led by judges and prosecutors; in the explosion of private regulations, such as the voluntary standards on corporate social responsibility; and in the transmutation of social movements’ struggles into human rights litigation.” Law increasingly provides the common language for, and demarcates the arenas of contest among, very different contenders: citizens and states; multinational corporations and indigenous people; states, citizens and international organizations.<sup>25</sup>

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<sup>25</sup> Comaroff and Comaroff 2001; Hirschl 2004; Santos and Rodriguez-Garavito 2005; Rajagopal 2003.

### ***Law and social rights***

3.55 In one example of how law is changing the contestability of policy arenas, a majority of developing countries have adopted social and economic rights in their constitutions, and citizens are increasingly using these provisions to advance development goals. (Brinks, Gauri and Shen 2015). This trend has been most striking in Latin America, where courts have transformed from weak, dependent and ineffective institutions to central players on issues at the forefront of politics and development. A key reason for this shift in role is that judicial actors have been emboldened by political fragmentation to assert the power of their institutions at the same time that citizens are demanding this role. (Helmke and Rios-Figueroa 2011; Huneus, Couso and Sieder 2010). In India, legal institutions—at least at the level of the Supreme Court—have also proven to be an important site of contest, with an extensive tradition of public interest litigation and high-profile legal challenges to dominant power interests and social norms.<sup>26</sup> The Indian Supreme Court has served to uphold the rights of the disadvantaged and enhance government accountability over such issues as child and bonded labor, environmental hazards, public health, and nondiscrimination (Deva 2009; Shankar and Mehta 2008). Courts in South Africa have also made important judgments holding government accountable to the provision of housing and to affordable antiretroviral drugs, among other things (Berger 2008; Klug 2005).

3.56 Importantly, in social justice litigation, the legal action itself need not result in a favorable judgment to be a successful part of contest. Even judicial defeats can be leveraged by activists to coordinate collective action around rights consciousness. (McCann 2004; Rodríguez-Garavito and Rodríguez-Franco 2015). As will be explored further in chapter 8, the success of such efforts depend to a large degree on the ability of claimants to ground the language of rights in local social and political structures of demand—a process Brinks, Gauri, and Shen (2015) call “vernacularization.” As Santos and Rodríguez (2005) argue, political mobilization at the local—and often international—level is a necessary precursor to effective rights-based strategies for the disadvantaged. Hence, efforts to empower the aggrieved to use law and courts must combine legal awareness with broader strategic coalition building.

3.57 Law has also proven to be a powerful tool of accountability even outside of legal institutions, by framing claims and serving as a coordinating device. For example, in China, citizens are increasingly deploying official laws and policies in efforts to hold district officials accountable for illegal extraction, rigged elections, and corruption: a process dubbed “rightful resistance.” Courts seldom feature in these efforts, which tend to “operate near the boundary of authorized channels, employ the rhetoric and commitments of the powerful to curb the exercise of power, hinge on locating and exploiting divisions within the state, and rely on mobilizing support from the community” (O’Brien and Li 2006). The use of legal discourse, without recourse to courts, has also played a central role in tenant associations’ claims to adequate housing in Kenya, indigenous groups’ contests over land and natural resources in Mexico, and garment workers’ efforts for fair labor conditions in Bangladesh. (Newell and Wheeler 2006). In these cases, law serves to ‘name and frame’—that is, to structure dialogue and provide a coordination device for more contentious strategies for accountability.

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<sup>26</sup> The trend of public interest litigation in India, however, has been criticized as shifting in recent years from pro-poor causes to promoting interests of upper classes (Gauri 2009). Indeed, if law and legal institutions can be used for pro-poor ends, they can likewise be used for other causes (Scheingold 2004).

### ***Legal institutions and credible commitment***

3.58 Where state legal institutions have lacked the capacity for credible commitment, they have, in some cases, sought support from international actors. Thus, for example, aware of the inability to commit to fair anticorruption procedures against powerful interests, Guatemala sought United Nations support to establish the International Commission against Impunity in Guatemala (Cicig), which has successfully prosecuted over 150 current or former government officials, and charged the sitting president, leading to his resignation. A number of countries, including Bosnia and Herzegovina, Cambodia, Fiji, Kosovo, and the Solomon Islands, have relinquished sovereignty to allow international judges and prosecutors on their courts to enhance credible commitment around sensitive and political cases. While these initiatives have led to successful prosecutions of sensitive war crimes and corruption cases, they have also been criticized for lack of sustainability in that they bypass rather than engage directly in the domestic bargaining arena.

3.59 Where domestic courts are perceived as weak in the face of powerful interests, citizens have brought legal cases to other jurisdictions. This has been facilitated by a growing recognition of the concept of universal jurisdiction for very severe crimes, as well as by the increasingly transnational character of powerful interests. For example, local communities affected by severe environmental damage caused by a mining company in Papua New Guinea sought redress in an Australian court, the home jurisdiction of the company. While the legal case itself was settled and was not wholly successful in containing the damage, it triggered a change in the local bargaining arena, mandating that community representatives be engaged in negotiating community development agreements with the company and government (Kirsch 2014).

### ***Transnational legal pluralism and contestability***

3.60 The legal arena today spans beyond nation states in other ways as well. As will be discussed further in chapter 9, we are in an era of ‘global governance’, characterized by a proliferation and fragmentation of global, regional, and transnational instruments including binding laws (so-called hard law, including treaties and conventions) and soft law (voluntary guidelines, standards, principles and codes of conduct). The domains covered by these instruments go far beyond relations among nation-states to reach deep into the way national state and non-state actors govern in many areas, including business, labor, crime, information, public financial management, intellectual property, procurement, utility regulation, human rights, food and safety standards, and environmental sustainability. The formation of these transnational governance regimes parallels this Report’s framework: they are the product of contests between multiple actors—state, private, civic—that are shaped by power, interests, and norms, which in turn are shaped and reshaped by the outcomes of these regulations (Braithwaite and Drahos 2000).

3.61 This web of legal pluralism creates opportunities for domestic actors seeking to contest prevailing power and norms. Sweat shop workers in Mexico and Guatemala successfully appealed to international labor standards and company codes of conduct to improve working conditions and unionization where domestic laws did not allow for it. Critical to success was their linkages with transnational advocacy networks that exerted pressure on local governments. (Garavito-Rodriguez 2005). Cambodian garment workers also benefited from international labor standards that served as a commitment device for the government in order to gain favorable trade conditions. (Adler and Woolcock 2009). Indigenous groups have been key players in the formation of international

standards for extractive industries, in particular the norm of free prior, informed consent. (Garavito-Rodriguez 2011). In these examples legal standards were converted into institutional arrangements that enhanced the contestability of the bargaining arena: collective bargaining arrangements, a tripartite labor arbitration council, and procedural requirements for consultations between extractive companies and local communities.

### Law in the governance framework

3.62 This chapter has unpacked the three roles that law plays in this Report's governance framework. Law is a key instrument through which policies are codified and implemented to order behavior; it is also an important tool for allocating and constraining power; and it is a critical vehicle for ordering contestation. Across these roles law simultaneously shapes and is shaped by power and norms, and the effectiveness of law depends on its ability to act as a commitment device and to enable collective action by coordinating expectations about how others will behave.

3.63 Divergence between the law on paper and what actually happens occurs when law is not backed up by credible commitment. This can be the result of weak legal institutions, for example, dysfunctional courts and enforcement mechanisms. But implementation gaps are often the result of the law conflicting with the interests of those who have power to block it, as we have seen in many efforts to deal with elite corruption through legal mechanisms. Prevailing social norms can also undermine the effectiveness of law, for example, where deeply held norms regarding gender run counter to legal prescriptions.

3.64 Law is not, however, simply a tool of the powerful. Scholars have noted a global trend toward the increased use of law and legal instruments as an important site for bargaining, enshrining and challenging policies and their implementation from transnational business regulation to environmental impacts to political transitions. By its nature law is a device that provides a particular language, structure and formality for ordering things, and this characteristic gives it the potential to become a force independent of the initial powers and intentions behind it. Thus, even where state capacity and legal institutions are weak, law can be a powerful instrument for enhancing collective action of state and nonstate actors to press their interests and change the nature of the policy arena. It is through this dynamic between power and contestation that societies shape their relationship with the rule of law.

#### Box 3.5 Understanding the role of law in context

As this chapter has argued, law is not an unqualified good. Depending on the context, law might functionally:

empower change actors	or	reinforce existing power
provide order and certainty	or	create conflict and exacerbate confusion
build legitimacy	or	undermine legitimacy
structure contests	or	distract from real sites of contest

In order to produce the effects on the left side rather than the right side, legal interventions should ensure that the forms prescribed by law are able to demonstrate commitment and to induce collective action toward the desired end. Specifically, effective laws are able to:

- Change preferences by enhancing substantive focal points around which coordination can occur
- Change incentives by changing payoffs to lower the cost of compliance, or increase the cost of non-compliance
- Shape bargaining spaces that increase contestability by under-represented actors

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### Spotlight 3 Legal and justice institutions

S3.1 Closing the gap between law on paper and in practice requires the existence of well-functioning legal institutions. Effective and equitable legal institutions operate as safeguards against abuses of power and channels for the protection of rights and peaceful resolution of conflict. Well-functioning legal institutions are important to elicit voluntary compliance by signaling legitimacy. By reducing transaction costs and increasing the predictability of behavior and certainty of process, they underpin credible commitment, which is needed to modernize socioeconomic relations.

#### *What are well-functioning legal institutions?*

S3.2 Core state legal institutions include those that declare law (legislatures, government agencies); enforce law (prosecutors, regulators, police, prisons) and apply law to individual instances (courts). These institutions must operate in an integrated fashion with the cadre of private lawyers, academics and civil society engaged in legal activity—the so-called “legal complex” (Karpik and Halliday 2011). They also require an appropriate enabling environment, including legal mandates, functional institutional systems and rules, and financial, human, and material resources. They need to be physically and financially accessible to the population, while resonating with peoples’ needs and perceptions of fairness so as to generate trust. To act as an effective check on power, courts especially need to be *independent* of political pressure, while remaining *accountable* and *effective* in that they are able to compel compliance with their decisions.

#### *Under what conditions do well-functioning legal institutions emerge?*

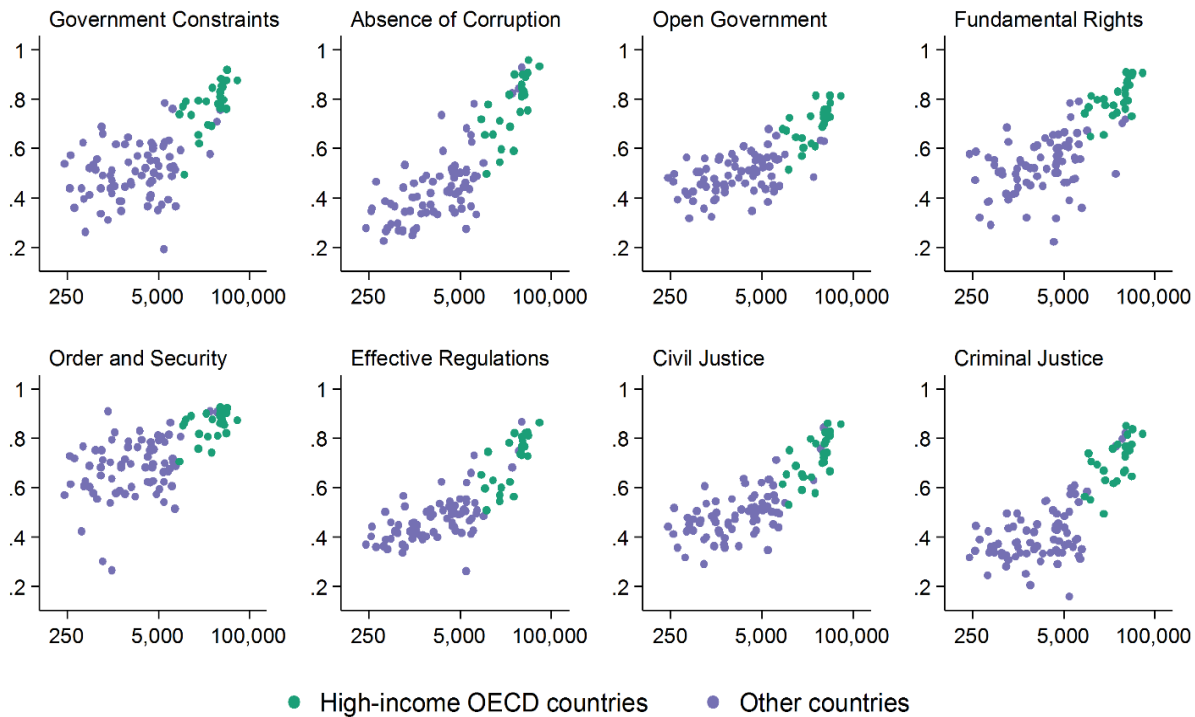
S3.3 All high-income OECD countries score well on de jure and de facto indicators of rule of law, including judicial independence, accountability, and effectiveness. This relationship illustrates the need for such institutions to support sophisticated and diversified economic models. But as this Report has emphasized, simply transplanting institutional forms to developing countries does not work; they need to emerge in a homegrown fashion from internal governance dynamics that reflect socioeconomic demands and other incentives. As figure S3.1 shows, there is a positive correlation between rule of law and income observed today, but this does not explain causality nor how countries move up the scale. The empirical and theoretical literature points to four factors that are most likely to contribute to the development of judiciaries that can act as effective check on power: historical factors, institutional factors, strategic factors, and ideational factors.

S3.4 *Historical factors.* One explanation for why some judiciaries emerge as credible and effective, while others do not, is rooted in the historical circumstances—in particular, colonial legacies—in which the modern justice system developed. Where colonial legal systems and their national aftermaths sought to incorporate, accommodate, and adapt to the contending normative orders of society, national law and courts have emerged as relatively effective and legitimate institutions, as has been the case in India. By contrast, where colonial systems created fragmented spaces of Western law and indirect rule through which native authorities were often invented, as in Nigeria and Kenya, national law and courts faced an uphill battle in establishing credible commitments to legality. While these dynamics tend to persist in some ways (through path

dependency), they are constantly renegotiated in response to underlying patterns of social and economic change (Daniels, Trebilcock and Carson 2011).<sup>1</sup>

**Figure S3.1 While high-income OECD countries generally have well-functioning legal institutions, the relationship between institutional quality and income varies in developing countries**

*Various rule of law indexes versus GDP per capita (log scale)*



Source: WDR 2017 team with data from World Justice Project (2014) and World Development Indicators (2016).

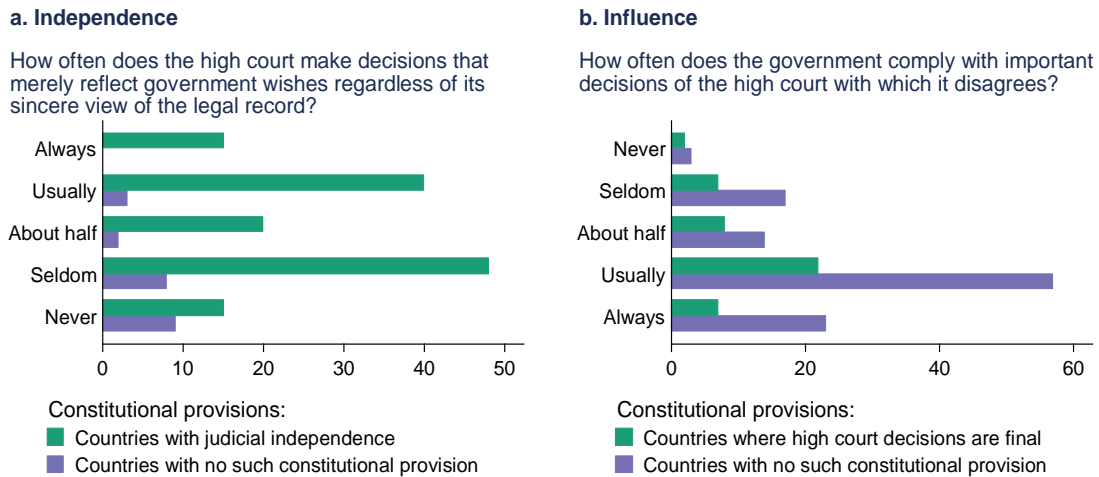
S3.5 *Institutional factors.* Courts are governed by an array of rules—constitutional and otherwise—that shape the independence, accountability, and effectiveness of the judiciary, including judicial appointment and disciplinary procedures, the scope of judicial review, case management systems and procedures, legal standing, and access. Judicial reform efforts often focus on strengthening such formal rules to protect judges from political pressure, incentivize efficiency, and promote access and transparency.

S3.6 But, as figure S3.2 shows, even the most stringent constitutional guarantees of independence and best practice forms of judicial appointment often do not correlate with de facto measures of independent judicial behavior (Feld and Voigt 2003; Rios-Figueoia and Staton 2012). Moreover, the same formal rules can produce different incentives, depending on broader contextual factors (Helmke and Staton 2011). At the same time, empirical studies show that seemingly minor technical rule changes can have major effects on a court’s role and assertiveness. For example, obscure rules regarding who has the right to bring a case (“standing rules”) were

<sup>1</sup> For more nuanced discussion of how legal cultures were forged by a dynamic interplay between imperial policies and native agency, see Yannakakis 2015.

instrumental in the rise to prominence of the Indian and Costa Rican courts. In short, rules matter, but their relationship to judicial effectiveness in practice is mediated by strategic and ideational factors (Helmke and Rios-Figueroa 2011).

**Figure S3.2 The correlation between de jure and de facto measures of judicial independence is weak**



Source: WDR 2017 team with data from V-Dem Institute (2016) and Comparative Constitutional Project (2016).

**S3.7 Strategic factors.** The first set of strategic factors relates to the calculus elites undertake to determine under which conditions they would endow courts with autonomy and effectiveness, given that this may be used against elite interests. The literature points to five key reasons. First, elites may strengthen judiciaries to *signal credible commitment for commercial investment* by raising the cost of political interference with economic activity, as has been the case in several fast-growing economies like China. The establishment of robust judicial institutions may also be in response to requirements for engagement in international organizations and transnational trade regimes (Moustafa and Ginsburg 2008). Second, elites may endow courts with capacity in order to use them to *enforce central policy, control agents, and maintain elite cohesion*. This was a key aim behind Mexico's introduction of the mechanism of *amparo*, allowing citizens to challenge arbitrary action by individual bureaucrats (Magaloni 2008).

**S3.8** Third, elites may bind their hands by establishing powerful courts during periods of political uncertainty as *political insurance* to protect their policies from being undermined in the event of a government transition (Ginsburg 2003; Staton and Moore 2011). Fourth, judicial review of legislation can serve an important *information-gathering role* for policy makers when they are unsure of how laws and policies will play out in practice (Staton and Moore 2011). Finally, elites may empower courts in order to *channel controversial political questions away from majoritarian institutions*. The Egyptian Supreme Constitutional Court was able to overturn socialist-era policies while shielding the executive from opposition (Moustafa 2007).

S3.9 In being used strategically by elites in these five ways, courts may be empowered with autonomy for some types of cases, but not others—and that power may be taken away when it no longer serves elite interests. But even limited autonomy may create spaces for judicial actors to assert themselves and to strategically expand their role. Judges’ calculus must take into account their institutional powers, but also the likelihood of compliance with their rulings. There is strong evidence that judiciaries are more likely to exercise power in cases of political uncertainty or fragmentation because this reduces the ability of others to put political pressure on courts. This accounts for the emergence of autonomous judicial behavior in Brazil, Indonesia, and Mexico, among other countries (Helmke and Rios-Figueroa 2013; Dressel and Mietzner 2012). Public expectations and demands on courts are also an important factor in this calculus, as is the broader role played by the private bar, legal academia, and other legal actors (Shapiro 2013; Halliday 2013). Judicial autonomy and effectiveness is thus an outcome of strategic interactions among the judiciary, other branches of government, and the public (McNollgast 2006).

S3.10 The experience of the Supreme Court of India illustrates this process. While endowed on paper with expansive constitutional powers of judicial review and rights protection, the Court initially played a very limited role in practice. The executive sought to keep it away from the regime’s policies by packing the Court with regime supporters and declaring emergency rule, curbing its powers. As India transitioned to multiparty politics and a coalition government, the Court began to assert its independence by expanding popular access to the Court through public interest litigation. Initially limiting its activism to issues that did not directly challenge elite interests, the Court gradually consolidated its strength through popular support (Mate 2013).

S3.11 *Ideational factors.* Despite having favorable institutional rules and strategic opportunities to consolidate power, some judiciaries remain constrained. The final factor concerns what is called legal culture: that is, the “contested and ever-shifting repertoires of ideas and behaviors relating to law, legal justice and legal systems” (Couso, Huneus and Sieder 2010). Simply stated, ideas, norms, beliefs, and values matter. For example, judges in Chile have been constrained by a tradition of legal formalism. By contrast, in Colombia, judges’ perceptions of their own role have shifted as indigenous groups have increasingly employed rights-based strategies (Domingo 2010). A social network analysis of Mexican judges depicts how professional networks can diffuse fundamental ideas about the role of judges (Ingram 2016).

### ***Implications for judicial reform efforts***

S3.12 Analyzing how these factors play out in a given context can help identify what kind of reformist activities are most likely to have traction. Investments to improve the efficiency and effectiveness of commercial courts, for example, may take root where elite incentives and business demands align in favor of effective impartial courts. Investments to strengthen citizen access and empowerment and improve judges’ perceptions of their own roles are more likely to prove fruitful where strategic opportunities exist to expand the judicial role to limit abuse of power and protect rights. Conversely, the absence of such conditions may undermine efforts to build the capacity of legal institutions.

S3.13 Where conditions do not favor empowerment of formal legal institutions, reformists can look to a broader set of formal and informal institutions that may be relevant in terms of meeting the key functions of commitment, coordination, and cooperation for particular issues. Commitment



devices for commercial transactions include reputational considerations that might be served by industry mechanisms of alternative dispute resolution.<sup>2</sup> A range of customary, communal, and/or nonstate institutions may serve as effective cooperation mechanisms to resolve social and economic disputes peacefully. Neighborhood mediation in urban Papua New Guinea has proven functionally capable of managing disputes within communities in ways that formal police and courts have not. Tribal and customary courts in Afghanistan, Liberia, and South Sudan have brought closure to vengeance killings, land disputes, and a range of social concerns, where formal mechanisms in some cases have exacerbated tensions. (Isser 2011). In such cases, efforts to improve desired functions will be better served by understanding the strengths of existing institutions, and seeking to enhance and complement their functional capacity by expanding accountability.

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<sup>2</sup> For examples of social mechanisms of commitment, see Greif (2006), Dixit (2004), and Ellickson (1991).

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## Part II

# Governance for Development



## Part 2 Introduction

### Governance for development

1. Part II of the Report applies the framework to three core development outcomes: security in chapter 4, growth in chapter 5 and equity in chapter 6. It looks at how commitment, cooperation, and coordination fundamentally underlie the effectiveness of policies to promote these outcomes. It then unpacks how the distribution of power can constrain that effectiveness, taking into account how the process of development itself—such as the composition of growth or the level of inequality—influences the relative bargaining power of certain actors, *de facto*. Ultimately, it explores how enhancing contestability in the policy arena, effectively changing incentives, and reshaping preferences and beliefs of different actors—for example, through leadership—can make policies more effective to deliver on development over time.

2. *Governance for security.* Governance can lead to better security and less violence—under certain conditions. Security can prevail when certain forms of governance, such as power sharing, resource redistribution, dispute settlement, and sanctions, are able to create incentives for actors not to use violence. Solving commitment and cooperation problems is critical. When cooperation is lacking, contending sides may walk away from the bargaining table, and citizens may not comply with the governments' rules. When commitment is not credible, violence may become the preferred way to resolve conflicts. Warring factions may renege on peace agreements, policy makers may default on promises to transfer resources to discontented groups or regions, disputants may fail to abide by court judgements, or policemen may abuse citizens instead of protecting them. The degree of cooperation and the credibility of commitments can be improved by establishing constraints on unchecked power, and mechanisms which do not exclude relevant individuals and groups from the policymaking process. This can lower the likelihood of violence and open the door to economic growth.

3. *Governance for growth.* Governance matters for investment and productivity, the two drivers of economic growth. The credible commitment of governments to protect property rights, enforce contracts, and enhance market competition gives individuals and firms incentives to reinvest their profits, innovate, and increase their productivity. The relative power and influence of different interest groups determines the credibility of this commitment. The capture of the policy-making and policy implementation processes by private interests can undermine the effectiveness of institutions and slow down economic growth. Preferential treatment for connected firms and barriers to entry for newcomers—such as access to loans, ease of licensing requirements, or import barriers—stifles competition and leads to resource misallocation, with a toll on innovation and productivity. Designing policies that are compatible with the existing balance of power may be more effective than designing policies that are best from a technical point of view, but have a high risk of capture by powerful groups. To elicit government commitment and compliance by citizens and firms, policies need to address, and eventually overcome, incentive structures that allow small numbers of self-interested individuals and groups to capture policy making and resource allocation, undermining equity.

4. *Governance for equity.* Policies that allocate and redistribute resources—including the proceeds of growth—within and across generations enhance equity. The two main redistributive policy instruments are the provision of public goods and services, and fiscal policies for public

spending and revenue collection. Commitment to broad-based redistribution may be weak when power imbalances are strong. Officials may target benefits to narrow groups of citizens in exchange for political support, or may capture public spending through means such as the diversion of financial resources, if accountability mechanisms are not strong, for instance. In other cases, officials may be responsive only to those citizen groups that wield greater influence, such as favoring the interests of teacher unions over those of students. If resources are likely to be redistributed away powerful interests, they are likely to resist and counter the adoption and implementation of policies to enhance equity. Giving powerful actors incentives to adopt and implement redistributive policies can improve equity. At the same time, collective action to improve citizen participation and reduce the capture of the policy-making and policy implementation processes is essential to adopt and sustain equity-enhancing reforms.



## Chapter 4 Security and governance

### Can governance solve the problem of violence in society?

4.1 Sometime around 1775 BCE, Zimri-Lim, the king of the ancient Mesopotamian city of Mari, in today's Syria, left us with the world's earliest account, engraved on a clay tablet, of the use of arbitration and restitution to settle a dispute between two of his vassals. He wrote, addressing one of them: "You have raided his country. Everything you took, gather it together and return it" (Munn-Rankin 1956: 95). On another occasion, the king negotiated a power-sharing agreement over a contested city with a more famous rival, king Hammurabi of Babylon. Bargaining extended over several years—"Remove [that city] from the treaty tablet and I shall commit myself!" offered Hammurabi at one point—but no agreement could be reached, a consequence of the uneven balance of power between the two kingdoms (Heimpel 2003: 379). War ensued, and in 1759 BCE, the king of Babylon destroyed Mari, boasting that he "turned the land into rubble heaps and ruins," and displaced its entire population (Heimpel 2003: 177).

4.2 Can dispute settlement, power sharing, restitution, and other forms of governance solve the problem of violence in society? Yes, under certain conditions. Violence recedes when individuals, groups, and governments have incentives not to use it, and when not using it eventually becomes the norm. Institutions of governance create incentives to reach agreements (that's cooperation) and enforce them (that's commitment) that prevent, reduce, or end violence. When forms of governance such as power sharing, resource redistribution, dispute settlement, and sanctions solve commitment and cooperation problems in ways that create incentives not to use violence, security prevails. When they do not, violence prevails. In the absence of cooperation, contending sides walk away from the bargaining table, and citizens do not comply with governments' rules. When commitment is not credible, warring factions renege on peace agreements, policymakers default on promises to transfer resources to discontented groups or regions, disputants fail to abide by court judgements, policemen abuse citizens instead of protecting them, and violence ensues.

4.3 Discrepancies in the distribution of power between groups with conflicting preferences, the exclusion of certain groups from the bargaining table around which policies are made and implemented, and certain norms of behavior determine the degree of cooperation and the credibility of commitments, and ultimately, the likelihood of violence. Constraints on unchecked power, more contestation around the bargaining table, and in the longer term, changes in norms of behavior, are how governance can lead to less violence and better security outcomes.

### Security, governance, and development

#### *Security is a precondition for development*

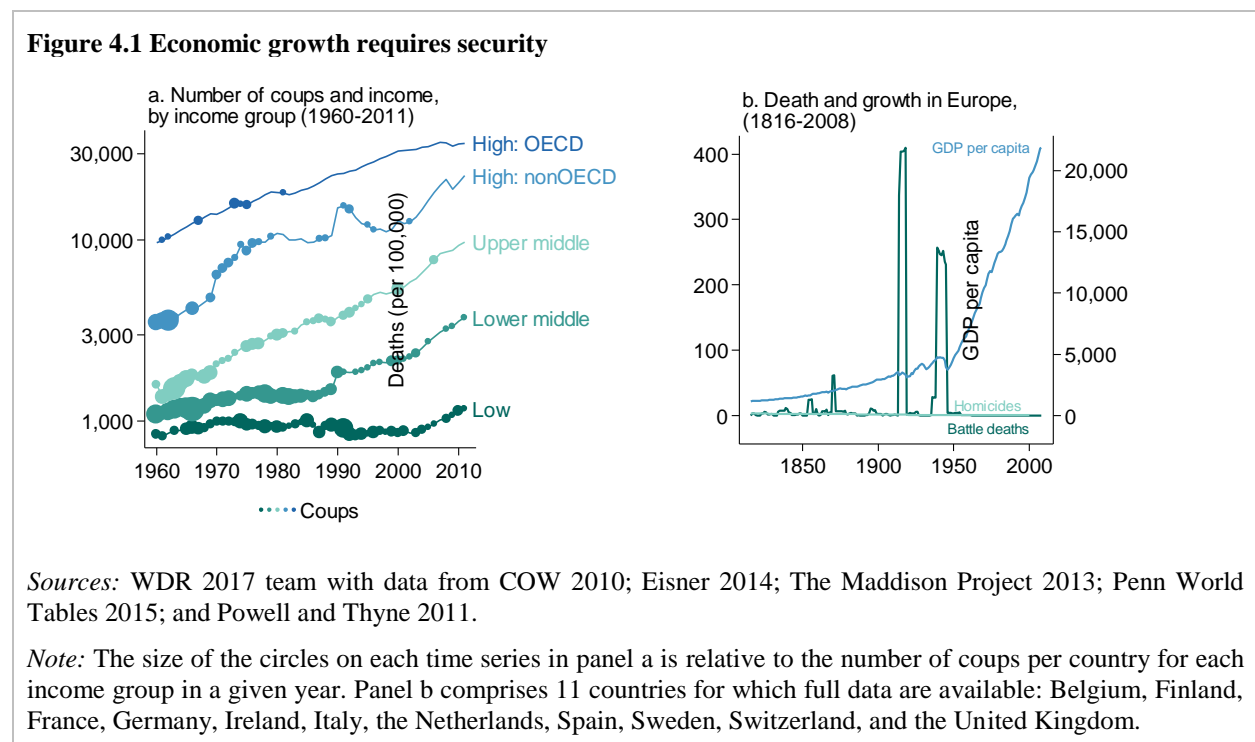
4.4 *Security*—the security of people—is the freedom from violence and the threat of violence (coercion).<sup>1</sup> It is a fundamental dimension of well-being, and a first-order characteristic of

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<sup>1</sup> This chapter is about the security of people, as opposed to national security, or the security of territories. Also, the particular threat it discusses—violence—means that the definition of security used here is narrower than "human security" (where threats are multiple, ranging from loss of income to food shortages, infectious diseases, and environmental threats, in addition to violence) yet broader than "citizen security" (where the threat is violence, but mainly that stemming from crime). The chapter does not discuss other threats, but recognizes that they can lead to

development (Sen 1999, UNDP 1994). The security of property and contracts means little if people themselves are not secure. In addition to being an important value in itself, security is also instrumental for welfare because violence and the threat of violence disrupt economic activity, divert and destroys goods and resources, increase uncertainty and transaction costs, and affect the productive capacities of individuals and societies (World Bank 2011; Ibáñez and Moya 2010). Rather than representing discrete, opposed states, security and violence are on a continuum. This is why this Report measures security as the reduction in the incidence of violence.<sup>2</sup> The threat of violence, however, is difficult to measure. Compounding the measurement challenge is the overlapping and coexistence of situations of violence and security (Raeymaekers 2013).

4.5 More secure societies are more prosperous (figure 4.1). Most of the growth of higher-income countries between 1950 and 2011 is actually not from experiencing faster growth, but rather from shrinking less—and less often—from crises or wars than lower-income countries (figure 4.2). In the even longer run, annual data on 14 European countries and the United States starting in 1820 shows a sharp reduction in the frequency of shrinking after 1950, the period following World War II, which was the last mass scale episode of organized violence in these countries (Wallis 2016).

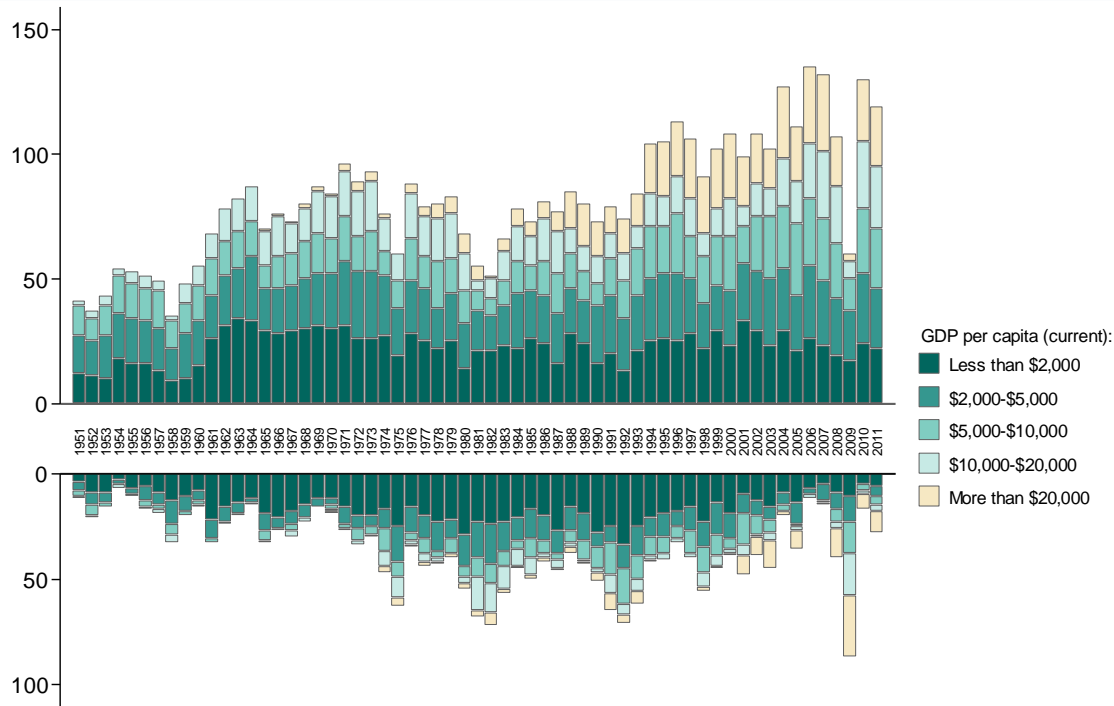


conflict and violence. In addition, the chapter defines violence as the use of physical force intended to kill, harm, or destroy.

<sup>2</sup> Peace, a concept even broader than security, and not addressed in this chapter, is measured by the level of safety and security in a society, the number of international and domestic conflicts, and the degree of militarization. See Global Peace Index 2015 report (Institute of Economics and Peace 2015).

**Figure 4.2 Growing faster does not explain long-term growth; shrinking less from crises or wars—and less often—does**

*Number of countries experiencing positive or negative annual growth in income per capita, by income level, 1951–2011*



Sources: WDR 2017 team, based on Wallis (2016) with data from the Penn World Tables 2015.

Note: Countries are categorized by per capita income (in terms of purchasing power parity, PPP) in the given year.

4.6 In 2014, a good 3,800 years after the violent Mesopotamian episode of Babylon and Mari, more than 1.4 billion people lived in countries affected by violence (OECD 2014). More than 740,000 people die each year as a result of armed violence.<sup>3</sup> The majority of these deaths—490,000—occur in countries not affected by ongoing wars (Geneva Declaration Secretariat 2015). Homicides claimed an average of 377,000 lives between 2007 and 2012;<sup>4</sup> civil wars, rebellions, and other forms of political violence caused 101,400 fatalities in 2014 alone (UCDP/PRIO 2015). There were 57.7 million displaced persons worldwide at the end of 2014 (UNHCR 2015). Violence

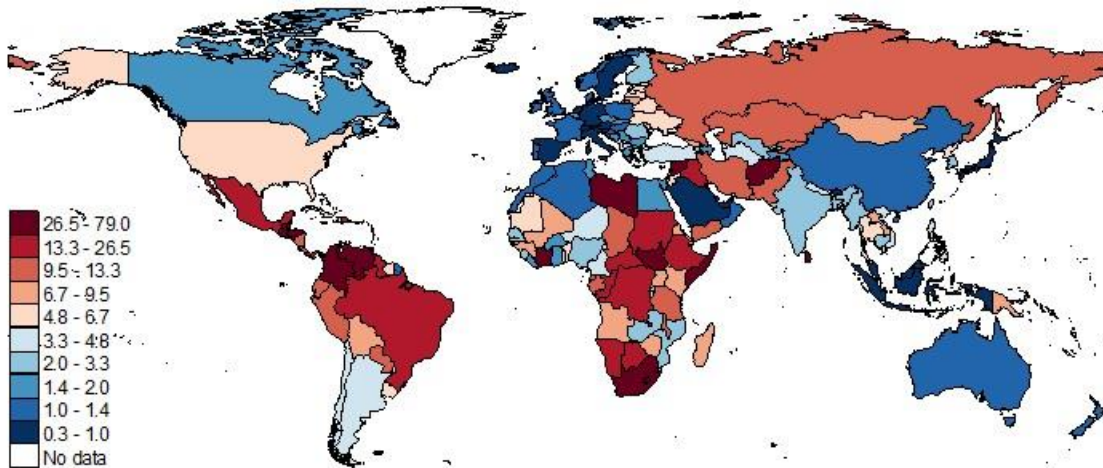
<sup>3</sup> This chapter uses a single framework—a unifying model of violence—to address the relationships between governance, security, and development, and applies the model to all types and actors of violence. There are many typologies of forms of violence, which often overlap, including violence from civil war, repression, rebellion, coups, interstate conflicts, and genocides; also violence from gang activity, terrorism, piracy, and organized crime; communal violence; urban violence, riots, and civil strife; and interpersonal and gender-based violence. A particular characteristic of modern violence is that these forms of violence can combine and the lines between them become blurred (Geneva Declaration Secretariat 2015; World Bank 2010 Violence has also many agents or actors. Governments, political militias, rebels, criminal gangs, communal militias, rioters, and external armed forces can all be sources of violence in a country. Sometimes it can be difficult to tell them apart. Different actors of violence often operate side by side at a given point in time; violence also mutates over time, and so do the identities and affiliations of its perpetrators.

<sup>4</sup> WDR 2017 team based on Global Burden of Armed Violence Report 2015. These figures are for intentional homicides. The number rises by 3,864,000 if unintentional homicides are included. The World Health Organization (WHO) defines homicides as “injuries inflicted by another person with intent to injure or kill, by any means.”

is a major problem in 37 countries (map 4.1).<sup>5</sup> The list includes not just weak, low-income states such as Afghanistan, Somalia, and South Sudan, but also strong, rising economic giants like Brazil, Mexico, and South Africa.

**Map 4.1 Violence is a major problem for more than 1.4 billion people**

*Violent deaths per 100,000 residents per year, 2008–12*



*Source:* WDR 2017 team based on COW 2015; Global Burden of Armed Violence 2015; WDR 2011.

*Note:* Violent deaths comprise organized violence and homicide deaths.

4.7 The cost of violence to development outcomes is staggering (figure 4.3). In 2015, violence cost the global economy \$14.3 trillion, or 13.4 percent of world GDP. This cost has risen by more than 15 percent since 2008.<sup>6</sup> Violent conflict has a negative impact on GDP per capita (figure 4.4). Civil war reduces growth by around 2.3 percent a year (Collier 2007; Dunne and Tian 2014). Violent crime also hinders economic development (Dell 2015). A 1 point decrease in homicide rates per 100,000 people results in an increase of 0.07 to 0.29 percent in GDP per capita growth over the next five years (World Bank 2006). At the micro level, violence results in changes in household composition; losses in the productive capacities of household members; the destruction of productive assets and livelihoods; and displacement (Justino 2009; Ibáñez and Vélez 2008).<sup>7</sup> Violence and its threat also indirectly impacts trade, investment, and growth through the uncertainty and the loss of trust and cohesion they generate (Zak and Knack 2001; Knack and Keefer 1997). For example, the Syrian war and the emergence of the so-called Islamic State directly cost Syria and Iraq 14 percent and 16 percent in per capita welfare from April 2011 to April 2014, respectively, but adding the foregone benefits of trade integration between the two

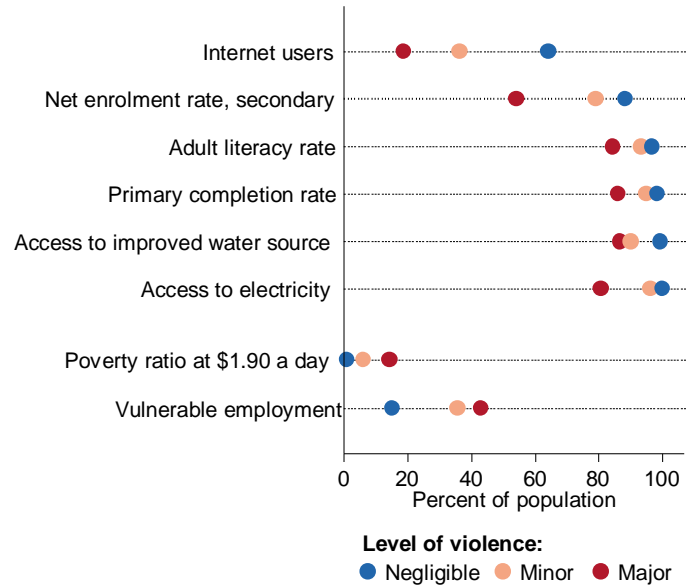
<sup>5</sup> This is the number of countries in the first quintile of Map 4.1, where the incidence of violence is measured by the number of deaths in armed conflict, in addition to the number of homicides.

<sup>6</sup> Global Peace Index 2015 Report.

<sup>7</sup> This chapter argues that typologies of actors and forms of violence share similar qualitative features, from the vantage point of individuals, households, groups, and communities at the center of dynamics and processes of violent conflict. Individuals and households can experience different types of violence in similar ways; conversely, the same type of violent conflict—indeed, the same violent conflict—can affect individuals and households in different ways, with some losing and others benefiting from it.

countries almost doubles the total costs of war, to 23 percent and 28 percent (Ianchovichina and Ivanic 2016).

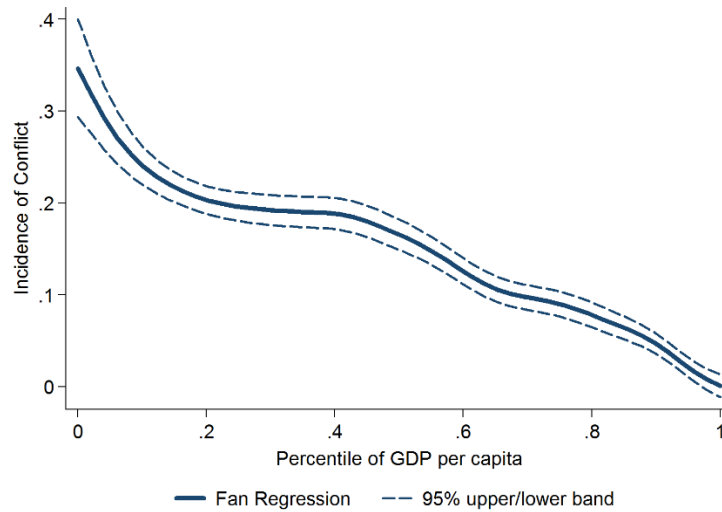
**Figure 4.3 Violence has a high cost on development**



Sources: WDR 2017 team, using data from WDI 2015; Geneva Declaration Secretariat 2015; WDR 2011; UCDP/PRIO 2015.

Note: Displays median values for all countries, by level of violence, for which development outcome and violent deaths data are available, ranging from 91 countries for poverty ratio data to 170 countries for access to electricity. Vulnerable employment is expressed as a percentage of total employment.

**Figure 4.4 Violent conflict reduces GDP per capita**



Source: WDR2017 team based on Blattman and Miguel 2010 using data from WDI 2015 and UCDP/PRIO 2015.

### ***Security affects governance by changing power and norms***

4.8 Today's governance is the child of yesterday's violence. From the earliest records of human societies until the modern era, violence has been the norm (Pinker 2011). It was not until violence was constrained by the state that development began to occur on a large scale (North, Wallis and Weingast 2009). Even the countries that enjoy the highest per capita incomes and most peaceful societies in the world, such as most of Europe, emerged out of wars and violent contests for power (Tilly 1985, 1990).<sup>8</sup> They were “fragile states” for most of their historical trajectory.

4.9 How these countries made this transition from violence and underdevelopment to security and prosperity reveals intriguing patterns. As commerce expanded in medieval Europe, *violence specialists*—individuals or groups that procured resources for themselves primarily through force or the threat of force—traded the provision of security for financial resources to finance their wars (Braudel 1966). They allowed economic activity to flourish under their protection, founded states, and ceded some power and rights to business and other elites (Duby 1987; Bates 2001). These rights were gradually expanded and eventually conceded to the majority of the population (Aminzade 1993; Acemoglu and Robinson 2006). Constraints on unbridled power and other outcomes of these bargains between elites were formalized into laws. Violence did not disappear—on the contrary, more revenues were available to finance more external wars—but it was now monopolized by these emerging states, and productively was channeled toward the provision of law and order, the combating of crime, and the protection of property rights (Bates, Greif, and Singh 2002). Modern governance was born.

4.10 Today, millions of people live under the rule of non-state armed groups, contemporary equivalents of the medieval violence specialists who gave rise to the Western European states.<sup>9</sup> *Wartime institutions*—the “rules of the game that result from the interaction between civilians and armed factions”<sup>10</sup>—have created new, enduring realities on the ground, with profound implications for processes of state and nation building in the aftermath of violence (Justino 2016). Places such as the de facto state of Somaliland provide a compelling illustration of the sustainability of the governance arrangements that arise organically—and without donor intervention—from the bargains struck between armed rebels, business communities, and civilians. They exemplify the significance of these homegrown rules for the future governance of post-war countries, and the puzzles they pose to the international development community (Philips 2013).

4.11 Violence and security change the distribution of power between groups, and consequently impact governance—how these groups interact within a set of rules, which are themselves a function of the groups' relative power (see chapter 2 and Tilly 1978).<sup>11</sup> One group's use of force can strengthen or weaken, even annihilate, the power of other groups, almost by definition: assassinations, mass killings, repression, coups, and revolutions do just that. New actors emerge

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<sup>8</sup> This narrative has been extended by some authors to contemporary states in Eastern Africa and Southeast Asia, too. See Weinstein 2005; Slater 2010.

<sup>9</sup> See Gambetta 1996; Weinstein 2007; Mampilly 2011; Ahmad 2015; Arjona, Kasfir, and Mampilly 2015; Sanchez de la Sierra 2015.

<sup>10</sup> Justino 2016, background paper for the WDR 2017.

<sup>11</sup> As Tilly (1978), p.62 notes: “Great shifts in the arrangement of power have ordinarily produced—and have often depended on—exceptional moments of collective violence.”

and gain power as a result of rebellions and wars. Historical and contemporary examples abound.<sup>12</sup> Sometimes, the threat of impending violence, and even low levels of violence, can serve a signaling function and suffice to shift balances of power, such as in South Africa before the 1992 referendum on ending apartheid (Strauss 1993). Indirectly, individuals and groups can use violence and coercion to concentrate the proceeds of growth and development in their hands and increase their relative power, by strengthening networks of patronage or gaining informational advantages (Levitsky and Way 2012). In theory, violence also decreases the power of those who use it (Arendt 1970). By contrast, security can consolidate the position of those already in power, hence cementing existing power asymmetries in the short run.

4.12 Moreover, violence also affects norms of behavior and can shape new values and attitudes, including attitudes toward violence itself (see box 4.1, for a discussion of gender-based violence). This impact can be positive as well as negative. Exposure to violence from war has surprisingly salutary and persistent effects on altruism (Burundi), empathy (Liberia), and political participation and social mobilization (Sierra Leone). It has also been linked to increased trust in government (Uganda), voluntary compliance with authority (Liberia), as well as higher levels of social capital, reciprocity, and interpersonal trust (Nepal).<sup>13</sup> It can also shape attitudes toward women along several aspects—including labor force participation, marriage and divorce (Germany after World War II), political participation (Peru), and bargaining among household members—and contribute to changes in gender roles.<sup>14</sup> Violence also changes identities and beliefs, including as a result of migrations and changes in the composition of households (Justino, Leavy, and Valli 2009).

4.13 However, the increase in cooperation brought about by exposure to violence is mostly observable within groups, rather than between groups, leading to forms of parochialism, or identity-based insularity (Bowles and Gintis 2011). This could in theory generate more violence by reinforcing within-group cohesion based on distrust of others. Violence has the observed effect of hardening attitudes toward others and can also help construct identities in more rigid ways (Grossman, Manekin, and Miodownik 2015). These new norms and identities increase the support for elites who favor the continuation of violence to strengthen or extend their hold on power (Fearon and Laitin 2000; Fearon 2006). The power and resources that accrue to political elites who benefit from the use of violence then fuel more violence (Besley and Persson 2011).

4.14 These two-way relationships between violence and norms, and violence and power, highlight the broader point that violence can be persistent and self-sustaining. It tends to occur in interlinked episodes, with its intensity subsiding between cycles (World Bank 2011). Within-country and cross-country analysis of historical violent conflict in Africa between 1400 and 1700 CE shows that it is associated with more post-colonial violent conflict, in addition to lower levels of trust and a stronger sense of ethnic identity (Besley and Reynal-Querol 2014).

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<sup>12</sup> For an historical example, see Bieber 1999; for a recent one, see Boone 2011.

<sup>13</sup> Voors and others 2012; Hartman and Morse 2016; Bellows and Miguel 2006; Blattman 2009; Blair 2015; Gilligan, Pascale, and Samii 2011.

<sup>14</sup> Buvinic and others 2013; Justino and others 2012; Akbulut-Yuksel, Khamis, and Yuksel 2016; García-Ponce 2015; Calderon, Gafaro, and Ibáñez 2011.

#### **Box 4.1 Gender-based violence, power and norms**

Gender-based violence (GBV) reflects power inequalities between women and men. Women and girls are more commonly the victims of GBV—a manifestation of power imbalance tilted in favor of men that characterizes many, mostly patriarchal cultures around the world. “Violence against women is not only a manifestation of sex inequality, but also serves to maintain this unequal balance of power” (Watts and Zimmerman, 2002, 1232). Collectively shared norms about women’s subordinate role in society, which potentially lead to violence against them, perpetuate the power imbalance.

Female genital mutilation (FGM), sex selection, child marriage, dowry-deaths, honor killings, and widowhood rituals are harmful cultural practices that are supported by various social norms and beliefs. For example, FGM is traditionally believed to preserve a girl’s virginity until marriage; not conforming to the practice may lead to social exclusion, stigma, and the inability to find a husband (UNICEF 2013). Sex selective abortions, infanticide, neglect of female children, and mistreatment of women who did not bear male children are manifestations of pervasive son preference, typically grounded in rigid patrilineal and patrilocal family systems and the special role of male children in religious rituals (Das Gupta and others 2003; Jayachandran 2015, Milazzo 2014). Dowries—a practice that strengthens son preference, as it leads parents to consider daughters as liabilities—has often been linked to brutal violent acts against women as a way to extract a higher dowry from the wife’s family, including harassment, domestic violence, murders, and suicides (UNFPA 2013). Honor killings involve murders, often committed by close relatives, in the name of “family honor,” as a way to sanction the refusal to enter an arranged marriage, attempts to marry outside their own social group, or being the victim of rape (UNFPA 2000; Pande 2015). Widows are sometimes victims of violence by in-laws and humiliating rites and isolation as part of the mourning process to demonstrate grief and innocence for their husband’s death (Chen 2000; Sossou 2002).

The continuation of these practices is supported by both women and men. The power imbalance can become internalized, and violence can even become acceptable for the victim, who may be afraid of challenging shared norms out of fear of backlash (they may not even be aware of alternatives to the norm). More positive attitudes toward FGM are typically found in countries where prevalence is higher. Interestingly, support for the continuation of FGM is generally similar among women and men, but considerably higher among women in four high-prevalence countries: Guinea, Sierra Leone, Eritrea, and Chad. Among women, greater support is expressed by those who have themselves undergone FGM. Acceptability of wife beating is higher among women than men in many countries (panel b). Likewise, reported preference for sons over daughters is consistent among women and men in India: 22 (20) percent of women (men) report that they want more sons than daughters (IIPS 2007).

Biased formal laws restricting women’s economic opportunities reinforce (and are reinforced by) discriminatory gender norms, which in turn strengthen the power imbalance. While many countries have recently carried out reforms to remove legal restrictions, about 90 percent of the 173 countries reviewed in a recent study still have at least one legal gender difference on the books (including laws requiring husband’s permission to work, to travel, to register a business, and prohibitions to work in certain industries or hours) (World Bank 2015).

The persistence of these cultural practices partly depends on reciprocal expectations about the behavior of others (Mackie 2000, with specific reference to FGM). As long as discriminatory norms are broadly shared by a critical mass of individuals who expect that others will conform to the practice, there will be no incentive to deviate from it. A shift requires coordination of beliefs, as each individual’s action depends on expectations of what the others will do. Strategic interdependence of individual beliefs will maintain the unequal distribution of power. Many state laws (such as those prohibiting FGM, domestic violence, child marriage, sex selective abortions, and dowries), often introduced under domestic and international pressure from women’s movements, have been ineffective in reducing the prevalence of harmful practices because of the failure to understand the conditions for norms shifting and the need to translate laws in the context of the local culture (see chapter 3). Other forces may lead to persistence that do not depend specifically on social reciprocal expectations, but rather on private motives that vary considerably across individuals and may require specific policy interventions (Efferson and others 2015).

*Source:* WDR 2017 team.



## ***Governance can prevent conflicts from becoming violent***

### *Development is a conflictual process*

4.15 Social choices, political change, and development itself are all inherently contentious and conflictual processes. The status quo benefits some segments of society; any change will benefit others, and conflict ensues (Acemoglu and Robinson 2006). This Report defines *conflict* as an active disagreement or dispute that arises when two or more individuals or groups believe that their policy choices, interests, preferences, or concerns are incompatible. Accordingly, conflict in itself is not necessarily negative, and can even be a constructive force for social change (Keen 1998). It is an integral element of human interactions, and exists in all societies at all times.

4.16 Poverty, inequality, and other manifestations of the unevenness of the development process generate tensions and distributive conflicts (Hirschman 1958; Bardhan 2005; Knight 1992).<sup>15</sup> In addition to uneven development, three other broad sets of factors cause conflicts: identity and ideology; resources, including land; and shocks. More often than not, these drivers combine (box 4.2).<sup>16</sup>

#### **Box 4.2 Drivers of conflict fall under four broad categories, which often combine**

*Identity* is perhaps the broadest category. It encompasses ethnicity, race, language, territory, caste, gender, sexual orientation, religion, belief, and potentially all “markers” of difference between human beings. Identity carries the seeds of conflict in its womb: those who share the same identity are part of the “in-group,” while those who do not are the “out-group”—the others. When people acquire a strong and exclusive sense of belonging to a single group, the stage is set for conflict (Sen 2006). Just as identities are a primary driver of conflict, conflict is the main way identities are shaped (Fearon 2006; Berman and Iannacone 2006): “There is nothing like conflict to determine, delineate, and accentuate the sense of belonging” (Lianos 2011).

*Resources* are another major driver of conflict, whether they are natural resources such as oil, minerals, and gemstones; common pool resources like fisheries, forests, grazing land, or water basins; or private resources such as agricultural land or cattle. A rich literature associates natural resources with the onset of violent conflict (Ross 2015; Caselli, Morelli, and Rohner 2015). Resources can trigger conflict whether they are scarce or abundant (Bardhan 2005; Collier and Hoeffler 1998). Conflict over the mismanagement and overuse of common pool (or open access) resources is ubiquitous and has been the subject of landmark analysis and case studies (Ostrom 1990; Ellickson 1991). Resources also generate rents, which can be used to fuel and sustain conflict (Besley and Persson 2011).

*Economic and other shocks* may also drive conflict: An external (*exogenous*) event or condition (such as a drought, climate change, the discovery of a new trade route, or a hike in commodity prices) or an internal (*endogenous*) event or condition (such as technological change or demographic shifts) can disrupt a stable situation by introducing tension for the control of scarce or expanding resources.<sup>a</sup>

Finally, the *development process* itself, or rather its unevenness, in the form of poverty, inequality, and urban migration can be a powerful driver of conflict.<sup>b</sup>

Drivers of conflict can combine. Horizontal inequality—the confluence of ethnic identity and income inequality—is a particularly explosive combination (Esteban and Ray 2008; Esteban, Mayoral, and Ray 2012). Extreme

<sup>15</sup> This category of drivers of conflicts is consistent with the notion of “relative deprivation” first introduced by Ted Robert Gurr in his seminal 1970 book, *Why Men Rebel*; it is also close to the notion of “status discrepancy” of another influential theorist of conflicts, John Galtung.

<sup>16</sup> WDR 2011 identified a range of factors associated with violent conflict. It referred to them as internal and external “stresses,” whether economic, security-related, or political, adding that “they can combine and precipitate actual violence.” This WDR calls a subset of these factors “drivers” and shows instead that they cause all conflicts, not just violent ones.

scenarios feature all drivers. Such was the case of the Darfur civil war in Sudan, where local conflicts over land and water resources, droughts, poverty and inequality, and ethnic and religious polarization all conspired, at a time when local governance broke down, to make this conflict one of the biggest tragedies of our time (De Waal 2007).

*Source:* WDR 2017 team.

a. For droughts, see Miguel, Satyanath, and Sergenti (2004). For climate change, see Burke, Hsiang, and Miguel (2015). For commodity price shocks, see Dube and Vargas (2012); Bazzi and Blattman (2014). For demographic shifts, see Goldstone (2002).

b. For poverty, see Justino (2009). For income inequality, see Fajnzylber, Lederman, and Loayza (2002); Montalvo and Reynal-Queyrol (2008); Stewart (2008); Enamorado and others (2016). For urban migration, see World Bank (2010).

### *Conflict and violence are not the same and have different determinants*

4.17 Yet conflicts, irrespective of what causes them, need not erupt into organized violence. Examples are numerous. At the micro level, peaceful protests, strikes and lockouts, boycotts, and mass resignations are all examples of nonviolent manifestations of conflicts over any of these sets of drivers. At the country level, Australia, Botswana, and Norway all have oil or mineral wealth, yet none has experienced significant violent conflict in generations. Singapore and Switzerland are ethnically, religiously, and linguistically diverse, but enjoy some of the lowest levels of violence anywhere. Belgium recently experienced acute conflict between groups representing its two main ethno-linguistic components, including nine months without central government, but no violence erupted. Why? The answer lies in the existence of effective institutions of governance. They make all the difference for why and when a conflict turns violent. A main message of this chapter is that institutions of governance—the specific institutions for policy making and policy implementation—can address conflicting interests and preferences without the recourse to violence.<sup>17</sup>

4.18 There are converging indications that the use of organized violence to resolve a conflict is the outcome of a rational decision: leaders go to war when they believe the expected benefits of a war outweigh its expected costs (Tilly 1978; Fearon 1995); young men join gangs and rebellion movements when this option is superior to the next best opportunity foregone (Justino, Bruck, and Verwimp 2013; World Bank 2011). Institutions and norms shape behavior—including violent behavior. They create incentives for individuals and groups to use violence, or refrain from using it, to resolve conflicts by determining the expected gains from each option. These incentives differ under different institutional settings. For example, the existence of a credible threat of sanctions will discourage individuals from using violence. The absence of this deterrent will likely decrease the cost of the violent option. Violent conflict, then, regardless of the factors or combinations of factors that cause it, it is the outcome of a failure of institutions.

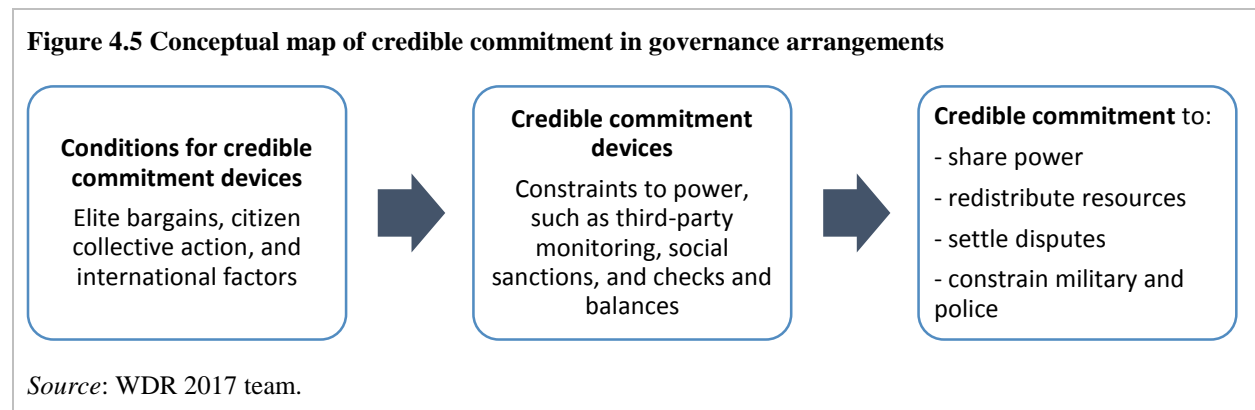
4.19 Ironically, some of the clearest insights into how institutions of governance shape incentives to prevent and reduce violent conflict have come from recent work on the ways violent groups maintain order and security within their own ranks (Justino 2016). Prison bands and slum gangs create informal governance rules to adjudicate disputes, divide resources, and enforce sanctions among their members (Skarbek 2014; Venkatesh 2006); so do criminal associations such as the Sicilian Mafia (Gambetta 1996). Pirate organizations provide a fascinating illustration of the emergence of rules of governance aimed at resolving conflicts driven by material inequalities

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<sup>17</sup> Engerman and Sokoloff 2002; Boix 2003; Acemoglu and Robinson 2006; North, Wallis, and Weingast 2009.

and perceptions of unfairness, and at eliciting cooperation among members of the group (Leeson 2011). “Rebelocracies” give rise to war-time institutions that often take on the basic functions of states (Arjona, Kasfir and Mampilly 2015; Arjona 2014). Examples of rebel governance include dispute resolution mechanisms, property rights arrangements, systems for resource distribution and the provision of security and public services (Mampilly 2011; Stojetz and Justino 2016).

4.20 Whether formally or informally, institutions of governance solve commitment and cooperation problems in ways that create incentives not to use violence. What these governance institutions exactly are, how they solve these functional problems, and the conditions under which they work (or fail) to prevent, limit, or end violence is the subject of the rest of this chapter (figure 4.5).



### ***Governance can improve security in four ways***

4.21 This Report identifies four categories of governance institutions that create incentives for individuals, groups and governments to refrain from using violence to resolve conflicts (table 4.1).<sup>18</sup> Other types of institutions, such as markets, play only supporting roles.

4.22 *Sanction and deterrence institutions.* Governance institutions that punish and deter opportunistic behavior reduce incentives for violent behavior by increasing the cost of violence. These institutions correspond to the command function of law as presented in chapter 3. Over time, they shift behavior away from violence by changing norms and attitudes toward violence, leading to the internalization of new norms (box 4.3). Ultimately, they foster a culture of compliance based on legitimacy (see chapter 2). Examples include rules ranging from speed limits and penalty fees to prison sentences.

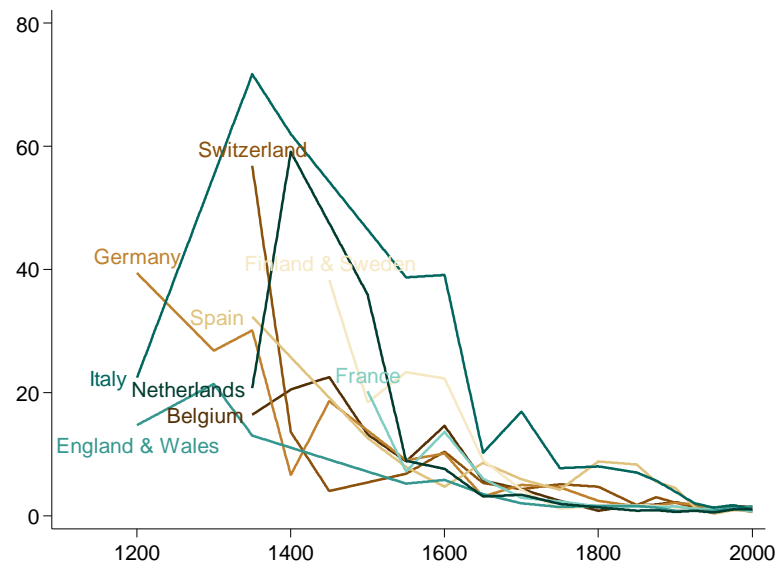
4.23 *Power-sharing institutions.* Governance institutions that balance, divide, and share power reduce the incentives to engage in violence by increasing the benefit of security. Examples include laws such as constitutions and electoral systems.

<sup>18</sup> There are institutions of governance that are intended to produce and sustain violence, such as concentration camps, slavery, or apartheid, but this chapter is not concerned with these.

### Box 4.3 The state's monopoly over violence can change norms and attitudes about violence over time

Long-term trends in violent crime show that homicide rates declined sharply in more than 10 Western European countries after 1650 (figure B4.3.1). This drop has been attributed to the effect of the expansion of state's monopoly over violence on norms of behavior and restraint, on trust in state institutions, and on states' and societies' attitudes toward homicide (Eisner 2003). Before the expansion of courts and state bureaucracies that accompanied the rise of the monopoly over violence, official attitudes toward homicide were lenient if the motives were passion or the defense of honor, and society perceived private retaliation as an acceptable way of restoring order. Between the sixteenth and seventeenth centuries, dispute settlement moved out of the private sphere and became the prerogative of judges, and perpetrators of homicide came to be seen as criminals. Campaigns of social awareness; increased bureaucratic control of everyday life; improved trust in and legitimacy of the state as an overarching institution; the evolution of the notion of honor, which lost its cultural significance; and the liberation of the individual from his or her obligations to the group—in short, a change in norms—all appear to have also played a role (Rousseaux 1999; Tilly 1992).

**Figure B4.3.1 Homicide rates across Europe have declined dramatically over the past 800 years**



Source: WDR 2017 team based on Eisner (2003) with data from Eisner (2014).

4.24 *Redistributive institutions.* Governance institutions that allocate and redistribute resources and resource rents work in the same way as power sharing institutions. Both correspond to the role of law as a tool for ordering power between competing individuals or groups, as discussed in chapter 3. They manifest themselves in budgets, social transfers, and victim compensation schemes.

4.25 *Dispute resolution institutions.* Governance institutions that resolve and arbitrate disputes reduce incentives for using violence by stabilizing expectations. They correspond to the role of law as a tool for contestation, bargaining, and resolution. Examples include institutions of property rights such as contracts and titles (*ex ante*) and courts (*ex post*).

**Table 4.1 These four categories of forms of governance matter for security**

Power-sharing	Resource redistribution	Dispute settlement	Sanction and deterrence
<ul style="list-style-type: none"> <li>• Inclusive decision-making guaranteeing representation</li> <li>• Constitution-making process</li> <li>• Coalition governments</li> <li>• Executive position for individuals or groups</li> <li>• Vetoes for minorities</li> <li>• Supermajority requirements</li> <li>• Positive action mechanism such as legal quotas</li> <li>• Electoral systems with proportional representation</li> <li>• Multiparty systems</li> <li>• Executive-legislative balance of power</li> <li>• Federalism</li> <li>• Administrative and political decentralization</li> <li>• Regional autonomy</li> </ul>	<ul style="list-style-type: none"> <li>• Fiscal decentralization</li> <li>• Taxation</li> <li>• Social security system and safety nets</li> <li>• Social services</li> <li>• Subsidies and cash transfers</li> <li>• State funds</li> <li>• Public employment</li> <li>• Political patronage</li> <li>• Natural resource management</li> <li>• Victim compensation schemes(including nonmaterial)</li> </ul>	<ul style="list-style-type: none"> <li>• Mediation and conciliation</li> <li>• Negotiation</li> <li>• Litigation and arbitration (judges, jury)</li> <li>• Contracts, titles</li> <li>• Courts</li> <li>• Elders councils</li> <li>• Ombudsmen</li> <li>• Peace negotiators</li> </ul>	<ul style="list-style-type: none"> <li>• Military</li> <li>• Police</li> <li>• Prosecutors</li> <li>• Courts</li> <li>• Prisons</li> <li>• Penalties and fines</li> </ul>

***Sanctions and deterrence can reduce violence***

*The state’s monopoly over violence serves as an elite bargain to reduce violence*

4.26 In traditional agrarian societies, when security was still in the hands of private individuals and groups, the credible threat of violence through retaliation served as a deterrent against violence, and was the main determinant of order and security (Evans-Pritchard 1940; Bates 1983).<sup>19</sup> The threat of revenge largely helped reduce violence, but security was fragile, and the specter of violence always loomed (Bates 2001; North, Wallis, and Weingast 2012). Similar security arrangements based on deterrence persist in many parts of the developing world, such as the informal institution of bride exchange (“*watta satta*”) in rural Pakistan (Jacoby and Mansuri 2010).

4.27 Modern societies, by contrast, are fundamentally characterized by the concentration of security arrangements in the hands of the state, which has a monopoly over the means of violence and coercion (Mann 1984; Weber 1965). At its core, the state’s monopoly over violence is the outcome of a collective agreement between powerful actors—an elite bargain, really—over who can use violence and when its use is acceptable (Wallis 2016).<sup>20</sup> The use of violence and coercion under this agreement is coordinated and organized by the state, which typically enforces the

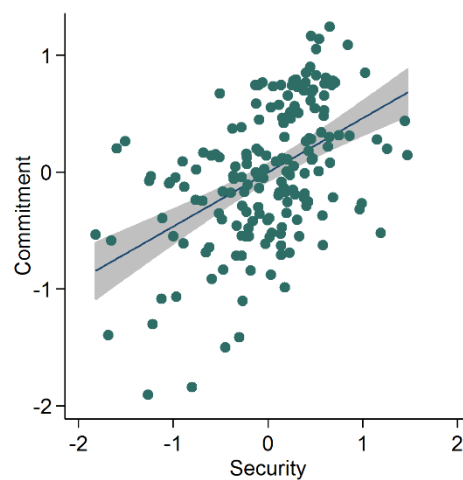
<sup>19</sup> “The very readiness of the Nuer to employ violence provides a reason, then, that violence so rarely takes place” (Evans-Pritchard, 1940, quoted in Bates 2001). The Nuer are an ethnic group in today’s South Sudan.

<sup>20</sup> Max Weber, in his essay, “Politics as a Vocation,” originally theorized the monopoly over violence as one agreement between powerful groups over the use of violence. The authors are grateful to John Wallis for making this important point.

agreement through sanctions and deterrence, but also by sharing power, redistributing resources, and settling disputes.

4.28 The state’s monopoly over violence is an ideal, which no state attains in all places all the time. It is the outcome of complex historical processes that unfold over decades, if not centuries. The elite bargains that give rise to it are contested, renegotiated, and reasserted every day, everywhere. The stock of capacity to enforce these bargains and deter groups tempted to defect or renege on them is uneven and discontinuous over time and space. Because of its imperfect nature, it is more useful to think of the state’s monopoly over violence in terms of gradations, and measure it by the degree of order and security in a country (figure 4.6).

**Figure 4.6 Order and security are highly correlated with commitment**



*Source:* WDR2017 team based on the team’s own aggregation of the commitment indicator (as a measure of property rights, contract enforcement, and lack of expropriation without proper compensation) and the security indicator (as a measure of crime, conflict, and political violence). Results presented as residuals after controlling for the natural logarithm of income per capita.

4.29 Violence of another kind occurs when the state’s monopoly over violence falls apart (Bates 2008a; 2008b). This organized violence, the result of a bargaining failure, becomes the preferred—and rational—way to for certain individuals and groups to alter the distribution of power in their favor or to pursue their interests (Fearon 1995; Walter 2009). Such is the case of broken states, like Libya, Somalia, and the Republic of Yemen; peripheral areas of many stronger states, such as in the Arab Republic of Egypt, Nigeria, and Pakistan; but also the so-called “ungoverned spaces” (which are often just “differently governed”), such as inner-city neighborhoods of Baltimore and Chicago, even some French “banlieues” (Pujol 2016).

#### *Deterrence and sanctions may reduce violence*

4.30 Deterrence and sanctions maintain order and security by raising the cost of engaging in violence before and after it occurs, and by limiting opportunities to use violence. Formal institutions of deterrence and sanction include the military, as well as the array of institutions falling under the criminal justice system, such as the police, prosecutors’ office, courts, prisons,

penalties, and fines. Under the state’s monopoly over violence, the coercion emanating from these institutions deters and constrains those tempted to use violence to pursue their objectives.

4.31 There is no definite academic consensus on whether increased police presence and higher incarceration rates reduce violent crime (Chalfin and McCrary 2014; Cameron 1988). In theory, other factors being equal, increases in incarceration rates and in police forces should reduce violent crime by way of deterrence and incapacitation, respectively (Becker 1968; Levitt 1997). Some statistical analyses confirm these findings, with application to Latin America, where violent crimes are the highest in the world (Di Tella and Schargrotsky 2004; Soares 2004). Empirical evidence from a sample of Latin American countries indicates that the countries with the lowest levels of criminal violence (Argentina, Chile, and Costa Rica) make the most intense use of sanction and deterrence, while the countries with the highest level of crime (Brazil, Colombia, and Venezuela) had the lowest incarceration rates and numbers of police (Soares and Naritomi 2010).

*However, the commitment not to abuse citizens works much better*

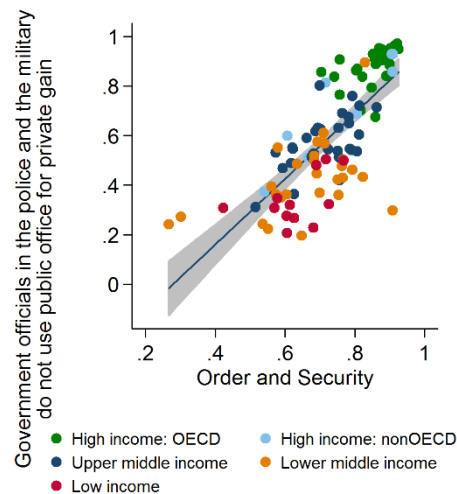
4.32 However, analytical studies suggest that *mano dura* approaches—“heavy hand,” a set of aggressive government policies to combat criminal gangs in Latin America—are counterproductive (Kleiman 2011). They posit that the penal system can harden youth criminals and make them more prone to more serious crimes upon release, and that heightened police engagement in marginalized communities might increase the risk of police abuse of citizens and undermine citizen trust and community cohesion (World Bank 2010; Berkman 2007). Conversely, programs such as the “Youth and the Police” project in Belo Horizonte, Brazil, which sets up workshops and seminars between police and youth groups, have been shown in some preliminary evaluations to improve local police-community relations (Berkman 2007).

4.33 In Rio de Janeiro, Brazil, “Pacifying Police Units” (UPPs) combine increased police presence to regain control of urban territory from armed criminal groups with a new model of “proximity policing.” This program seeks to build closer ties with local residents by holding community meetings and social events, providing soccer courses to teenagers, and engaging in informal dispute settlement. In addition, it starkly reversed policemen’s financial incentives by offering performance bonuses for reducing police homicides, to replace an earlier policy that offered higher salaries to police officers who shot suspects in acts of legitimate defense. A recent evaluation of the impact of the introduction of the UPPs indicates that homicides by police would have been a massive 60 percent higher without UPP intervention (Magaloni, Franco, and Melo 2015).

4.34 While the state’s monopoly over violence is a necessary condition of security, it is by no means sufficient to guarantee the long-term security of people and property. Violence can, and often does, come at the hand of the state itself, particularly through its military and its police. Ruling elites often resort to military force against civilians to avoid having to share power (Acemoglu and Robinson 2006). Police forces often threaten and brutalize the population of gang-ruled urban slums instead of protecting them, as occurs in some U.S. and Latin American cities. Governments, or the private interests that have captured them, often violently expel local communities from their land for reasons ranging from granting concessions to mining corporations to expanding infrastructure projects (Hall, Hirsh, and Murray Li 2011; Moyo, Tsikata, and Diop 2015).

4.35 A fundamental question then becomes: under what conditions are states capable enough to protect citizens by exercising a monopoly over violence, while at the same time credibly committing not to use violence against citizens (see figure 4.6) (Madison 1788; Weingast 1995)? Constraints on unchecked powers provide answers to the question (figure 4.7). In the example of Rio de Janeiro’s police reform, international factors loomed large in the background. The pressure of international visibility and the threat of damage to the city’s reputation ahead of the 2014 soccer World Cup and 2016 Olympic Games which it was to host, provided the national and local government with enough incentives to commit to—literally—tie their own “heavy hands” and check the power of the police. They did so by shifting the police’s own incentives away from the use of excessive lethal violence. A fuller discussion of how international factors can tilt the balance of power away from some groups (in this case, the police as an elite) and toward others (the marginalized citizens of the *favelas* of Rio) can be found in chapter 9.

**Figure 4.7 Constraining state power and balancing power between social groups ensures security**



*Source:* World Justice Project 2015, Rule of Law Index Factor 5, “Order and Security” (consisting of “Crime is effectively controlled”; “Civil conflict is effectively limited”; “People do not resort to violence to redress personal grievances”) and Factor 2.3 (“Government officials in the police and the military do not use public office for private gain”). Results presented as residuals after controlling for the natural logarithm of income per capita.

### ***Power-sharing can reduce violence***

4.36 Power-sharing mechanisms give multiple contending elites a stake in the decision-making process and can rebalance power in the governance arena. Some form of power sharing aimed at coopting elites and constraining majority rule has been attempted to end violence in nearly all conflicts within states in the past few decades. Power-sharing arrangements are especially relevant for societies divided along ethnic and religious identity lines, such as in Bosnia and Herzegovina, Northern Ireland, Kenya, Lebanon, and South Africa, but also in countries where the conflict is a legacy of opposing ideologies, like Colombia.

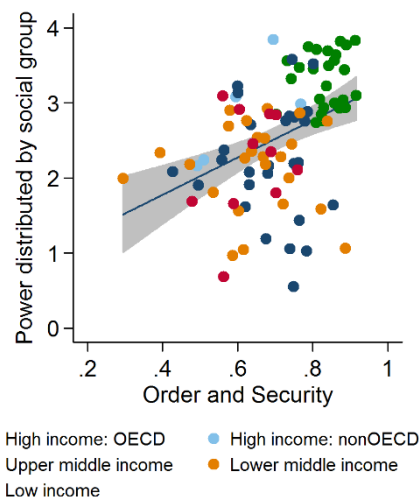
4.37 Power-sharing institutions can take many forms. They can be inclusive, when particular offices or processes in national government guarantee the representation of certain groups. Examples include: designated executive positions for individuals or factions (Iraq, Kenya,



Lebanon, Somalia); ensured minority voice in policy making, through vetoes for minorities in coalition governments or supermajority requirements; positive action mechanisms, such as legal quotas for women and marginalized groups in public office (India); and forms of legislative selection that guarantee representation of all factions and groups, such as electoral systems with proportional representation. A second set of forms is dispersive institutions, which distribute power among groups at the subnational level. Examples include federalism (Belgium, Nigeria); administrative decentralization (Nepal, Sierra Leone); or regional autonomy (Aceh, Indonesia; Bougainville, Papua New Guinea; Catalonia, Spain; Corsica, France) (Gates and others 2016).

4.38 Cross-country statistical analyses robustly associate institutions of power sharing with better security outcomes (Gurr 1993; Linder and Bächtiger 2005) (figure 4.8). Executive power sharing in broad multiparty coalitions, executive-legislative balance of power, multiparty systems, and proportional representation electoral systems are all significantly correlated with less incidence and risk of internal conflict, and less vulnerability to domestic terrorism, after controlling for economic and population characteristics (Lijphart 2012). Statistical and empirical evidence in favor of decentralized and federal governance institutions is not as strong.<sup>21</sup>

**Figure 4.8 An even balance of power is associated with positive security outcomes**



*Source:* World Justice Project, Rule of Law Index 2015 Factor 5, “Order and Security” (consisting of “Crime is effectively controlled”; “Civil conflict is effectively limited”; “People do not resort to violence to redress personal grievances”) and V-Dem v.6 (“Power distributed by social group”) (where a score of 0 means political power is monopolized by one social group and a score of 4 means that social groups have equal political power).

*Power-sharing can reduce violence by giving parties in a conflict incentives to cooperate*

4.39 Mechanisms of power-sharing manage conflict by encouraging cooperative behavior among rival factions. They give leadership elites incentives to collaborate, bargain, and

<sup>21</sup> However, it is still positive. The same weaker findings also apply to these other consensual governance institutions: rigid constitutions that can be changed only by extraordinary majorities; systems in which laws are subject to a judicial review of their constitutionality by supreme courts or constitutional courts; and independent central banks (Lijphart 2012).

compromise with one another, and to encourage conciliation and tolerance among their followers. They also help mitigate the effects of the exclusion of minorities by majorities, reducing the likelihood of the onset of identity-driven violent conflict. Where violence has already occurred, they give rebel factions incentives to lay down arms, by offering them alternative avenues for contesting power in nonviolent ways, such as in Bosnia and Herzegovina, Liberia and South Africa.<sup>22</sup> Over time, cooperation builds trust in the power-sharing mechanism, and enhances its legitimacy—the extent to which people voluntarily comply with institutions and decisions.

4.40 The example of gender quotas in Indian village councils illustrates the links between power sharing, cooperation, trust and violence reduction. Exposure to women policymakers has encouraged greater reporting of crimes against women, and has led to increased police responsiveness and number of arrests, deterring violence in the long run (Iyer and others 2012). Similar natural experimental evidence from India shows that ethnic quotas foster solidarity and decrease hostility between eligible ethnic groups (Dunning 2010).

*Cooperation is more likely when parties in a conflict can credibly commit to deals*

4.41 Fighting parties are significantly more likely to cooperate and sign peace agreements to end wars if the deals contain specific power-sharing assurances (Hartzell and Hoddie 2003; Walter 2002). Enshrining power-sharing arrangements in peace agreements provides some indication of the parties' commitment to ending the war, removes motives to continue fighting, and has been negatively and significantly associated with renewed violent conflict (Walter 2015). However, with low trust prevailing among warring factions, as is the case in South Sudan and Syria civil wars, the implementation of the bargain and the consequent reduction in violence are dependent on all sides believing that the other(s) will not renege on the terms of the power-sharing agreement over time. Mechanisms that ensure the credible commitment of elites, both to one another and to their followers, play a major role in ensuring that, once reached, power-sharing arrangements are implemented and that violence stops (Keefer 2012).

4.42 Independent third-party mechanisms are the main mechanisms for ensuring the credibility of commitments in general (Schelling 1960; Bates 2008b). The same mechanisms can work to credibly commit parties in a conflict in the specific case of implementing power-sharing deals. For example, the deployment of international peacekeepers provided security guarantees for the agreements that ended the civil wars in Bosnia and Herzegovina, Liberia, and Sierra Leone. The commitment of regional and international powers played a similar role in reaching power-sharing accords in Lebanon, the Former Yugoslav Republic of Macedonia, and Mali.

4.43 However, third-party external enforcers and internal checks and balances cannot always ensure that power-sharing arrangements end the violence and restore order. Indeed, for every example of an international peace-keeping mission that successfully guarantees a power-sharing agreement, and for every example of checks and balances that bind leaders to effectively share power with others, there seems to be a myriad of examples that do not. Under which conditions do power-sharing arrangements promote order and security, and when do they fail?

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<sup>22</sup> Lijphart 1969, 2004; Hartzell and Hoddie 2007; Norris 2008; Reynolds 2011; Gates and Strom 2013.

*Commitment to share power is weak when power asymmetries are large, which can lead to violence*

4.44 Large power asymmetries between contending factions make it easy for the stronger side to renege on its promises and hard for the weaker side to hold it to account for failing to commit (Walter 2009). Power asymmetries rooted in governments' monopoly over of taxation resources account for the likelihood of violent repression (Besley and Persson 2009). They also explain why some wars last more than others (Fearon 2004). Conversely, power-sharing institutions can reduce violence when they constrain the power of ruling elites. The more accountable a government is to a large share of the population, the easier it will be able to credibly commit to share power, and the fewer incentives the sides will have to return to violence (Walter 2015; Gates and others 2016).

*The exclusion of powerful actors from the bargaining arena also leads to violence*

4.45 Violence can emerge when powerful actors are excluded from the policy bargaining arena. Lack of access to state institutions, resources, and services usually takes place along identity fault lines. The distribution of power among ethnic groups, measured by their access to central state power, is a strong predictor of violent conflict at the national level, whether in the form of repression by the state or rebellion against the state.<sup>23</sup> Cross-country statistical analyses using the Ethnic Power Relations dataset for all independent states from 1945 to 2005 indicate that states that exclude large portions of the population based on ethnic background are more likely to face armed rebellions (Wimmer, Cederman, and Min 2009).

4.46 The level of such exclusion seems to matter, too: the more excluded from state power ethnic groups are, the more likely their members are to initiate conflict with government, especially if they have recently lost power (Cederman, Wimmer, and Min 2010). More recent analysis using the same dataset for the period 1977–2010 also shows that the larger the share of the population excluded from state power on the grounds of its ethnic affiliation, the higher the level of violent repression by the state (Røæbek and Knudsen 2015).

4.47 Qualitative comparative and case-study analysis of violent conflict in post-colonial Africa share the same finding that exclusionary elite bargains have led to trajectories of civil war, while countries where elites have struck more inclusive elite bargains succeeded in avoiding violent conflict. The extent of groups' access to state structures (in the form of jobs in the government and the military) and to state resources (such as land, commercial licenses, and other rents) determine the degree of inclusiveness or exclusiveness of these elite coalitions (Lindemann 2008; 2010).

***Redistributing wealth can reduce violence***

4.48 Sharing power and redistributing wealth go hand in hand and follow the same logic. Access to power and decision making opens the door to control of resources and opportunities to extract rents. But elites can also redistribute wealth without having to share power, by simply using fiscal policy to transfer resources to groups that threaten to use violence to pursue their interests (Acemoglu, Robinson, and Verdier 2004; Bueno de Mesquita and others 2003). Budgets then

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<sup>23</sup> However, lack of access to state power is not the only determinant of violence; the capacity to mobilize against governments also matters (Cederman, Wimmer, and Min 2010), and so does the opportunity to mobilize. On the former, see (Fearon and Laitin 2003).

become the true battlegrounds for distributive decisions, and the reflection of bargains among elites and between elites and citizens (Dorotinsky and Pradhan 2007).

4.49 Redistributive mechanisms address conflicts driven by poverty and inequality, usually in combination with the three other drivers. They can address conflicts rooted in grievances about the lack of access or unequal access to land and natural resources; inequalities along identity fault lines (horizontal inequality); and economic or environmental shocks. Redistribution can also address conflicts from the greed of groups vying for access to the natural and material resources of the state and the opportunities to extract rents these resources generate.<sup>24</sup>

4.50 Forms of redistributive governance institutions, and policies include fiscal decentralization, intergovernmental transfers, taxation, social security systems and safety nets, subsidies and cash transfers, funds like pension funds and permanent funds, and by extension, social services like health care and education. Other institutions of governance can also serve redistributive purposes in addition to productive ones, such as the civil service.

*Redistribution can buy peace by strengthening the social contract between states and citizens*

4.51 Historically, governments used social policy and other broad redistributive programs as a way to maintain order and reduce civil unrest. One example is the mainstreaming of insurance schemes in nineteenth century Europe in the face of more assertive and better-organized labor movements (Justino and Martorano 2016). The causal effect of these redistributive social policies on improving security is well documented. In Latin America, where levels of both inequality and violence are among the highest in the world, levels of political violence gradually decreased in 16 countries in the 1990s and 2000s as government expenditure on social welfare steadily increased. Similarly, government expenditure on social services like health, education, and welfare in 16 Indian states from 1960 to 2011 was associated with a significant decrease in both the outbreak and escalation of riots across the country. That such reductions occurred in the medium term further suggests that the effect of these redistributive social policies is working through reductions in poverty and inequality, which take time (Justino 2015; Justino and Martorano 2016). In Afghanistan and India, more government spending on public services appears to have played a role in reducing insurgent violence (Beath, Christia, and Enikolopov 2012; Khanna and Zimmermann 2015).

4.52 Government interventions to reduce urban crime in Latin America display a comparable pattern of increasing security by reducing poverty and inequality. Brazil's conditional cash transfer program, Bolsa Familia, had a strong negative causal effect on urban crime in São Paulo as a result of increases in household incomes and changes in peer group membership (Chioda, De Mello, and Soares 2012).<sup>25</sup> Colombia's Familias en Accion Program in Bogotá displayed similar results

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<sup>24</sup> This chapter finds that the traditional division in the literature between conflicts motivated by greed and conflicts motivated by grievance cuts across drivers, actors, and cycles of conflict. This chapter does not find this distinction useful, in concept or in practice.

<sup>25</sup> Other studies have also examined the links between inequality and crime: Becker (1968); Ehrlich (1973); Chiu and Madden (1998); Imrohorglu, Merlo, and Rupert (2000); Fajnzylber, Lederman, and Loayza (2002); Bourguignon, Nuñez, and Sanchez (2003); Soares (2004).

(Camacho and Meija 2014). A critique of these programs is that they are too expensive for other, poorer cities to implement (World Bank 2010).

*Redistribution can buy peace by coopting elites*

4.53 Short of committing to universalistic redistribution—usually as a concession in return for ending or at least for abstaining from violent contestation—governing elites credibly commit to narrower subsets of the population, whether groups with a strong capacity for mobilization, or elites with veto power (Acemoglu and Robinson 2006). Bringing these smaller groups, or other elites, into the bargaining arena usually happens by way of *patronage*, a mode of governance where politicians, or patrons, attribute public jobs and benefits to supporters or clients (Keefer and Vlaicu 2008; Robinson and Verdier 2013). A time series cross-section study of 40 African countries found that expanding the size of cabinets by one additional minister reduces the risk of a coup sixteen times, more than the effect of a 1 percent increase in GDP (Arriola 2009).

4.54 Governments often resort to public employment to maintain the stability of coalitions and ensure the loyalty of key constituencies whose discontent could jeopardize security (North, Wallis, and Weingast 2012). Historically, government jobs in the United States were handed down to friends and family without consideration for merit. It was not until the Pendleton Act of 1883 that the U.S. government, under pressure from voters, took the first steps toward building a meritocratic civil service (Grindle 2012).

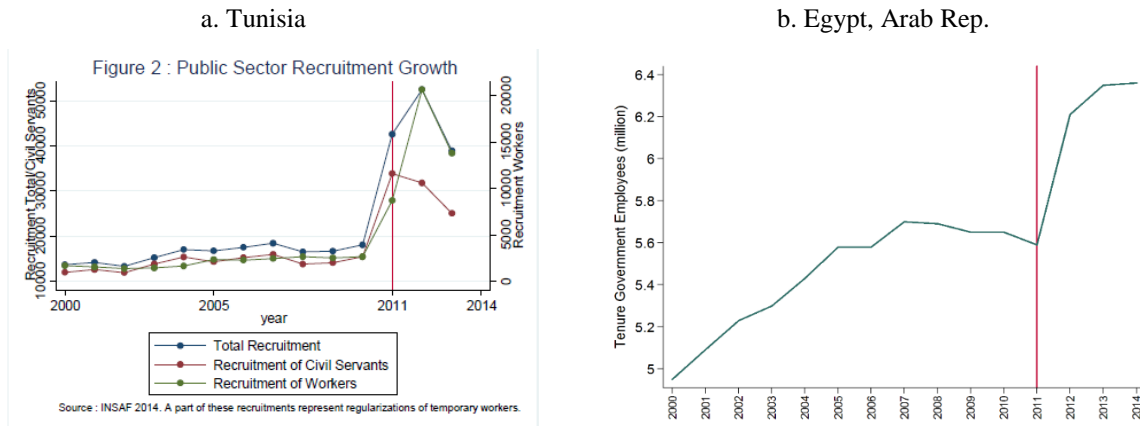
4.55 Today the civil service in many developing countries remains a prime tool for political patronage. During the Arab uprisings, oil-rich governments, confronted with mounting dissent at home and concerned about the contagion from neighboring countries, hiked both the numbers and the salaries of public employees, in an effort to “buy the peace” and maintain the loyalty and quiescence of a constituency deemed essential for the survival of the regime (Yom and Gause 2012; Brownlee, Masoud, and Reynolds 2013). In Egypt, some 600,000 temporary government contracts were converted to regular civil servant jobs between 2011 and 2014 (figure 4.9).<sup>26</sup>

4.56 Large increases in the public sector wage bill have ruinous effects on budgetary sustainability and administrative efficiency. Attempts at curbing the trend have generally failed or have not been sustained (World Bank 1999). Despite these problems, public sector employment can solve the first-order problem of violence. Timor-Leste is a case in point. Following widespread unrest in 2006, the new government used revenues from the oil windfall to increase the budget fourteen-fold, from \$135 million in 2006 to \$1,850 million in 2013. Public employment spiked from 20,000 to more than 35,000 during the same period, along with social transfers to veterans (Srivastava and Blum 2016).

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<sup>26</sup> Data from the Egyptian Central Agency for Organization and Administration (CAOA).

**Figure 4.9 Recruitments of civil servants increased exponentially in Tunisia and Egypt in the aftermath of the Arab Spring**



Source: Brockmeyer, Khatrouch, and Raballand 2015 for Tunisia; Darwish 2015 for Egypt, based on figures from the Egyptian Central Agency for Organization and Administration (CAOA).

### *Redistribution can become corruption*

4.57 The rent redistribution and patronage that accompany the bargains often necessary to maintain stability and solve the first-order problem of violence often come at the expense of public integrity (Szeftel 1998). In few countries are these trade-offs between “buying the peace” and the control of corruption more salient than in the Republic of Yemen. Before the revolution of 2011, Yemeni tribes were a central part of the elite bargain that ensured relative stability in this historically weak state. An essential element to these armed tribes’ loyalty to the central government was a vast patronage network, both formal and informal, which benefited cooperating tribal elites. The Ministry of Tribal Affairs handed out formal, monthly stipends to more than 4,500 tribal leaders across the country. The regime also favored local tribal elites in elections, who used their position as parliamentarians to secure public employment for their followers. While some of this employment was real—particularly in the army and security forces—an informal mechanism awarded government jobs to more than 40,000 “ghost workers”—clients and relatives of tribal leaders who received salaries without being expected to work. Patronage figures from this fictive employment amounted to as much as 6 percent of the national budget in the education sector alone (Egel 2013).

### *Redistribution can reduce violence by increasing trust in government and interpersonal trust*

4.58 The exact mechanisms by which redistributive policies achieve security entail the resolution of commitment and cooperation problems between governments and groups pressing for redistribution—whether these are powerful elites or mobilized citizens (Addison, Le Billon, and Murshed 2002). Sustained and steady increases in government expenditure on social welfare, such as those in Latin America in the 1990s and 2000s, signaled governments’ commitment to the social contract that ties the state and the citizens—or at least to the groups that would otherwise threaten elite control over the state (Bueno de Mesquita and others 2002, 2003). The political difficulty of rolling back these social welfare programs, which have come to be seen as

entitlements, make them particularly credible commitment devices (Acemoglu and Robinson 2006).

4.59 The existence in India and Latin America of social and political mobilization channels that address redistributive social conflicts without the need to resort to violence makes the commitment of governments to redistributive social policies even more credible. Such commitment, coupled with the demonstrated and repeated capacity of governments to make good on their promises, could increase trust in government over time, and reduce the chances of engaging in political conflict. Conversely, the poor credibility of governments in committing to transfer resources can lead to violence, if the chances of overthrowing the government by violent means are greater than the probability of its credibly transferring the resources (Acemoglu and Robinson 2006; Murshed and Tadjoeeddin 2009).

4.60 Guatemala presents an extreme example. A fiscal agreement had to be explicitly enshrined in the 1996 Peace Accords between the government and insurgency movements to get the government to credibly commit to reduce the inequities in income distribution and lessen the discrimination against indigenous groups that had sparked the lengthy civil war. The peace agreement included a provision to raise the tax rate by 50 percent, up from the rate of 7.6 percent of GDP in 1995. But this did not prove enough. While the rate reached 9.7 percent in 1998, the country's powerful land-owning elite, which had won the legislative elections in that year, reneged on the commitment by blocking the tax reform, threatening to jeopardize stability (Addison and Murshed 2001).

4.61 Social welfare policies can also reduce political conflict by helping strengthen interpersonal trust between citizens. Interpersonal trust has been classically linked to increased social cohesion and hence less social conflict in both theory and analytical case studies (see box 1.6 in chapter 1). Empirically, it is linked to reductions in crime levels (Lederman, Loayza, and Menéndez 2002). Empirical evidence linking social welfare to interpersonal trust is more limited, but empirical studies do show that interpersonal trust is higher between members of communities that are economically homogeneous and more equal. Conversely, participation in social activities, a close proxy of social cohesion, is lower in places where economic and social inequality is high (Alesina and La Ferrara 2002a, 2002b).

4.62 The link between redistributive institutions (like fiscal decentralization) and security levels is less well documented. One empirical before-and-after analysis of 98 districts in Java, Indonesia, shows that the incidence of routine violence in the form of neighborhood and village brawls and vigilante justice decreases as fiscal decentralization is implemented. It suggests that the commitment to devolve resources and autonomy from distant central governments to local governments may increase local government legitimacy, which in turn translates into more cooperative behavior and stronger cohesion among groups (Murshed and Tadjoeeddin 2008).

*Restitution and compensation also reduce incentives to engage in violence*

4.63 Governance institutions to recognize and redress grievances present a special case of redistribution. They reduce incentives to engage the state through the use of violence by seeking to right past wrongs, and may help avoid repeated conflict (Walter 2015). They include truth and reconciliation commissions such as in South Africa after the apartheid; victim compensation

schemes such as in El Salvador; and an array of material and nonmaterial measures, including symbolic ones, intended to restore people's dignity.

4.64 The symbolic dimension of these measures is not to be underestimated. The restoration of a sense of dignity and self-worth as citizens and human beings appears to have been an essential element of the set of factors that triggered the Arab uprisings. In the Republic of Yemen, following the revolution of 2011, the government set up a special fund to compensate former public sector and army employees from the southern part of the country for the loss of their jobs and the confiscation of their property after the south's failed secession attempt in 1994. Still, in one of the world's poorest countries, people's most pressing grievances were of a symbolic nature: they wanted their fallen to be recognized as martyrs, not traitors; the return and rehabilitation of the exiles; and a recognition by the central government of its past mistakes.<sup>27</sup> That neither the material nor the immaterial set of grievances were met in the end did not increase the country's chances to avoid the current conflict engulfing it.

### ***Dispute settlement can reduce violence***

4.65 Dispute resolution institutions are critical to security and development. They help reduce violence and protect property rights by resolving cooperation and commitment problems. Mechanisms of dispute resolution include mediation, conciliation, and negotiation, where parties try to reach mutually satisfactory, self-enforcing agreements on their own. They also include litigation and arbitration, where disputants rely on a third party such as a judge or a jury for resolution and for providing the credible commitment needed to enforce the resolution. These institutions can be informal, like elders councils in a village, or formal, like courts, ombudsmen, and peace negotiators.

4.66 Institutions of dispute resolution aim at resolving conflicts over material resources, whether scarce or abundant, such as land, water, extractives, and movable assets. They also aim at resolving conflicts over breaking norms of socially acceptable behavior—usually codified into laws—including the use of violence and other types of offenses. These norms of behavior vary from era to era, culture to culture, and place to place.

### ***Alternative dispute resolution institutions reduce violence by changing norms***

4.67 In the absence of strong formal institutions like the courts or police, individuals and communities resort to alternative dispute resolution mechanisms: a set of informal skills, practices, and norms of negotiations and mediation that aim to help parties reach self-enforcing bargains and reduce the cost and length of disputes. Alternative dispute resolution mechanisms improve cooperation by building trust and improving communication and mutual understanding among parties, and by cultivating a set of norms that encourage them to stay at the bargaining table. These norms of cooperation include “maintaining mutual respect; controlling emotion and anger; raising awareness of self-bias; building empathy with the other party; enhancing the legitimacy of the mechanism; and stigmatizing defection” (Blattman, Hartman and Blair 2014). When strong, centralized, third-party institutions that enforce contracts are weak or do not exist, disputants have

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<sup>27</sup> See the 2013 report by the Republic of Yemen Comprehensive National Dialogue Conference, “Report on the Outcomes and Recommendations of the First Phase of the Comprehensive National Dialogue Conference,” <http://www.ndc.ye/page.aspx?show=102>.



incentives to renege on their agreements. Informal social sanctions solve this commitment problem (Bardhan 1993). The norms promoted by alternative dispute resolution mechanisms, such as the shaming of would-be defectors, help enforce the bargains reached.

4.68 In Liberia, a large education campaign to promote alternative dispute resolution mechanisms in 86 treated communities in 2009 resulted in a 32 percent decrease in property destruction relative to the control group (Blattman, Hartman, and Blair 2014). Such land disputes are endemic in countries where property rights are not well defined or protected, and often result in communal violence (Onoma 2010; Fetzer and Marden 2016). In addition to reducing violence, changing norms of behavior also had unintended consequences: it exposed more disputes, reflecting power struggles between village elders and youth, but these were overwhelmingly peaceful. This particular finding underscores some of the main points this chapter makes: that conflict is a normal element of the change process, and is qualitatively distinct from violence; and that what matters for security is not the occurrence of conflict per se, but rather its peaceful resolution by institutions.

*Power asymmetries and norms of exclusion affect the effectiveness of dispute resolution mechanisms*

4.69 Dispute resolution mechanisms do not always achieve security. The field experiment in Liberia remains an example of self-enforcing dispute resolution institutions helping resolve low-intensity communal conflict, where the distribution of power between parties is relatively even. Such is not the case in the more acute conflicts over land and water resources that plague so many developing countries. These conflicts involve significant power dynamics, such as land grabs by governments and closely connected local elites, or extractive and agricultural concessions to multinational firms (Boone 2013; Hall, Hirsch, and Murray Li 2011). An evaluation of a donor-funded land mediation program also in Liberia indicates that once such power dynamics are at play, self-enforcing dispute resolution mechanisms no longer achieve reductions in violence (Hartman, Morse, and Kitt 2014).

4.70 The uneven distribution of power among parties to a dispute stands in the way of reaching and enforcing mutually satisfactory bargains. Stronger disputants have few incentives to make concessions and concede power and resources, and many incentives to renege on agreements over time, as the literature on bargaining power suggests.<sup>28</sup> Solving disputes and enforcing contracts through the threat or use of force then becomes the more rational strategy for a powerful actor because the benefits of its use outweigh its costs, like the risk of sanctions (Schelling 1960; Walter 2015). The existence of norms that exclude certain groups like women and minorities from the bargaining arena where disputes are settled reinforce power asymmetries and perpetuate inequitable and insecure outcomes (Platteau 2000). The exclusion of these groups from the bargaining arena undermines the process legitimacy of dispute resolution mechanisms (see chapter 1).

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<sup>28</sup> Wagner 2000; Powell 2004, 2006; Fearon 2004; Walter 2015.

## **Conclusion**

4.71 This chapter characterizes violent conflict, irrespective of what factors drive it, as a breakdown in governance. Violent conflict is the respective product of three factors: the unchecked power of individuals, groups, and governments (such as when police forces abuse slum dwellers instead of protecting them, or when ruling elites repress peaceful citizens); failed bargains between participants in the bargaining arena (such as when peace talks between rival factions break down, or when disputants fail to reach an agreement over a dispute); or the exclusion of individuals and groups from the bargaining arena (such as when important constituencies lack access to state resources, or when powerful groups are excluded from the policy-making process).

4.72 From a technical standpoint, forms of governance such as power sharing, resource redistribution, dispute settlement, sanctions, and deterrence that aim to achieve security and foster development can be readily identified. However, they can succeed in preventing, reducing, or ending violent conflict only when they constrain the power of ruling elites, achieve and sustain agreements and do not exclude relevant individuals and groups.

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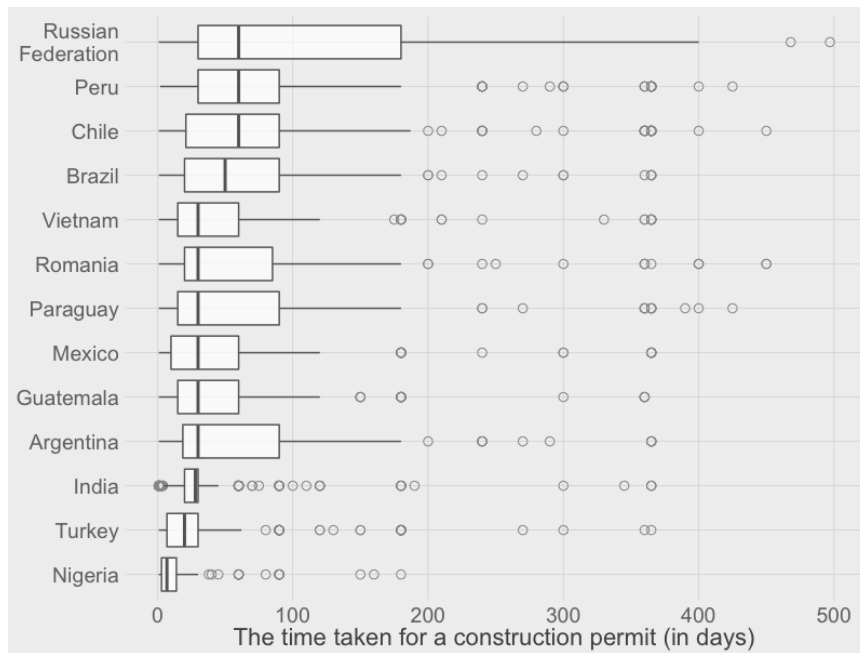
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## Chapter 5 Growth and governance

### How policy “capture” slows economic growth

5.1 If you were to ask a firm in Brazil or Mexico how long it had to wait to get approval for a new construction, the answer could range from as little as 1 day to more than 100 days (Figure 5.1). Such remarkable variation in the wait time experienced by firms within the same country is true of almost any basic regulatory procedure in most low- and middle-income countries, such as getting a license to set up a new firm or a permit to import some item.<sup>1</sup>

**Figure 5.1 Time needed for firms to obtain a construction permit varies widely**



Source: WDR 2017 team, using data from the Enterprise Survey.

Note: The figure shows a box and whiskers plot. The box ranges from the 25<sup>th</sup> percentile to the 75<sup>th</sup> percentile. The line in the middle of the box shows the median. The two lines on either side of the box extend to minimum and maximum values, excluding outliers. The dots indicate outliers.

5.2 One reason for the variance in regulatory implementation could be that some firms have more influence over the policy arena than others do. For example, a number of recent firm-level studies suggest that firms with powerful political connections are unduly favored in the way certain policies are designed or implemented, to the detriment of long-term economic growth. They get preferential access to state credit, land, and import licenses. The sectors in which they operate are protected from competition from other firms through high regulatory barriers to entry. This form of policy subversion has significant negative effects on the economy.

<sup>1</sup> In recent research, Hallward-Driemeier and Pritchett (2015) use firm-level data to analyze how the implementation of simple business regulations varies across firms within the same country. They find that procedural reforms, which simplify these regulations, are not associated with a reduction in this variation.

5.3 This chapter seeks to explain how, and when, powerful groups with narrow interests can have undue influence over policy (“capture”) and slow down economic growth, even in contexts of high state capacity.<sup>2</sup> Such dominant groups can include politically connected firms, or lobbies for industry, farmers, or consumers. The chapter also analyzes cases when shortsighted, opportunistic state actors renege on policy commitments, harming investors. In some cases, existing norms such as tolerance toward corruption in public agencies can reinforce such policy failures.

5.4 However, the influence of interest groups, while ubiquitous, does not always render growth policies ineffective; sometimes, it can even improve them. How this process plays out depends on the characteristics of government agencies that enact the policies in question, and the incentives of influential groups, such as industry associations, that interact with those agencies. Understanding what drives this difference can help identify ways to improve policy effectiveness.

5.5 One lesson that emerges is that designing second-best policies may be more effective than designing ideal policies that are at high risk of capture (such policies are considered *implementable*). It is also good to avoid policies that look good in the short term but could later end up reinforcing the power of dominant groups that could block further reforms, hindering future policy effectiveness. A third lesson is that undue influence from dominant groups can be counterbalanced by appropriate design of incentives within public agencies, checks and balances between agencies, and mechanisms that extend accountability to a broad group of firms and individuals. Such reforms can expand the set of implementable policies.

5.6 This agency-level approach assumes that the interests of high-level policy makers are aligned in the direction of reform. Whether that is the case depends on the evolution of the broader governance environment, a topic examined in part 3 of this Report.

### **How governance matters to growth: A microeconomic perspective**

#### ***What is the aggregate impact of governance on growth?***

5.7 There is a clear positive correlation between aggregate measures of governance and per capita income across countries (figure 5.2).<sup>3</sup> Since countries had similar levels of per capita income in the distant past, current differences in their per capita income are largely reflective of differences in their long-term growth rates.<sup>4</sup> Thus, governance and long-term growth are positively associated.

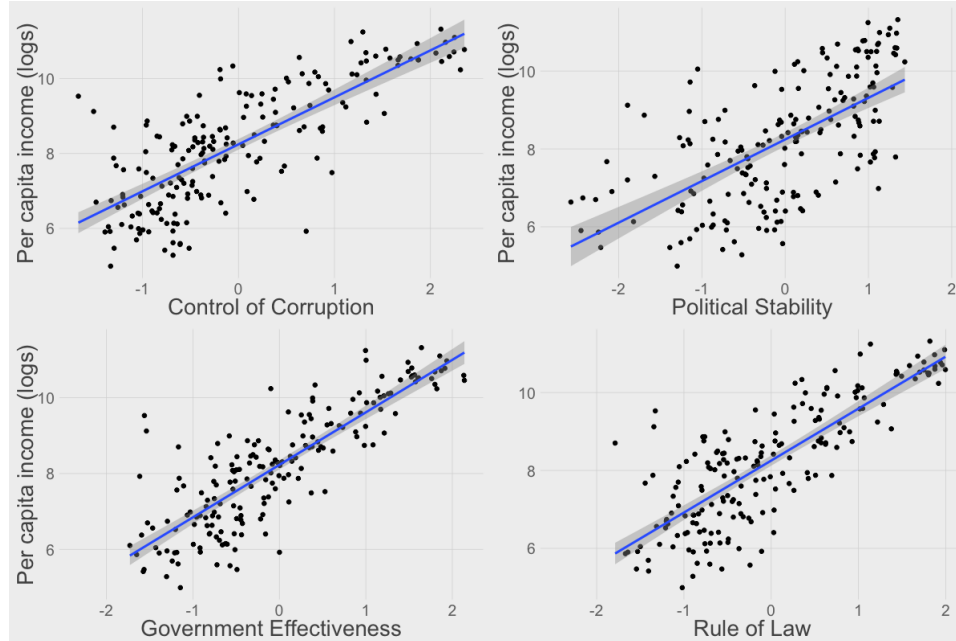
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<sup>2</sup> Traditionally, in the economics literature, capture is said to occur when the design of a *regulation* reflects the narrow interests of specific groups of firms and/or consumers (Stigler 1971; Peltzman 1976). This chapter applies the term more broadly to include not just regulations but any policy related to economic growth.

<sup>3</sup> The governance measures are from the Worldwide Governance Indicators (WGI) database.

<sup>4</sup> GDP per person differed only modestly across countries prior to the year 1600, so much so that the rising difference in GDP per person across rich and poor countries since then has been termed the “Great Divergence” (Jones, 2015).



**Figure 5.2 Per-capita income and governance are correlated**

Source: WDR 2017 team, using data from the World Governance Indicators (WGI).

Note: Per-capita incomes and WGI values are for the year 2010.

5.8 This correlation should be viewed with some caveats. It could reflect reverse causation from growth to governance, or some third factor (such as accumulated knowledge and skills) that affects both governance and income growth. Bearing in mind these caveats, many cross-country studies do suggest that the nature of governance—as reflected in broad institutional measures such as protection of property rights, rule of law, and absence of corruption—matters to long-term growth.<sup>5</sup>

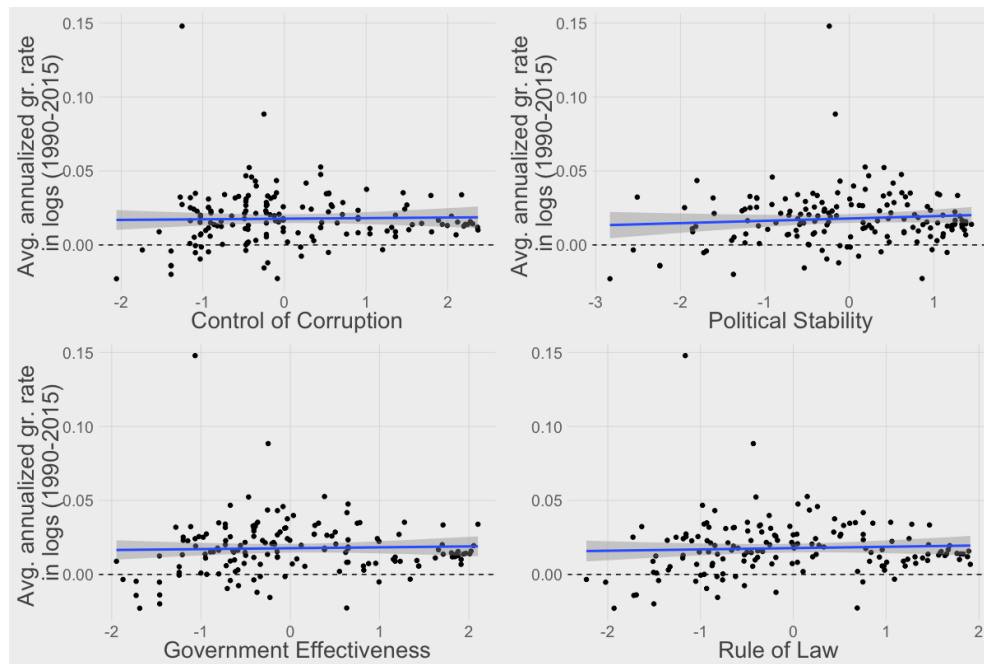
5.9 Even within countries, historical differences in institutions that affect property rights and collective action are associated with persistent differences in levels of economic development. For instance, in some regions of Peru, an extensive system of forced mining labor (the *mita*) was in effect between 1573 and 1812. Today, average household consumption levels in those regions are about 25 percent lower than in adjoining regions. One explanation is that in areas without the *mita*, a landowning class emerged, which had an incentive to set up stable property rights institutions. Areas that did not have the *mita* system still have more secure property rights and do a better job of providing public goods.<sup>6</sup>

<sup>5</sup> For example, Mauro 1995; Hall and Jones 1999; and Acemoglu and others 2001, that historical and/or culturally driven sources of difference in some dimensions of governance (such as security of property rights, corruption, and policies of economic openness) have had an impact on long-term growth in per capita GDP. Building on such approaches, Kaufmann and Kraay (2002) propose a methodology to investigate the two-way causality between governance and per capita income. Their results also suggest a positive causal effect from governance to long-term growth, but a weak and even negative effect running from income per capita growth to better governance. See Pande and Udry (2006) for a critique of such approaches.

<sup>6</sup> Dell 2010.

5.10 Viewing change over the shorter span of decades rather than centuries, the relationship between broad, aggregate measures of governance and economic growth is weaker (Figure 5.2).<sup>7</sup> In the last century, growth accelerations and slowdowns that lasted as long as a decade do not seem to be correlated with major changes in governance; nor do sustained periods of high growth lasting as long as three decades.<sup>8</sup> It is possible for economies to grow without big changes in the nature of governance, but it is not clear how long such growth can be sustained.

**Figure 5.2 Medium-term growth and governance are *not* correlated**



Source: WDR 2017 team, using data from the World Governance Indicators.

Note: WGI indicators are from the year 1996.

5.11 What are the mechanisms behind the aggregate relationship between governance and growth? Since different dimensions of governance are correlated across countries, it is not easy to delineate their impacts on growth through cross-country analysis alone. A more microeconomic analysis of the mechanisms through which governance affects growth is therefore a vital complement to the macroeconomic analysis of governance and growth.<sup>9</sup>

5.12 On the surface, growth in per capita income has two sources—investment and efficiency. Investment is the process by which economies accumulate physical capital, skills, and knowledge. Efficiency, on the other hand, determines how well this labor and capital are put to use. In general, at least half the per capita income differences across countries is accounted for by differences in

<sup>7</sup> The governance indicators are for 1996, the earliest year for which WGI data are available, while per capita income growth is measured for the 15-year period between 1990 and 2015. The observed patterns are robust to measuring growth over 1996–2015.

<sup>8</sup> See Hausmann, Pritchett and Rodrik 2005; Jones and Olken 2008; Eichengreen and others 2012; Rodrik, 2005; Levy 2014.

<sup>9</sup> Pande and Udry 2006.

their efficiency (*total factor productivity*, or TFP) levels, while the rest is due to differences in investment (accumulation).<sup>10</sup> Both accumulation and efficiency, therefore, matter to growth.

5.13 Countries place different emphasis on various forms of accumulation and efficiency in their growth models. Some growth models emphasize accumulation, such as the mobilization of savings for industrial investment. Other models emphasize efficiency growth through innovation and competition among firms. Growth models based on factor accumulation may require a different governance configuration than those based on efficiency. Transitioning from one model to another has proved to be a complex policy challenge.<sup>11</sup> (See spotlight 5 on the “middle-income trap” at the end of this chapter.)

5.14 Governance can affect investment and efficiency through two types of institutional “functions.” The first deals with commitment: that is, creating an environment in which firms or individuals feel secure in investing their resources in productive activities, and have the incentives to use them efficiently. The second pertains to socially beneficial collective action to coordinate investment decisions and promote cooperation between investors to solve potential market failures.

***The key functions: Enhancing commitment and collective action***

5.15 In the absence of credible commitment to the security of property rights (that is, when there is a risk of expropriation), the incentives for investment or innovation will be limited. Firms and individuals that experience lower security will invest less in productive activities. Moreover, differences across firms in the level of security from expropriation will affect the efficiency of resource use. If the more productive firms in an economy experience less security than the less productive ones, then investment by productive firms will be inefficiently low, leading to misallocation of resources and thwarting growth.

5.16 Consistent with theory, household-level studies find that farmers are more likely to make long-term investments in their land when their tenure is more secure, and urban households are more likely to renovate homes when the risk of being dispossessed is lower.<sup>12</sup> Secure rights also improve labor allocation because protecting one’s property is no longer a prime motive in decisions about where to work.<sup>13</sup> Similarly, studies find that firms that perceive themselves to be more secure from expropriation reinvest more of their profits in their business.<sup>14</sup> Theory also suggests that well-defined property rights should improve the functioning of credit and other asset markets, but empirical evidence for these predictions is weak.

5.17 Enforcement of contracts governing economic transactions is also critical because problems with contract enforcement prevent specialization and optimal division of labor.<sup>15</sup> Suppose a firm is considering whether to specialize in producing parts for a bigger firm. Once committed to this specialization, it will have no alternative but to sell those parts at whichever

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<sup>10</sup> Caselli 2005; Caselli 2016.

<sup>11</sup> Gill and Kharas 2015.

<sup>12</sup> Galliani and Schargrodsky (2011) review this evidence.

<sup>13</sup> Field 2007.

<sup>14</sup> Johnson, McMillan, and Woodruff 2002b.

<sup>15</sup> North 1990; Costinot 2009.

price that particular buyer offers. Hence, the firm will hesitate to specialize unless both parties can agree to an enforceable contract with a fair price. In small economies, reputation and relationships can be effective means of enforcement, but as growth leads to greater market size, impersonal interactions become more likely, and thus formal contract enforcement start to matter more.<sup>16</sup> Empirical studies find that a strengthened formal enforcement system can foster the creation of new business relationships, promote trade in goods, and increase the flow of credit to firms.<sup>17</sup>

5.18 The design and implementation of regulations that affect competition between firms is another policy dimension central to growth. For example, poorly designed licensing requirements for new firms can make it difficult for entrepreneurs to bring new investment ideas to fruition, and reduce competitive pressure on existing firms to innovate and become more productive.<sup>18</sup> A case in point was a policy of industrial licensing in India that required firms to obtain government permission before setting up a new factory or expanding output in an existing factory. The process of license approval was onerous and unpredictable. Loosening these requirements in some industries in the 1980s may have increased the efficiency levels by as much as 22 percent.<sup>19</sup>

5.19 Some forms of collective action, such as coordinating investment and ensuring cooperation to prevent free riding, can solve potential market failures that can impede growth and investments in public goods. While discussing all possible market failures is beyond the scope of this chapter, this chapter will illustrate the key issues by looking at a specific type of failure.

5.20 The insight that a failure to coordinate investment activity could lead to underdevelopment is decades old.<sup>20</sup> Suppose large-scale factories are more efficient, but investing in them is not profitable for individual firms unless done simultaneously in a group. This could be because those industries provide markets for one another, so the market size is too small to justify large-scale investments unless all the industries expand together. There are two possible outcomes, or “equilibria,” in such a situation. The first is one in which no firms invest in large-scale factories, and efficiency levels stay low. The second, better outcome is one in which firms are able to coordinate a simultaneous move to large-scale, efficient production. Such coordination problems can occur in many contexts, ranging from finance and adoption of technology to innovation and industrial clusters.<sup>21</sup>

5.21 Policies to address coordination and other collective actions problems are difficult to design and implement. For example, when spillovers between firms could lead to a coordination failure, governments could use subsidies or taxes to encourage firms to invest in a coordinated

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<sup>16</sup> Dixit 2007.

<sup>17</sup> Johnson, McMillan, and Woodruff (2002a) find that well-functioning courts help firms switch to new suppliers. Better contract enforcement is also associated with higher lending and lower rates of default (Japelli and others 2005, Castelar and Cabral 2001; Cristini, Moya, and Powell 2001). There is also evidence that better contract enforcement enhances the productivity impact of trade liberalization (Ahsan 2013).

<sup>18</sup> Among others, Haskel and others 2007, and Aghion and others (2009) present firm-level evidence on how competition (from entrants) affects productivity growth.

<sup>19</sup> Chari 2011.

<sup>20</sup> Rosenstein-Rodan 1943. Murphy, Shleifer, and Vishny (1989) model a more recent version of this idea.

<sup>21</sup> Hoff (2000) reviews models of coordination failures in a wide range of contexts, including social norms and corruption. Cooper (1999) reviews macroeconomic models of coordination failures, while Rodríguez-Clare (2005) reviews microeconomic models of coordination failures.

manner.<sup>22</sup> But targeting such a subsidy scheme to the right set of firms requires information on precisely which firms could have spillovers on one another, and on how much they are investing.<sup>23</sup> Such implementation challenges make policies to address collective action problems in growth particularly sensitive to the quality of governance. Industrial development policies that abetted the rapid industrialization of Japan, the Republic of Korea, and Taiwan, China in the second half of the twentieth century are exceptional examples of successful state-guided coordination of investment (see chapter 7).<sup>24</sup>

### **How policies are affected by undue influence from powerful groups: Moving beyond anecdotal evidence**

5.22 Poor capacity to design or implement policies could be one reason why governments do not enact policies that are functionally optimal for aggregate growth. Yet, even when such this capacity exists and a first-best policy has been identified, those in power may not have the incentive to choose that policy. Indeed, it is possible that specific actors in the policy arena have so much bargaining power that the policy's design or implementation maximizes their private benefits, not social welfare. This report defines this as *capture*. Capture is not easy to identify, and there is a risk of mistaking what was simply a misinformed policy choice for deliberate subversion. Recent years have seen a burgeoning of quantitative research into this question. This research has detected specific forms of capture, and in some cases has even measured its efficiency costs.

5.23 For instance, studies of trade policy suggest that even in high-income countries, policy choice can unduly reflect the preference of groups with high levels of influence in the policy arena. While low trade barriers are generally good for long-term growth, domestic industries that compete with imports stand to lose from them in the short term. Political influence or campaign contributions from industry lobbies and labor unions have been shown to affect the setting of import tariffs. Larger and better-organized industries that compete with imports tend to win more import protection.<sup>25</sup>

5.24 The potential power to influence policy is distributed unevenly not just across industries, but also across firms within industries. In most countries, some firms are much better connected to the government than others. Sometimes, state actors collude with such politically connected firms to subvert a policy in the interest of those firms, possibly to the detriment of unconnected firms in the same industry. Such capture by connected firms may not be as visible or as large-scale as, say, setting high tariffs in import-competing industries. However, the evidence suggests that it is far from trivial in economic terms.

5.25 In the 1990s, for example, some of Indonesia's largest industrial groups had strong connections to then-President Suharto. Between 1995 and 1997, negative rumors about President Suharto's health circulated on several occasions. In every episode, the more closely that industrial groups were connected to the president, the more their stock market returns fell (figure 5.4). This

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<sup>22</sup> Rodrick 1996.

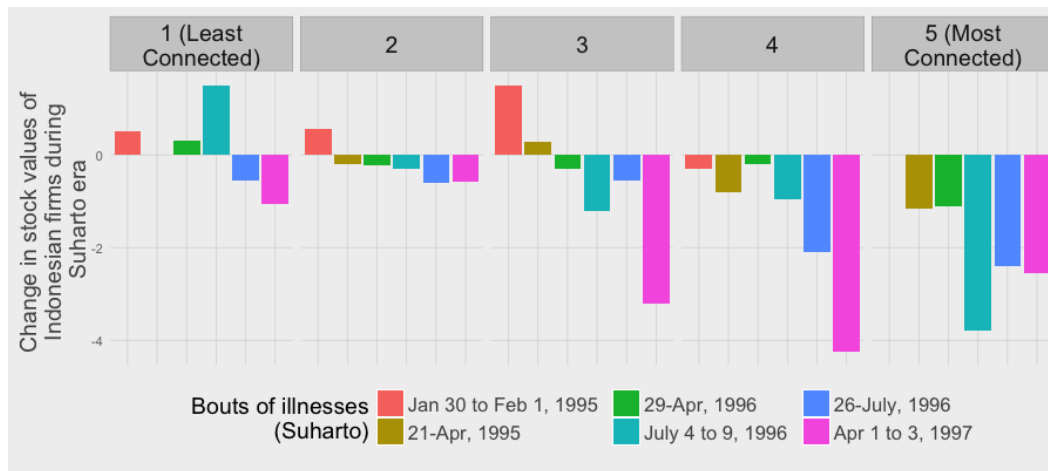
<sup>23</sup> Bond and Pande 2007.

<sup>24</sup> Wade 1990, Evans 1995, and Kohli (2004) analyze the East Asian story. Robinson (2009) discusses how such industrial development policies have largely failed in other parts of the world.

<sup>25</sup> For evidence from developed countries, see, for instance, Goldberg and Maggi 1999; Gawande and Bandyopadhyay 2000; Mitra, Thomakos, and Ulubaşoğlu 2002; and Esfahani 2005.

fall in value was greater the more severe the health rumor. Because this decline was not connected to other changes in market conditions or the productivity of connected firms, the drop in share price is a proxy for the private benefits of being able to capture policy through political connections.<sup>26</sup> Using a similar method, the estimated value of political connections in the Arab Republic of Egypt in the Mobarak era is about 13 percent to 16 percent of firm value.<sup>27</sup>

**Figure 5.3 The stock value of politically connected firms falls when the connection is in jeopardy**



Source: Fisman (2001), figure 1.

### *How politically connected firms gain undue advantage*

5.26 The benefits of policy capture to connected firms can be economically significant. Understanding the ways in which it occurs is therefore important.

5.27 *Diverting government loans.* One way in which state actors favor connected firms is to divert government loans to them. In Pakistan, for example, between 1996 and 2002, politically connected firms borrowed 45 percent more and had 50 percent higher loan default rates than other firms.<sup>28</sup> This preferential treatment was related entirely to loans from government banks. Moreover, it increased when the power of the connected politician increased, and fell when there was more electoral competition in his constituency. Another study from Brazil finds that firms that make campaign contributions to winning candidates have higher returns and subsequently receive greater credit from banks.<sup>29</sup>

5.28 *Tailoring macroeconomic policies to connected firms.* Evidence from Malaysia at the time of the Asian financial crisis suggests that even macroeconomic policies can be used to favor connected firms. In this case, international capital controls created a screen behind which politicians could favor connected firms through preferential credit. During the initial crisis period from July 1997 to August 1998, politically connected firms lost market value. However, after the

<sup>26</sup> Fisman 2001.

<sup>27</sup> Chekir and Diwan 2014.

<sup>28</sup> Khwaja and Mian 2005.

<sup>29</sup> Claessens, Feijen, and Laeven 2008.

imposition of capital controls by Prime Minister Mahathir's government in September 1998, firms connected to the prime minister gained value, especially those that had found it hard to get loans before capital controls were imposed. By contrast, firms connected primarily to the deputy prime minister, who was fired during the crisis, did not gain in value.<sup>30</sup>

5.29 *Granting import licenses to favored firms.* Another way to channel favor to connected firms is to grant import licenses only to specific (favored) firms. In Suharto-era Indonesia, being politically connected tripled the likelihood of receiving a license relative to a firm's competitors. The licenses conferred monopolistic power on the licensee. For example, a highly connected firm in the milk industry was granted import licenses for 12 inputs necessary to produce milk, whereas some other firms in the same industry had 3 to 4 licenses, at most. This forced competitors to rely on the connected firm or on inferior domestic supplies.<sup>31</sup>

5.30 *Using market regulations to favor firms.* Market regulations can also be used to favor connected firms. For example, regulatory barriers to the entry of new firms can be a means of protecting incumbents, to the detriment of market entry and competition. In Tunisia during Zine El Abidine Ben Ali's regime, firms under the control of the ruling clan accounted for a disproportionately high share (21 percent) of total private sector profits.<sup>32</sup> The superior profits of these connected firms may have been due to the heavy regulation of firm entry, investment, and foreign direct investment in the sectors where they had a heavy presence. The gap in profits between connected firms and others was higher in more regulated sectors, suggesting that entry regulation served to shield connected firms from competition. Similarly, in Mobarak-era Egypt, heavier regulations, bigger import barriers, energy subsidies, and better access to land were used to diminish competition in sectors dominated by connected firms.<sup>33</sup>

### ***Political cycles and populism***

5.31 Potentially, any group of firms, workers, or consumers that is politically influential can exert influence on policies. For example, the adoption of "Green Growth" policies which are socially beneficial and would not necessarily slow down economic growth could be blocked by influential groups of farmers or consumers who stand to lose from them in the short-term (box 5.1). And sometimes it is hard to predict which side will manage to tilt policies in its favor. Regulation of utility industries is a typical case. In such industries, the unregulated price can be inefficiently high, and there is a valid economic argument for regulating prices. On one hand, regulators could collude with the utility firm to set a high price that is too generous to the latter.<sup>34</sup> On the other hand, if the relative influence from consumer advocacy groups is stronger, the regulator might end up setting a low price that is too taxing for the utility.

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<sup>30</sup> Johnson and Milton 2003.

<sup>31</sup> Mobarak and Purbasari 2008.

<sup>32</sup> Rijkers and others 2014.

<sup>33</sup> Diwan and others 2015.

<sup>34</sup> See, for example, Stigler (1971) and Peltzman (1976) for theory; and Dal Bo (2006) for a review of the empirical evidence on capture, largely from the United States.

### Box 5.1 Why some people see red when they hear Green Growth

“Green growth is about making growth processes resource-efficient, cleaner and more resilient without necessarily slowing them.” (Hallegatte and others 2012). There are many reasons why environmental conservation is also good for long-term economic growth and development. Economic production depends on the stock of natural resources and on environmental quality (“natural capital”). Green growth strategies can increase natural capital by preventing environmental degradation. Environmental protection can also make an indirect contribution to growth by correcting market failures. For example, a policy that addresses market failures leading to urban congestion can improve air quality and increase urban productivity. Greener growth can also improve well-being directly by improving air and water quality.

However, switching to greener growth strategies could impose short-term costs on some groups in society. Take the case of agricultural policy. In 2005, faced with food insecurity, Malawi introduced a fertilizer subsidy for smallholder maize farmers. Intensive fertilizer use, such as that promoted by this subsidy, can have substantial long-term costs on the environment and the economy. But the subsidy did lead to an immediate increase in farm output. Moreover, small farmers would not find it easy to adopt greener approaches using smaller but more targeted doses of fertilizers and more organic fertilizers. Getting rid of the subsidy would therefore hurt maize farmers for some years (Resnick, Tarp and Thurlow 2012)

It could be that the groups that stand to lose from green growth policies in the short-run have oversized influence over the policy arena, and are able to block reforms and undermine commitment. Since many of the benefits from cleaner technologies are intangible and dispersed, the potential losers of from such reforms are likely to be better able to organize. They can also constitute an electorally vital constituency. Malawi’s fertilizer program has been popular among small farmers, and the party in power when the subsidy was introduced needed their support because it had a relatively weak rural vote base. Indeed, there was a large increase in subsidy funding as the 2009 elections approached.

In other cases, switching to greener growth strategies can entail losses for influential groups of consumers and firms. For example, South Africa announced an ambitious climate change plan in 2010, one that would necessitate a large reduction in the share of electricity generated by coal-fired plants, in a country where electricity is in short supply and coal is a relatively abundant source. The plan, despite being watered down a year later, has been opposed by consumers, labor unions and business interests, particularly those in mining and heavy industry (Resnick, Tarp and Thurlow 2012). These examples show that the design of green growth policies must take into account how the potential resistance from short-term losers.

Sources: Hallegatte and others 2012; Resnick, Tarp and Thurlow 2012.

5.32 *Tilting policies in the favor of politically influential groups.* Sometimes, politicians direct public investment to benefit narrow groups of supporters (*clientelism*) (see chapter 6). Client-based allocation of public investment is likely to be highly inefficient. More generally, public resources can be allocated in favor of politically influential groups without necessarily involving a strict patron-client relationship.

5.33 For example, many countries have developmental programs that direct state credit to small firms, rural enterprises, and farmers. This credit can be used to favor groups that have outsized political influence. One study finds that in India during 1985–2009, agricultural credit from state banks would increase by 5–10 percentage points in an election year (figure 5.5).<sup>35</sup> This increased lending during election years targeted places where the electoral race was particularly close, hinting at the political motives behind the credit boom. Such political cycles in government lending during elections years have been observed in many countries.<sup>36</sup> In Italy, the interest rates charged

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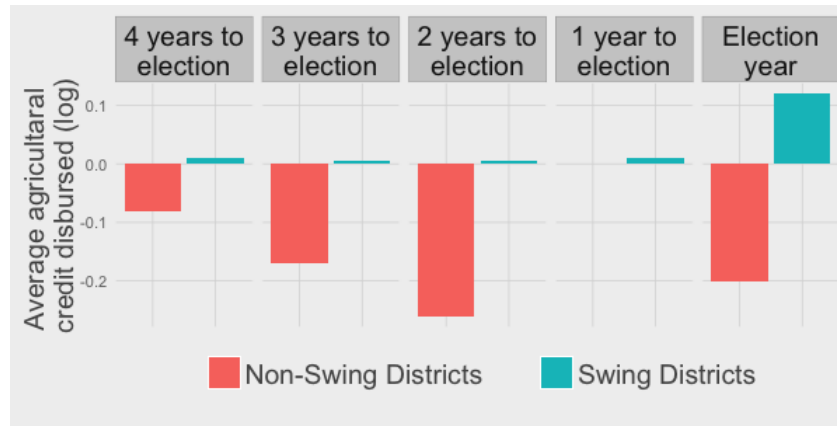
<sup>35</sup> Cole 2009.

<sup>36</sup> Dinc 2005.



by politically affiliated banks vary with the election cycle, which is also suggestive of political influence on lending.<sup>37</sup>

**Figure 5.4 Government credit to electorally competitive districts increases during election years in India**



Source: WDR 2017 team, using data derived from Cole 2009, figure 1.

Note: The data cover the years 1985 to 2009.

5.34 *Misallocating public investment.* Failed industrial development programs provide another example of how political influence can undermine growth by misallocating public investment. Governments often direct public investment to specific sectors or regions, ostensibly to address coordination failures. Such programs could become a vehicle for providing hidden benefits to politically influential groups.<sup>38</sup> For instance, landowners and workers in politically important regions might gain if an industrial zone is located in their region and raises land prices and wages.

5.35 The disappointing experience of Sub-Saharan Africa with industrial coordination policies is illustrative. Defying economic logic, one program in Ghana involved the transport of cattle hides to a tannery 500 miles to the south of the country, then sending the leather back north to a footwear factory 200 miles away, all to serve a market a further 200 miles north. Poor siting of the tannery thus rendered the program economically unviable. Some of these case studies conclude that poor location decisions were the outcomes of political influence. In Zambia, for example, the Industrial Development Corporation evidently chose economically infeasible locations for many subsidiary firms mainly on the basis of providing employment in rural areas.<sup>39</sup>

### *The cost of capture*

5.36 The most obvious cost of policy capture is the inefficient allocation of public resources. For example, bank loans should go to the most productive firms, but that is not necessarily the case when lending is based on a firm's political connections. In Pakistan, connected firms got a disproportionately large share of credit but were more likely to default on their loans than other firms, and were less productive. Based on the gap in productivity between connected firms and

<sup>37</sup> Sapienza 2004.

<sup>38</sup> Coate and Morris 1995.

<sup>39</sup> Robinson 2009.

other firms, the annual loss from giving disproportionate amounts of credit to connected firms could have been as high as 1.6 percent of GDP.<sup>40</sup>

5.37 Such misallocation can also have a long-term cost on growth through detrimental effects on the basic economic process of creative destruction: that is, the entry of new firms, investment by existing firms to become more productive, and the exit of unproductive firms.<sup>41</sup> Entrepreneurship is likely to be discouraged in an environment where firms with political influence earn rents at the expense of more efficient or more innovative firms that lack influence. By tilting the playing field against ordinary firms, such capture can also make growth less inclusive. Measuring such long-term costs is difficult.

5.38 This reckoning of the costs of undue influence on policies is relative to a benchmark in which resources are efficiently allocated. However, the removal of means of rent seeking by influential firms could have other systemic effects on the economy. Indeed, there is a view according to which many low-income economies are characterized socioeconomic relationships based not on impersonal rules but on personal connections and privilege.<sup>42</sup> In this political order, the elites manipulate the economy to maintain rents for powerful groups. This serves to maintain social order and restrain violence. In such a world, “capture” is just a symptom of underlying political economy problems, and so long as those are not addressed, simply prohibiting means of capture and rent seeking will not lead to efficient outcomes. It could even worsen growth prospects. In other words, the effects of policy changes that block certain channels for rent seeking could depend on the underlying equilibrium of the political economy.<sup>43</sup>

#### ***When interest group influence is not necessarily bad for policies***

5.39 Sometimes, the self-interest of powerful businesses can coincide with policies that are good for long-term growth. The expansion of trading opportunities in the Mediterranean in the tenth to twelfth centuries, for example, led to the establishment of a broad-based merchant class in that part of the world. This merchant class was interested in market-supporting institutions that would enable trade for all its members. It used its economic power to push for the establishment of robust contracting institutions and constraints on the executive (by ending the practice of hereditary Doges in Venice and instituting a de facto parliament).<sup>44</sup> Over time, however, wealth concentrated in a narrower set of merchant families. No longer needing the support of smaller merchants, the big merchant families used that concentrated wealth to institute an oligarchy.<sup>45</sup>

5.40 Case studies that are more contemporary suggest that business associations have helped governments improve various dimensions of the business environment (such as secure property rights, fair enforcement of rules, and public infrastructure provision) for their collective benefit,

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<sup>40</sup> Khwaja and Mian 2005.

<sup>41</sup> See Aghion, Akcigit, and Howitt (2014) for a summary review of this theory of growth.

<sup>42</sup> See Pritchett and Werker (2012) for a discussion of “deals-based” systems. A similar concept of “limited access order” is discussed in North, Wallis, and Weingast (2009).

<sup>43</sup> Acemoglu and Robinson 2013.

<sup>44</sup> Similarly, opportunities created by the rise of Atlantic trade in the 1600s led to the rise of a merchant class in Great Britain and some European countries, such as the Netherlands. Their influence may have helped establish strong property rights and contracting institutions in these countries (Acemoglu and others 2005).

<sup>45</sup> Puga and Trefler 2014. The background note by Levchenko (2016) provides a summary of this and other recent research on impact of trade on institutions.

through lobbying efforts or better monitoring of public officials.<sup>46</sup> They have also helped in solving coordination problems. The Republic of Korea's phase of growth through export-oriented industrialization, which lasted for three decades, exemplifies this kind of pro-growth state-business interaction.<sup>47</sup> Other cases include the footwear manufacturers' association in Brazil, the coffee federation in Colombia, and the textile manufacturers' association in Thailand, all of which played a coordinating role in reducing the costs of information about export markets.<sup>48</sup>

5.41 *Broad-based business associations* are more likely to have an interest in pushing for better institutions rather than narrow rents. It is in the collective interest of firms in an industry to prevent policy capture by a few of them. Industry groups can develop collective mechanisms that prevent members from colluding with state officials and subverting policies in their narrow interest.<sup>49</sup> Indeed, case studies suggest that business associations whose membership represents a large segment of the industry tend to be more influential, and more "developmentally oriented" in their influence.<sup>50</sup>

5.42 *The extent and type of transparency* also affects the nature of state-business interaction. When a state agency and the firms with which it interacts have a monopoly over critical information, there is a greater scope for them to collude and subvert policy in their mutual interest. Consider the regulation of a natural monopoly such as a public utility. Typically, the regulatory agency would cap prices and compensate the utility firm based on an assessment of the latter's cost of production. In such situations, the firm could gain by colluding with the regulator to overstate its cost. The gain to such collusion is larger (and the chances that it will be detected lower) when the regulator and the firm know more about the cost than others do.<sup>51</sup>

5.43 *The nature of the government agencies that interact with firms* also determines when state-business links will degenerate into narrow interest group capture. One example is the effectiveness of some industrial development agencies in East Asia, such as Japan's Ministry of Trade and Industry (MITI) in the 1950s to 1970s.<sup>52</sup> MITI officials had a high degree of autonomy, as well as strong business ties. While this was necessary for the agency to be effective in coordinating industrialization, it also exposed it to capture. MITI, however, was also highly meritocratic, with bureaucrats following long-term career paths, clear rules, and established norms. It drew staff largely from a select group of elite technocrats who had strong informal ties to one another, giving the agency an unusually high level of internal coherence. This organizational strength may have prevented MITI from being captured by narrow interests.

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<sup>46</sup> Doner and Schneider 2000.

<sup>47</sup> See, for example, Evans 1995. However, the story of the Republic of Korea also suggests that productive business-state relationships can sometimes degenerate into instruments of capture. There is evidence that large businesses eventually captured some of the state support that was meant to kick-start investment (Eichengreen 2012).

<sup>48</sup> Doner and Schneider 2000.

<sup>49</sup> Dixit 2015.

<sup>50</sup> Doner and Schneider 2000.

<sup>51</sup> Laffont and Tirole 1991; 1993.

<sup>52</sup> Evans 1995; Wade 1990.

## Policy design under risk of capture

5.44 How should the risk of undue influence from dominant groups factor into the design of policies and the government agencies responsible for their implementation? This chapter first discusses a pragmatic approach to policy design that duly considers the probability of capture.

### *Designing policies that are implementable*

5.45 Sometimes, when the possibility of capture looms large, policies that are first-best on the basis of economic efficiency are less implementable than second-best ones.<sup>53</sup> The reason for this is that even a powerful interest group has to expend effort and resources to gain influence. Unlike the first-best policy, a second-best policy could render the benefit from capture too small to be worth this cost. Often, this principle leads to policy designs in which there is less room for discretion at the implementation stage. When a regulator has limited discretion and mainly enforces rigid rules, there is less scope for subverting the enforcement of those rules to award undue favor. As a result, the benefit from capture is too low.

5.46 Admittedly, designing policies that are less susceptible to capture involves a tradeoff with efficiency. Replacing regulatory discretion with rigid rules gives the regulator less room to adapt enforcement to changing conditions. Rigid regulation thus imposes excessive costs on firms. Box 5.2 illustrates the trade-off.

#### **Box 5.2 The advantages of a second-best approach of more rigid but less efficient rules when capture is likely**

What explains the rise of business regulation in the United States in the early decades of the twentieth century? Before 1890, issues regarding industrial safety, quality, and anticompetitive practices were mostly resolved in courts through private litigation. Gradually, however, regulatory agencies took control of matters regarding competition, antitrust policy, and food and drug safety. One reason for the rise of regulation was that courts were increasingly seen as being ineffective at reducing harmful anticompetitive practices of large firms with deep pockets. Historical accounts suggest that large corporations had too much influence in the process of selecting judges, and could also sway court decisions in their favor through a combination of superior lawyers, political influence, and outright bribery.

A simple model of alternative enforcement mechanisms explains why, under certain conditions, regulation could be more effective than litigation. Consider the case of enforcing a quality standard in firms. One way to enforce this standard is through ex post mechanisms such as litigation: that is, to leave it to an affected consumer to bring a lawsuit against a violating firm, and not interfere before a violation is alleged. Another way is to enact ex ante rules about how the good must be produced, and appoint regulators who inspect firms and fine those in violation of those rules.

In general, litigation is the more efficient way to enforce product quality. This is because it gives each firm the flexibility to find the most efficient way to produce the good while meeting the quality standard. Regulation, in contrast, imposes rigid rules and entails high administrative costs. But litigation might be less implementable when capture is possible.

Why? In the case of litigation, the probability that someone will actually file and win a lawsuit (the “detection rate”) is low. Hence, for litigation to be an effective deterrent, the damages imposed on those found guilty must be high. In contrast, since it is cheaper to verify if firms are following regulation, the detection rate under regulation is higher, and even a small fine can be an effective deterrent.

Now suppose that capture is possible: that is, a firm can pay a bribe to a judge or regulator to avoid the fines. In the case of litigation, the fine is so high that a guilty firm would rather bribe the court than pay the damages. In contrast,

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<sup>53</sup> Laffont and Tirole (1993).

in the case of regulation, the fine may be so low that bribing the regulator to avoid it is not worthwhile. Thus, as it gets easier for firms to capture courts or regulators, regulation becomes more efficient relative to litigation. This could explain why regulation became more pervasive in the United States when corporations became larger and had more resources to effect capture.

*Source: Glaeser and Shleifer 2003.*

5.47 The risk of capture by self-interested, myopic state actors can also be addressed through pragmatic policy design—although with the same efficiency trade-offs. Think of a situation where a government wants to attract foreign direct investment (FDI), but there is a history of FDI disputes, and investors are hesitant because they perceive a high risk of expropriation. While strengthening checks and balances on state actors can reduce the perceived likelihood of expropriation, such institutional reforms take time. In the meantime, there are ways to design the FDI contract that make expropriation less likely. Efficiency dictates a revenue-sharing scheme in which the host country gets a fixed amount every period, leaving the investor with strong incentives to increase profitability. However, when expropriation is a possibility, a more practical revenue-sharing scheme is one in which the host country automatically gets more (less) revenue when profits are high (low).<sup>54</sup> This scheme reduces the government’s incentive to expropriate when profits are high.

5.48 To put it in general terms, policies that are compatible with the existing balance of power may not be ideal, but they can effectively deliver growth. For example, in China, the Township Village Enterprise (TVEs) policy yielded strong investment growth until the mid-1990s.<sup>55</sup> This was an unusual way of committing to property rights because TVEs were under the control of local community governments, and not, as is more common, under fully private or central government control. Nevertheless, it was effective, given China’s context at that time. China had inherited a strong ideology opposing private property from the era of central planning, and there was an absence of legal protection for the private property rights of firms. In contrast, the central government needed the political support of local governments, and was less likely to interfere with the property rights of TVEs. This made the commitment to TVEs’ property rights credible.

### ***Anticipating how a policy could change the balance of power***

5.49 Beyond its immediate impact on investment and production, an economic policy could have far-reaching consequences for governance—and hence growth—by altering the balance of power. Consider how a policy that promotes international trade could have such an effect. The long-term developmental consequences of the rise of Atlantic trade in the early modern era is a good example.<sup>56</sup> This trade led to a rise of a merchant class in Great Britain and select other polities in Europe (such as the Netherlands), a group that was interested in well-functioning contracting institutions and in protecting themselves from expropriation by the state. The power acquired by this group helped them shape the institutional formation in those countries, eventually leading to the establishment of modern capitalist institutions.

5.50 But new international trade opportunities have not always lead to better institutions. Consider the sugar boom that swept over the Caribbean islands around the 1650s, and lasted for

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<sup>54</sup> Engle and Fischer 2010.

<sup>55</sup> Qian 2003; Yao 2014.

<sup>56</sup> Acemoglu and others 2005.

more than 200 years.<sup>57</sup> Before the advent of large-scale sugar production, these islands were typically smallholder peasant societies. The sugar boom concentrated power in the hands of large plantations owners—a development that has been associated with the rise of slavery, as well as the persistent undermining of the property rights of small farmers in the region. This institutional stunting had serious adverse consequences for long-term growth.

5.51 These examples suggest that when assessing a policy, it is important to understand the conditions under which it can lead to a concentration of economic power in a way that would undermine socially beneficial institutions.<sup>58</sup> It is best to avoid policies that could increase the dominance of groups whose interests are not aligned with further socially beneficially institutional reform, even if that policy is optimal from a textbook economics perspective.<sup>59</sup>

5.52 The experience of Russian Federation and Eastern European countries in their transition toward market economies illustrates this principle.<sup>60</sup> At the time, there was a general sense among economists that privatization of state-owned enterprises (SOEs) was a priority for improving the efficiency of these economies. Thus, Russia and many Eastern European countries focused on rapid, large-scale privatization of SOEs. But the way in which this was implemented created a new class of oligarchs that were able to block other pro-competitive policies (such as easing the procedure for setting up a new business). As a result, many of these economies are still struggling with inefficient, oligopolistic industries. In contrast, Poland chose to focus first on reforms making it easy for new firms to enter, and privatized existing firms more gradually. This sequencing created a class of young firms that were collectively interested in further reforms, while preventing the sudden emergence of a powerful group of large firms that could block reforms.<sup>61</sup>

### **How the design of public agencies mediates the influence of powerful groups**

5.53 Why is it that some public agencies are able to work with different interest groups to design and implement policies without being unduly influenced by any particular group, while others get captured by dominant groups? The answer depends on a number of features of the internal design of bureaucracies, such as how officials are selected, how the performance of officials is assessed and rewarded, and how much discretion they have in implementing those goals. The allocation of functions across agencies and the role of oversight agencies such as auditors, also matters.<sup>62</sup> Finally, as discussed in the *World Development Report 2015*, bureaucratic norms can emerge that facilitate or obstruct capture.<sup>63</sup>

### ***Selection methods, incentives, and intrinsic motivation***

5.54 Recently, a number of studies have empirically examined how selection and incentive structures in bureaucracies affect the behavior of officials. This research can be useful for

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<sup>57</sup> Levchenko 2016.

<sup>58</sup> Do and Levchenko 2009.

<sup>59</sup> Acemoglu and Robinson 2013.

<sup>60</sup> See Roland and Verdier 1999.

<sup>61</sup> Jackson, Klich and Poznanka 2005.

<sup>62</sup> Tirole 1994.

<sup>63</sup> See Spotlight 1 of World Bank 2015: 60.

understanding how agency design could make officials less susceptible to bribery or other forms of undue influence by those seeking to capture a policy.

5.55 Better selection and incentive structure can improve bureaucratic performance, but there are limits to their effectiveness.<sup>64</sup> Consider incentive tools, such as pay-for-performance schemes. Randomized evaluations of these schemes in the context of frontline provision of public health and education find positive impacts on the task performance of public officials.<sup>65</sup> Pay-for-performance could weaken the incentives of officials to collude in policy capture if that would mean missing performance targets. However, designing performance incentives is not easy in most public agencies.

5.56 One issue with incentive schemes is that many government agencies have multiple objectives. Making officials' pay too dependent on achieving any one objective can lead to a disproportionate focus on that objective, to the exclusion of others.<sup>66</sup> For example, when police agencies in the United States are allowed to keep the revenue they obtain from assets they seize in drug arrests, they increase drug arrests, but at the cost of reducing enforcement of other petty crimes.<sup>67</sup> Focusing on one-dimensional incentives could also encourage overzealous or biased behavior by officials. This concern is especially salient among officials whose jobs involve the exercise of expert judgment, such as regulators and judges. Making their rewards dependent on taking a particular position could induce them to distort their judgment routinely in favor of that position. For example, a regulator who is rewarded according to the number of violations detected might become too zealous in detecting "violations," or demand even higher bribes to not report violations.

5.57 Besides financial incentives, the "intrinsic motivation" of public officials also matters to how they behave. Both survey and lab experiments suggest that public officials are intrinsically more motivated toward public service than private sector employees are.<sup>68</sup> Such pro-social motivation is also correlated with better job performance.<sup>69</sup>

5.58 The environment in which officials work matters to their intrinsic motivation. For instance, reduced caseloads and increased salaries have a more positive effect on the performance of judges in U.S. state supreme courts when those judges are given more discretion in selecting cases (Ash and MacLeod 2015). This is consistent with the hypothesis that judges are intrinsically motivated to work hard on important cases. Reducing caseloads and increasing salaries give them the time and financial security to focus on producing high-quality judgments, especially when they have the discretion to choose important cases.

5.59 The effects of a change in the operating environment in a public agency could depend on the extent to which its officials are already motivated in a pro-social direction. If officials care only

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<sup>64</sup> Some of the discussion in this section is based on a review paper by Finan, Olken, and Pande 2015.

<sup>65</sup> For example, Banerjee, Glennerster, and Duflo 2008; Glewwe, Illias, and Kremer 2010; Basinga and others 2011; Muralidharan and Sundararaman 2011; Duflo, Hanna, and Ryan 2011; Gertler and Vermeersch 2012.

<sup>66</sup> Tirole 1994.

<sup>67</sup> Baicker and Jacobson 2007.

<sup>68</sup> See Cowley and Smith (2014) for survey-based evidence, and Banuri and Keefer (2013) for evidence from lab experiments.

<sup>69</sup> Perry and Hondegheem 2008.

about monetary rewards and are susceptible to bribes, reducing the extent of discretion in decision-making can restrict the scope for capture. But this approach might not be effective in an agency where levels of intrinsic motivation for public service are already high, as it could undermine that intrinsic motivation.

5.60 Could offering higher wages also attract high-quality and intrinsically motivated individuals into public service? To examine this question, a recent field experiment randomized salaries for public sector job offers in Mexico.<sup>70</sup> This experiment was part of a drive to recruit community development agents for less developed municipalities. It found that higher compensation is associated with increased quality of the applicant pool: that is, the applicants were smarter, had better personality traits, higher earnings and a better occupation profile. The high-wage applicant pool was also more motivated toward public service. But other studies suggest that in some contexts, offering higher wages attracts quality (as reflected in previous wages and work experience) at the expense of pro-social motivation.<sup>71</sup>

5.61 As suggested by the case of MITI and certain other industrial development agencies in East Asia, meritocratic selection methods can attract officials who are competent and also less susceptible to undue influence. But since technical competence and intrinsic motivation for public service are separate attributes, it is not clear if merit-based selection will generally result in a pool of officials motivated in a pro-social direction. Again, the answer could depend on the context. In India, one study finds a correlation between the proclivity to cheat in dice games and expressing interest in public sector jobs.<sup>72</sup> In such an environment, civil service exams might select individuals who are smart but not necessarily motivated for public service.

5.62 Selection methods can also influence the degree to which officials are responsive to particular interest groups. A study that compares direct election with political appointment of power utility regulators across U.S. states finds that elected regulators have a more pro-consumer stance (Besley and Coate 2003). Regulatory policy is just one of many policy areas that politicians are responsible for, and it is not very salient to voters. As a result, appointed regulators are more likely to respond to the interests of political elites than voters. But when regulators are appointed through voting, regulatory policy becomes salient to voters.

### ***Norms in public organizations***

5.63 Conformity to accepted norms of behavior in one's organization could be a powerful driver of individual behavior in government organizations. Honesty can become a self-reinforcing norm in some agencies, while corrupt norms of behavior can set in in others.<sup>73</sup> In organizations where corruption is considered acceptable because "everyone does it," a temporary reform that shocks some officials into behaving more honestly could disrupt this bad norm, leading to a permanent, self-reinforcing improvement.

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<sup>70</sup> Dal Bó, Finan, and Rossi. 2013.

<sup>71</sup> Finan, Olken, and Pande 2015.

<sup>72</sup> Hanna and Wang 2015.

<sup>73</sup> This, in the language of game theory, is the existence of "multiple equilibria" in organizations: one on which honesty is a self-reinforcing norm, another in which corruption is the norm. See Bardhan 1997; and Hoff 2000.

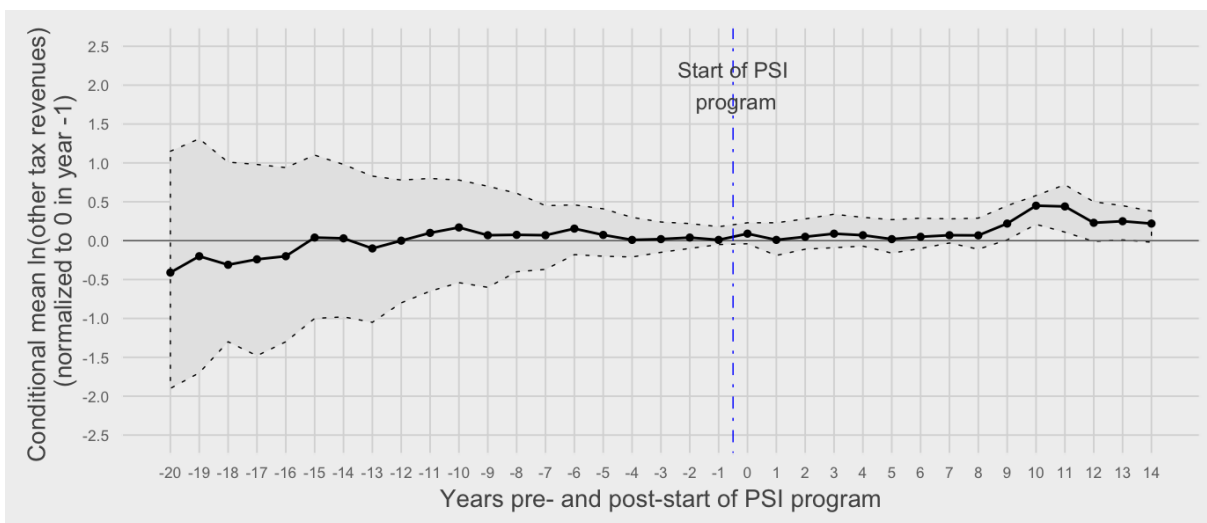


5.64 Although systematic evidence on such norm-shifting reforms is lacking, an example from the Republic of Korea’s past suggests that an intervention that operates on multiple fronts to shift norms could work. “Park Chung Hee, president of Korea from 1961 to 1979, inherited from Syngma Rhee a corrupt bureaucracy that chose policies based on self-enrichment. Within a month of seizing office, Park dismissed the top 10 percent of bureaucrats, jailed a number of the country’s leading businesspersons for corruption, and sent the rest of the bureaucracy to two-week training courses in management, efficiency, and public spiritedness. He then monitored the performance of economic bureaucrats and quickly shifted them from one bureau to another so that they could not develop corruption networks. These efforts transformed the government’s functioning.”<sup>74</sup>

### Monitoring

5.65 Monitoring by higher agencies can deter officials from colluding in policy capture, and generate useful information for third parties that are interested in preventing capture. Audits, for example, have been shown to reduce leakage in village-level public investment programs.<sup>75</sup> Informed third parties can also be recruited as monitors. Consider customs fraud (such as the underreporting of import values), one way in which firms can subvert the implementation of trade policy through bribery or other means of influence.<sup>76</sup> In this case, foreign inspectors at the point of origin have accurate information about the value of shipments, and are less susceptible to the influence of domestically powerful firms. A study using data from 104 developing countries between 1980 and 2000 finds that countries that hire foreign inspectors to verify the tariff classification and the value of shipments before they leave their origin country increase import duty collections 15 to 30 percentage points, on average (figure 5.6).<sup>77</sup>

**Figure 5.5 Third-party monitoring increases tax revenue by reducing customs fraud**



Source: Yang 2008.

Note: PSI = Pre-Shipments Inspections. Data are for 104 developing countries between 1980 and 2000.

<sup>74</sup> Hoff (2000, 19).

<sup>75</sup> Olken (2007)

<sup>76</sup> Fisman and Wei (2001); Sequeira and Djankov (2014).

<sup>77</sup> Yang (2008).

5.66 But monitoring has its limits. Monitoring can make officials overcautious, worsening their performance.<sup>78</sup> And monitors themselves are not immune from capture. Such was the case of a system of environmental audits of firms in an Indian state, Duflo and co-authors (2013) find. In the prevailing audit system, auditors who had been hired by the firms themselves were conducting pollution audits. The study finds that such auditors underreport the incidence of pollution by firms. Replacing this system with one in which auditors were randomly assigned to firms and paid fixed wages from a central pool reduced the underreporting of pollution by auditors.

### ***Mechanisms of horizontal accountability***

5.67 *Effective checks and balances* within the government should reduce the risk of short-term, opportunistic behavior by a few state actors. Consistent with this hypothesis, there are fewer FDI disputes in counties with stronger horizontal political constraints, as measured by the number of independent branches in government with veto power over policy change, and the degree of party alignment across different branches of government.<sup>79</sup> Even in authoritarian regimes, the existence of legislative bodies increases investment by raising the cost of expropriation.<sup>80</sup>

5.68 Compared to high-income countries, formal checks and balances within government in low and middle-income are weak, on average (figure 5.7). Strengthening these institutions is a long-term project. However, the *principle* of horizontal accountability lends itself to other context-specific approaches. For examples, non-state mechanisms of accountability between the state and elite groups can also help the state commit to property rights—albeit those of a select group of investors. In post-Mao China, for example, the institutionalization of the ruling party helped create a stable environment for investment by party cadres.<sup>81</sup> Specifically, a set of institutional changes in the party increased the flow of information to party cadres and gave them the potential to organize collectively in the face of any expropriation by the state. This threat of collective action by cadres, in turn, increased the state’s commitment to their property rights. Thus, in a context where the state could not credibly commit to secure property rights for the general public, a commitment to the property rights of a subset of the public—party cadres—was nonetheless achieved. The scope of this arrangement was naturally limited: an overly large cadre size would have made it difficult for party cadres to share information and organize collectively.

5.69 *Dividing power between government agencies and creating independent oversight agencies* can reduce the chances of “grand” capture of policy by dominant special interest groups. This principle can be illustrated by considering the design of regulatory agencies.

5.70 When regulators and regulated firms have a monopoly over information pertinent to the regulation (such as the firms’ cost structure), they can collude over regulatory design. In such circumstances, the division of power across regulatory agencies can reduce the monopoly over information and thus deter collusive capture.<sup>82</sup> But such a division of power is not without its drawbacks. It can make it harder to coordinate regulatory policy, and slow down decision-making.

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<sup>78</sup> Lichand, Lopes, and Medeiros (2015) find evidence that monitoring of municipal audits reduced procurement, and thereby worsened health outcomes.

<sup>79</sup> Jensen and others 2012.

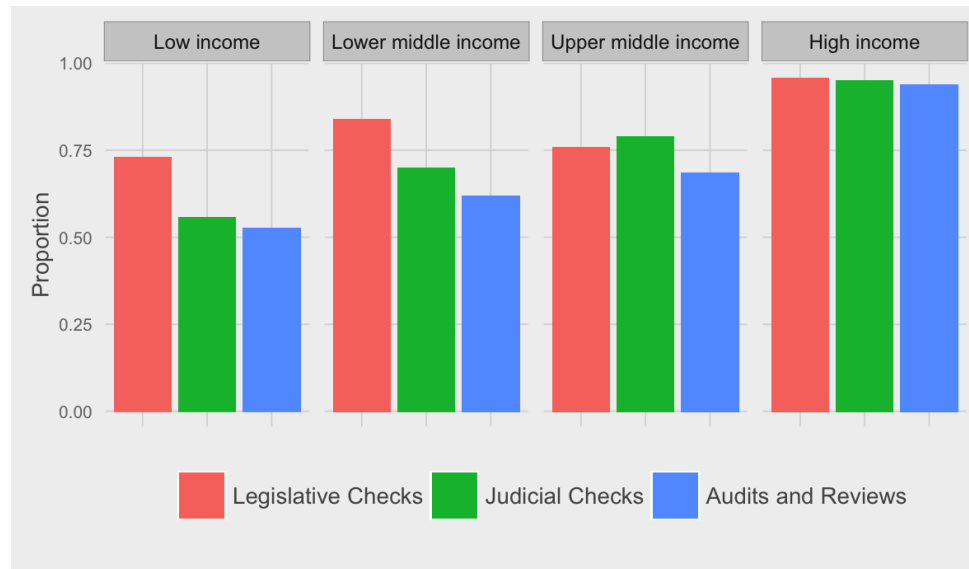
<sup>80</sup> Wright 2008.

<sup>81</sup> Gehlbach and Keefer 2011.

<sup>82</sup> Laffont and Martimort 1999.

Further, suppose that the regulator is in fact motivated by public interest, while acquiring information and expertise for regulatory design is difficult. In such cases, splitting functions between agencies could be counterproductive, since a single agency would find it easier to consolidate information and expertise.

**Figure 5.7 Formal checks and balances are weaker in low- and middle-income countries**



Source: WDR 2017 team, using data the World Justice Program and WDI.

5.71 There is evidence that review and oversight of regulatory agencies by other government branches, such as the judiciary, can help prevent or invalidate regulatory decisions that are not in the public interest. Looking across countries, the strength of judicial independence and constitutional review (the power of courts to check laws passed by the legislature that go against a rigid constitution) are associated with stronger protection of property rights and less regulation of firm entry.<sup>83</sup> In the United States, the delegation of decision-making authority to bureaucratic agencies and of arbitration authority to courts helped make regulatory policies more consistent.<sup>84</sup> It has also helped to level the playing field for less powerful actors. However, even in a country like the United States where the judiciary is a strong institution, judicial review has its limits; in particular, the judiciary can only step in after being approached by an affected party with the legal standing to do so.<sup>85</sup>

5.72 A case study of the U.S. Office of Information and Regulatory Affairs (OIRA) suggests that the existence of an agency tasked with crosscutting oversight of regulators, based on cost-benefit analysis, can also help prevent capture.<sup>86</sup> The study suggests that it is hard for any particular narrow interest group to capture OIRA because it is a generalist institution, and not focused on a single regulatory issue. Moreover, its practice of using standardized cost-benefit analysis in

<sup>83</sup> La Porta and others 2004.

<sup>84</sup> Spiller and Tommasi 2005.

<sup>85</sup> Magill 2013.

<sup>86</sup> Livermore and Revesz 2013.

assessing regulations also helps to counteract the potential use of biased information and analysis by industry or consumer interest groups to influence regulations.

5.73 Institutions of accountability too are politically embedded, and could be subverted by powerful narrow interests. Nonetheless, even in countries with complicated governance environments, the state is rarely monolithic, and accountability institutions often manage to preserve autonomy. A recent case study of telecommunications in three middle-income countries—Mexico, South Africa, and Turkey—is illustrative. While the telecom sector remains monopolistic or oligopolistic in all of these countries, recent years have seen clear improvements in access, technology and market competition. One reason is that accountability institutions—the judiciary, competition commissions and telecom regulators—have often acted autonomously against anti-competitive practices. At the same time, past developments suggest that broader political economy forces affect their level of autonomy.<sup>87</sup>

### *Mechanisms of vertical accountability*

5.74 While economically dominant groups such as large firms have the resources to gain influence in the policy arena, consumers and citizens are a diffuse interest group, facing a collective interest problem when advocating for their policy preferences.<sup>88</sup> Hence, mechanisms of vertical accountability that facilitate collective influence by citizen (or consumer) groups could help balance influence in the policy-making process.

5.75 *Media coverage* can help reduce the influence of special interest groups on policies by increasing that of ordinary voters, recent research suggests.<sup>89</sup> Dyck and others (2013) document the effect of “muckraking” magazines on the voting patterns of U.S. representatives and senators in the early part of the 20th century to show that media coverage induces more populist legislative outcomes. When the benefits of preventing special interest capture of a policy are diffuse, individual voters may lack the incentive to exert effort into gathering information on that policy. The media can therefore substitute for “collective action” in information gathering. This populist tilt is likely to be stronger when the policy issues are more newsworthy and the media is profit maximizing, as these factors increase the incentives of the media to cater to a wider consumer base, especially low-income groups.

5.76 *Procedural requirements on government agencies for seeking diverse inputs during policy design and rollout* can also balance influence. In the United States, the Administrative Procedure Act has put in place a series of procedural requirements that provides for participation of different interest groups in the regulatory process. Under this Act, “Regulatory agencies must provide notice, must inform about proposed rule makings, must make their decisions taking into account the submissions of interested parties, and cannot rush nor make decisions in the dark.”<sup>90</sup>

5.77 *Mechanisms that facilitate policy input from consumer and citizen advocacy groups* can also countervail the influence of dominant industry lobbies. There is evidence to this effect from the context of regulatory bodies in the United States, which have devised a range of mechanisms

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<sup>87</sup> Atiyas, Levy and Walton 2016.

<sup>88</sup> A classic exploration of this idea, in the context of regulation, is Stigler 1971.

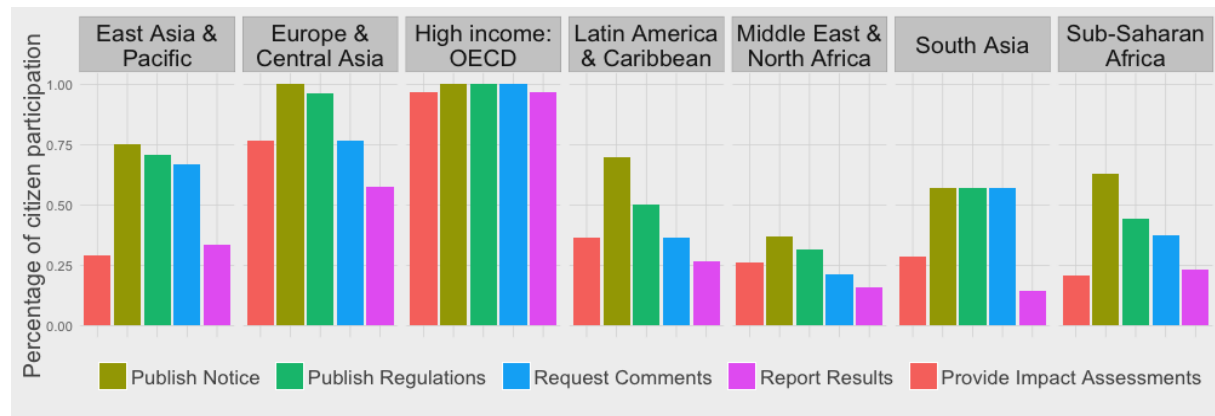
<sup>89</sup> Dyck Moss and Zingales 2013.

<sup>90</sup> Spiller and Tommasi 2005: 535.

that facilitate consumer advocacy.<sup>91</sup> In the 1970s, the big oil price shocks ended a period of declining prices, and many energy utilities sought an increase in the prices they were allowed to charge. In response, many states introduced consumer advocacy groups to balance the pressure from producers. Price increases were lower in these states, indicating an increased influence of consumers in regulatory price setting.<sup>92</sup>

5.78 Participatory mechanisms in regulatory institutions are still relatively uncommon in low- and middle-income countries (figure 5.8).<sup>93</sup> For instance, most high-income countries provide advance notice of regulatory changes, and make information about existing regulations publicly available. This is relatively uncommon in low- and middle-income countries. Mechanisms to collect feedback from the public are also rare in those countries, as are those that report on the results and impact assessments of regulatory policies.

**Figure 5.8 Formal avenues for broad-based participation in regulatory decision-making are limited in low- and middle-income countries**



Source: WDR 2017 team, using the World Bank’s citizen engagement in rulemaking data

### Finding the right approach

5.79 In conclusion, there are ways to alter both policy and institutional design that can reduce the harm from capture. In terms of policy design, it is important to think pragmatically about the risk of undue influence and identify implementable policies—if not first-best ones. Another lesson is to avoid policies that look good in the short term but could later end up reinforcing the power of dominant groups that could block further reforms.

5.80 Better public agency design can help expand the set of implementable policies. First, how public officials are selected into service and the incentive structure they face within their organizations matter. This should take not just economic motivation into account, but also intrinsic motivation for public service and norms of behavior. In policies where there is a significant role for discretion during implementation, credible monitoring mechanisms can further discipline

<sup>91</sup> Dal Bó (2006) reviews the empirical evidence on advocacy and other accountability interventions in the context of regulatory bodies. Schwarcz (2013) is a case study of some citizen advocacy mechanisms in insurance regulation across U.S. states.

<sup>92</sup> Holburn and Spiller 2002.

<sup>93</sup> <http://rulemaking.worldbank.org>.

implementation. Second, mechanisms of horizontal and vertical accountability in public agencies also help in balancing influence in the policy arena. For instance, general-purpose oversight agencies can act as a check on the capture of agencies in charge of specific policy areas. Mechanisms that facilitate less powerful, diffuse interest groups in having a bigger say in the policy arena could help even out influence from more powerful, narrow interest groups.

5.81 The discussion of regulatory agency design in the United States served to illustrate these principles. But this is not to say that low- and middle-income countries with difficult governance environments should simply copy the formal structures of horizontal and vertical accountability that are found to work in high-income countries. Adapting these blueprints to specific governance environments is ultimately a matter of experimentation, but the capacity of existing agencies and the existing balance of power should both factor into this process.

5.82 For example, consider the design of mechanisms for strengthening regulatory advocacy by citizens and small firms. In the United States, some states have created a public agency tasked with acting as a proxy advocate for consumers, while others have opted to offer incentives and support for existing advocacy groups to participate in regulatory decision-making.<sup>94</sup> Neither approach is likely to be effective in settings where public agencies and consumers advocacy groups have low capacity. However, case studies suggest that some low- and middle-income countries have successfully used participatory mechanisms such as public-private dialogues (PPDs) as an intermediate institutional design for vertical accountability (box 5.3). PPDs do not necessarily rely on the existence of proxy advocate agencies or strong citizen and small business advocacy groups, and instead mobilize local communities in the context of specific reforms. Successful PPDs can go on to become more formally institutionalized.

**Box 5.3 Participatory mechanisms in policy design: The “Bulldozer Initiative” in Bosnia and Herzegovina**

Strengthening mechanisms for inclusive public-private dialogue could lead to better information flows and accountability in the design and implementation of business climate reforms. A case in point is the “Bulldozer Initiative” in Bosnia and Herzegovina. The initiative mobilized local business communities to give suggestions for reforms, and to become more engaged with the authorities during implementation. In the process, it reduced the influence of narrow interest groups.

Remarkably, the first phase of the initiative collected 250 proposals to reform the business climate. Independent experts, including economists, lawyers, and industry experts, assessed the proposals through a process designed to minimize undue influence from narrow interest groups. This process was very selective: for example, only 5 percent of proposals made the final list in the second phase. The work of the initiative did not end at designing and selecting proposals: members of the initiative also provided feedback and helped with monitoring during implementation, which lasted more than two years for some reforms. A biannual Bulldozer publication served to inform the public about this process, with the relevant government body receiving a score for each reform being implemented.

An independent evaluation of the initiative suggests that it had positive impacts in terms of identifying and effectively implementing a range of reforms. Following this experience, Bosnia and Herzegovina decided to institutionalize a system of grassroots public-private dialogue for future business climate reforms.

Current evidence on the impact of such initiatives is based on case studies, and large-sample, rigorous evaluations have not been conducted. Given the promising evidence from cases, more pilot initiatives with rigorous evaluations should be encouraged.

*Source:* Herzberg 2007.

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<sup>94</sup> Magill (2013).

5.83 Countries with difficult governance environments could also experiment with “ring-fencing” reforms—or in other words, building “islands of effectiveness.”<sup>95</sup> For example, in many countries, the dominance of powerful business groups or other political considerations makes it difficult to liberalize firm entry or to enact other business climate reforms that would increase competition between firms. In such settings, creating Special Economic Zones (SEZs) with their own rules is a way to ring-fence competition within specific locations. China’s extensive use of SEZs, beginning with coastal SEZs that were focused on export-oriented firms, is a case in point. Studies suggest that SEZs led to significant increases in investment and productivity in local economies.

***Reforms at the top: The overall governance environment***

5.84 Chances are that the agency-level reforms discussed so far will not be pursued seriously if commitment to them at the highest levels of policymaking is lacking. Consider the varying experience with the introduction of anti-corruption agencies, as described in Fisman and Werker (2011). In 1974, Hong Kong introduced an Independent Commission Against Corruption (ICAC) that reported directly to the governor general of Hong Kong, recruited employees from the civilian population, and paid relatively high salaries. The ICAC seemed like a textbook example of agency design to strengthen checks and balances in the government, and by all accounts, it was remarkably effective. Starting from a relatively low position, Hong Kong, China today ranks in the top twenty worldwide of Transparency International’s corruption perceptions index.

5.85 Nevertheless, the ICAC model has not had much success in other countries. In Kenya, for example, the journalist appointed as head of the anti-corruption agency was removed once the agency turned its attention to high-level corruption. The success of Hong Kong’s ICAC was partly because Hong Kong’s governor general reported to the prime minister of England. The authorizing environment for ICAC was well governed and stable, and the commitment to making ICAC work did not depend on a fortuitous, fragile configuration of interests at the highest levels. This issue—how the broader governance environment becomes more committed to reform—is discussed in part 3 of this Report.

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<sup>95</sup> Fisman and Werker 2011; Levy 2014.

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## Spotlight 5 Middle-income trap

S5.1 Contrary to what many growth theories predict, there is no tendency for low- and middle-income countries to converge toward high-income countries (figure S5.1) (Jones 2015). Recently, considerable attention has focused on countries experiencing growth stagnation at middle-income levels, a condition that Gill and Kharas (2007) coined the “middle-income trap.” Although middle-income economies are no more likely to stagnate than economies at any other income level (Bulman, Eden, and Nguyen 2014), a compelling economic theory that can guide growth for middle-income countries is still lacking. Indeed, this lack of a “satisfactory growth theory” to inform development in middle-income countries was the original reason for referring to a “middle-income trap” (Gill and Kharas 2015). This spotlight uses the Report’s framework to argue that the difficulty many middle-income countries have in sustaining growth can be explained by power imbalances that prevent the institutional transitions necessary for productivity growth.

Figure S5.1 Many countries have not converged toward high-income



Source: WDR 2017 team using Penn World Tables Version 8.1.

### Is middle-income growth different?

S5.2 Middle-income countries may face particular challenges because growth strategies that were successful while they were poor no longer suit their circumstances. For instance, the reallocation of labor from agriculture to industry is a key driver of growth in low-income economies. But as this process matures, the gains from reallocating surplus labor begin to evaporate, wages begin to rise, and decreasing marginal returns to investment set in, implying a

need for a new source of growth. Middle-income countries that get “trapped” fail to sustain total factor productivity (TFP) growth; in contrast, “escapees” find new sources of TFP growth (Daude and Fernández-Arias 2010). Indeed, 85 percent of growth slowdowns at middle-income levels can be explained by TFP slowdowns (Eichengreen, Park, and Shin 2013).

S5.3 For middle-income “escapees,” evidence suggests that one source of sustained TFP growth is an increasingly efficient allocation of resources. At a broad level, escaping countries experience much more rapid transitions out of agriculture and more rapid increases in manufacturing/industry (Bulman, Eden, and Nguyen 2014). Perhaps more important is the allocation of resources across subsectors, and across firms within sectors. Because the productivity levels of firms in the same subsector can be markedly unequal, the entry of new firms and exit of unproductive firms (“creative destruction”) and the extent to which productive firms are able to gain a bigger market share by reallocating inputs between firms, is important for TFP growth (Hsieh and Klenow 2009; Bartelsman, Haltiwanger, and Scarpetta 2013; Melitz and Polanec 2015). For example, when capital and labor in Indian and Chinese manufacturing firms are hypothetically “reallocated” to match the level of efficient allocation observed in the United States, the two countries experience TFP gains of 40–60 percent and 30–50 percent, respectively (Hsieh and Klenow 2009).

S5.4 Other analyses of the middle-income trap have focused on a lack of industrial upgrading (Ohno 2009; Doner and Schneider 2016). Evidence suggests that middle-income “escapees” have more diversified and sophisticated exports than those that remain stuck (Felipe, Abdon, and Kumar 2012). Such upgrading requires proactive government policies and coordination between domestic firms. A related view is that market failures may occur in many countries when private incentives to enter new sectors are less than social returns, necessitating a process of economic development as “self-discovery” (Hausmann and Rodrik 2003).

S5.5 Efficient resource allocation and industrial upgrading require a different set of institutions than those that enable growth through resource accumulation. Efficient allocation requires new institutions to manage competition and “creative destruction.” Industrial upgrading requires the institutional capacity for greater intersector and government coordination, possibly through a strategic alliance between government and business (Doner and Schneider 2016). Product differentiation to succeed in new export markets requires “modern and more agile” property rights institutions and capital markets (Kharas and Kohli 2011).

### **Political economy traps**

S5.6 The creation of these institutions may be stymied by vested interests. “Creative destruction” and competition create losers—and in particular may create losers of currently powerful business and political elites. This is a more politically challenging problem than spurring productivity growth through adoption of foreign technologies, which tends to favor economic incumbents (Acemoglu, Aghion, and Zilibotti 2006). These political challenges may be particularly great in middle-income countries because actors that gained during the transition from low- to middle-income may now be powerful enough to block changes that threaten their position.

S5.7 In this sense, the challenges that middle-income countries face go beyond policy choice to the challenge of power imbalances. Yet with few exceptions, discussions of the middle-income trap have generally focused on the *proximate causes* of transition difficulties, and on selecting the



right policies, rather than the *underlying determinants* of these transitions. Understanding the policy arena in which elites bargain is essential for explaining the political economy traps faced by middle-income countries.

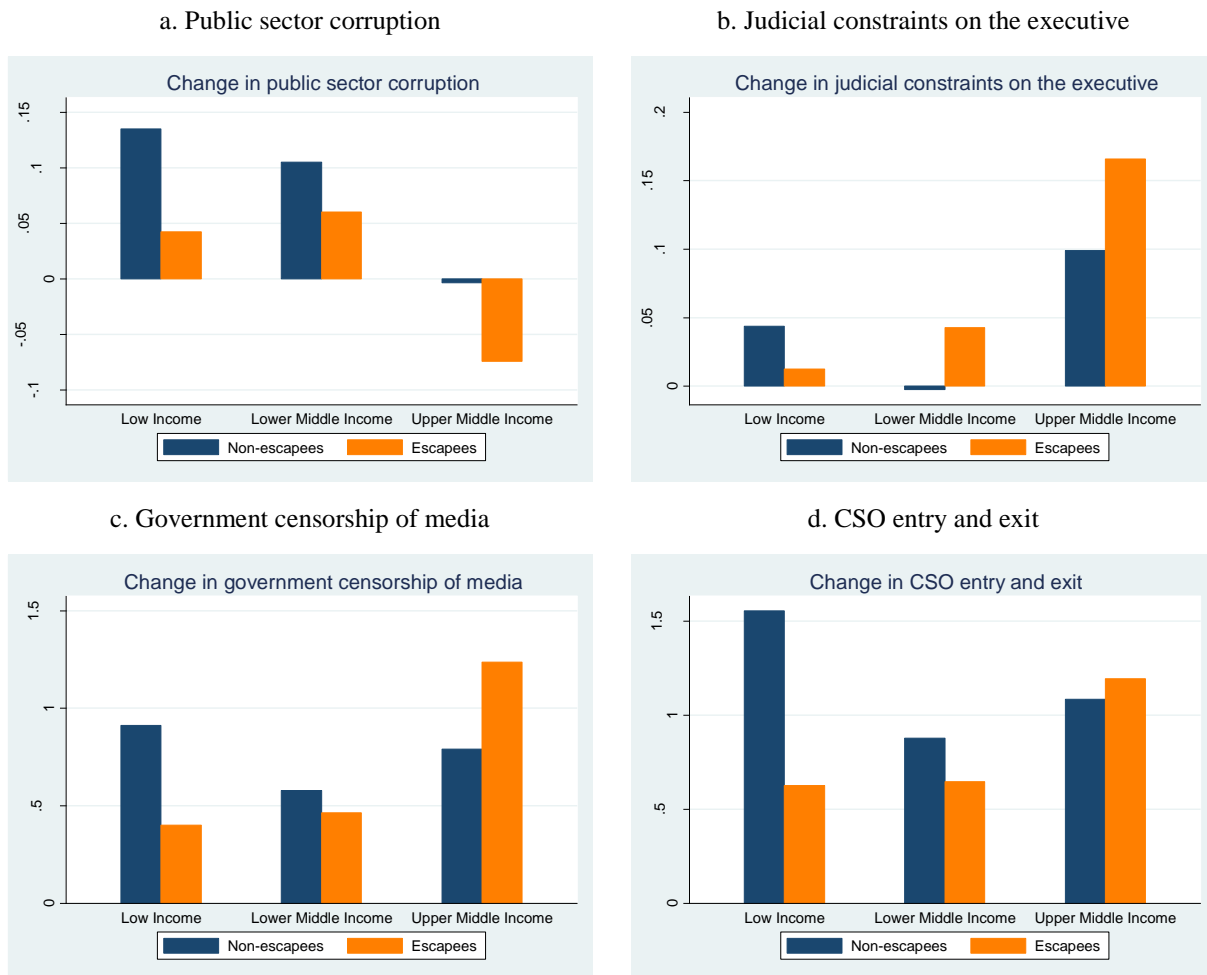
S5.8 One such political economy trap is a persistent deals-based relationship between government and business. Deals-based, sometimes corrupt, interactions between firms and the state may not prevent growth at low income levels; indeed, such ties may actually be the “glue” necessary to ensure commitment and coordination among state and business actors (see spotlight 2 on corruption). But they become more problematic for upper-middle-income countries. For instance, theory suggests that as markets expand and supply networks become more complex, deals-based relationships can no longer substitute for impersonal rules-based contract enforcement become (Dixit 1997). Consistent with this hypothesis, upper-middle-income “escapees” lower their levels of corruption significantly before becoming high-income economies, while “non-escapees” do not see an improvement in corruption (figure S5.2, panel a). In “non-escapees,” corruption may prop up the status quo, undermining competition and the creation of new growth coalitions.

S5.9 Combatting entrenched corruption and creating a level playing field for firms implies a need for accountable institutions. At upper-middle-income levels, legislative, judicial, media, and civil society checks become increasingly important. Indeed, “escapees” tend to see much larger improvements in these institutional checks when they are at upper-middle-income levels than “non-escapees,” although the differences between successful and unsuccessful countries are less distinct at low- and lower-middle income (figure S5. 2, panels b, c, d).

S5.10 The sources of these rules-based institutions for contestation and accountability are discussed in part 3 of this Report, but comparing “escapees” and “non-escapees” helps identify several conditions that make institutional reforms and thus successful transitions more likely. Recently, many countries that have transitioned have had strong and representative business groups, including East Asian economies and Chile. Well-represented business groups helped lead to pro-growth coalitions that could push for “non-particularistic” policies benefiting broad interests to enable broad-based growth. Other recent transitioning countries have had a source of external support/pressure for reform: nearly half of the countries that have grown recently from middle- to high-income are in Europe, where the external commitment provided by European Union accession and membership has made institutional development credible.

S5.11 Moreover, lower levels of inequality may also help prevent institutional sclerosis at middle-income levels. High levels of inequality can generate societal cleavages that prevent the emergence of the growth coalitions necessary for reform (Doner and Schneider 2016). The data show that “escapees” not only have lower levels of inequality when they become middle income, but they do not experience the large increases in inequality that characterize “non-escapees” on average (Bulman, Eden, and Nguyen 2014). Middle-income countries should therefore value equity not just as an aim in itself, but also as a precondition that increases the likelihood of escaping the middle-income growth trap.

**Figure S5.2 Checks on corruption and accountability institutions improve more in countries that escape upper-middle-income status to high-income status than “non-escapees”**



Source: WDR 2017 team based on VDem 2015.

Note: The bars represent average change in the relevant category for all “non-escapees” (blue) and “escapees” (orange) during the time when a country is at the income level specified. “Escapees” are defined as those countries that reach the subsequent income levels during the sample period (1950-2011). “Non-escapees” are those that remain trapped at the same income level or move to a lower income level. All four panels use the same methodology. Public sector corruption (v2x\_pubcorr) is an index ranging from 0 to 1, with 1 representing the most corruption. Judicial constraints on the executive (v2x\_jucon) is an index ranging from 0 to 1, with 1 representing the greatest constraints. Government censorship of media (v2mecenefm) and CSO entry and exit (v2cseeorgs) are ordinal variables ranging from 0 to 4, with 4 representing the most accountability (i.e., the least media censorship and the most civil society entry and exit).

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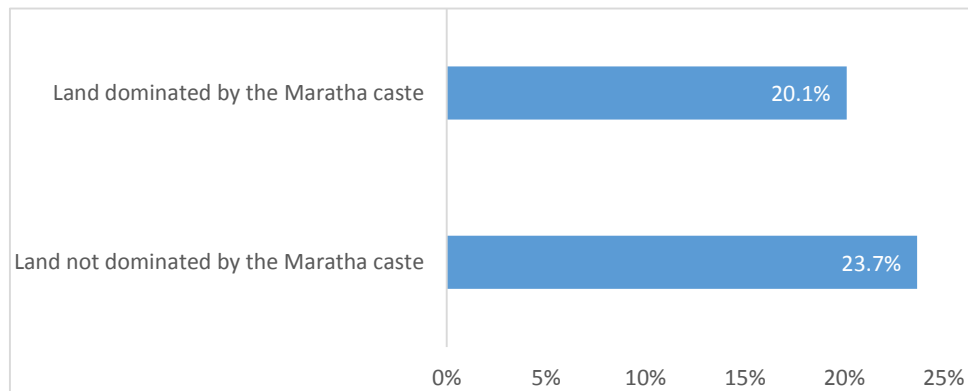
## Chapter 6 Equity and governance

### Equity reforms on paper are not enough: Deeper reforms are needed

6.1 In the Indian state of Maharashtra, villages that are dominated by the Maratha caste are 10 percent less likely to implement national antipoverty programs than other villages, even though the population, who votes in free elections, consists largely of poor or landless laborers (figure 6.1). Why? A credible explanation is that the local landed elites from the Maratha caste hold political power and use it to block national antipoverty programs, exchanging votes against the provision of—informal—insurance to voters in times of financial crisis. The academic literature refers to this arrangement as *clientelism*: providing goods to specific “clients” in exchange for their support. The Marathas lead the village councils that are in charge of implementing antipoverty programs. They use their political influence to block the implementation of these programs, even though they are centrally funded and do not require tax increases. The Marathas block, in particular, the implementation of the Employment Guarantee Scheme, which offers a legal guarantee for work all-year round at the minimum wage for adult members of rural households, and should, in theory, help bring agricultural wages up to the level of the state’s minimum wage. The Marathas are particularly successful in clientelist strategies thanks to other “services” that they can provide, such as their trading networks. Prevailing social norms in the villages—the caste system—help the Marathas maintain their political influence, as they are the traditionally dominant caste in Maharashtra and are better able to enforce sanctions (Anderson, Francois and Kotwal 2015).

**Figure 6.1 Clientelism leads to blocking antipoverty programs**

In the Indian state of Maharashtra, villages dominated by the Maratha caste are less likely to implement antipoverty programs because of clientelism



Source: WDR 2017 team, based on Anderson, Francois, and Kotwal 2015.

Note: The graph presents the mean percentage of programs that were implemented in Maharashtra's villages, of the total of below poverty line programs and the Employment Guarantee Scheme. These programs are supposed to be available in the full universe of the villages.

6.2 This example illustrates several important aspects that shape the economic opportunities of the poor and, more broadly, the disadvantaged. Some members of entrenched elites that face little competition may choose to influence policy adoption and implementation, blocking policies that go against their interests. On paper, it looks promising to make village councils decide on

beneficiaries, in a setting where the councils are freely elected: local governments can seemingly be held accountable, and the beneficiaries can seemingly better observe and control their efforts because they are closer to them. In theory, village councils are also better able to target beneficiaries and select public works projects that are most useful for the community. In reality, however, some members of the local elites may take advantage of their role in the allocation of resources to block redistribution, exchanging political support for short-term benefits.

6.3 Expanding opportunities for disadvantaged individuals is potentially beneficial for growth in the medium and long term, but may threaten the interests of certain groups. When such groups have direct influence on policy design or implementation, including because of existing patterns of inequality in income or wealth, they may be able to block or undermine reforms. Policy design thus needs to take into account the bargaining power of the different actors involved. Threats to policy adoption and implementation need to be fully considered, building in ways to increase the cost of blocking reforms. To expand the set of equity-oriented policies that can be implemented, it is necessary to modify the policy bargaining process by changing the incentives or by reshaping the preferences of actors who bargain, or by reducing entry barriers for actors who are more likely to adopt redistributive policies—including actors from disadvantaged groups.

6.4 Collective action—including the commitment that enables it—is necessary for equity-oriented policies to take place (box 6.1). Collective action is essential, for instance, for investments that expand opportunities; from collecting taxes to fund investment in healthcare, to monitoring whether teachers are present and performing in schools. The commitment that supports this collective action relates to the credible enforcement of sanctions and compensation for redistributive policies.

6.5 Asymmetries in bargaining power shape how collective action and commitment are sustained, ultimately affecting whether equity-enhancing policies are adopted. Groups that directly influence policies are labeled as *elites* in this Report. They may have more bargaining power because of existing inequality in income or wealth but also due to weak collective action in society. Indeed, in the presence of weak collective action, political elites may have fewer incentives to invest in public goods and improve equity, and may, instead, engage in narrow patron-client relationships that maintain their ability to influence decision making. For instance, in Sierra Leone, President Siaka Stevens dismantled the railway leading to the region with a high presence of supporters from the competing party. The incentives that members of the economic elite face also play a role for taxation and public spending. The first antipoverty programs in nineteenth century Great Britain, for instance, were pushed by the top one percent of landed elites. These schemes aimed to keep labor in the countryside and prevent it from migrating to urban areas, against the backdrop of the French Revolution, which may have spurred some fear of revolts.

6.6 Even when reforms for equity are passed, they may be made ineffective in various ways that are shaped by bargaining power. Elites are not monolithic (indeed many elite members favor reform) and they can influence equity in different ways. Some elites may not have direct influence on policy design or adoption, but they may directly influence policy implementation. Here too, existing patterns of inequality matter. For instance, local elites such as village chiefs, who may be more entrenched than state elites, may capture land reforms or shape expenditures in their favor if they are in charge of allocating them. Public sector workers play a key role in policy implementation. In clientelist settings, they may extract rents through corruption or absenteeism,

hampering the delivery of services such as education and health. In addition, the interests of elites may be reinforced by norms. As illustrated above, the caste system allows the Marathas to sustain their political influence. Policies that do not take into account prevailing norms can fail to address the constraints that shape individuals' opportunities.

6.7 Asymmetries in bargaining power need not result in failed policies: reforms can be successful in improving equity if their design takes into account the bargaining power of different actors. In order to adopt policies that imply losses for certain powerful actors, it may be necessary to bundle them with other policies that benefit these actors. Furthermore, it is necessary to take into account how the bargaining power between actors will affect policy implementation, including at the national and local level, across income groups, and between service providers and users. Targeting cash transfers, may be the most cost-effective way to compensate the poor after a subsidy reform that led to price increases, but broadening the number of beneficiaries may be necessary to garner support for the reform.

6.8 To increase the success of reforms that require profound changes, it may be necessary to modify the bargaining process: changing the incentives or preferences of actors who bargain, or allowing new actors to contest policies. For instance, greater participation of disadvantaged groups can help change the incentives of actors who bargain over policies: the enfranchisement of disadvantaged groups has led to the adoption of policies in their favor. Direct participation in decision-making can also improve cooperation. For instance, in Ghana, when businesses are involved in the design of tax policies, they are more likely to pay their taxes. Greater transparency and better information can also help improve the monitoring of the actions of members of political elites and service providers. However, such reforms can be complex, frequently involving setbacks. Their process is described in part 3 of this Report.

#### **Box 6.1 What Is Equity?**

In an equitable society, individuals should have equal opportunities to pursue a life of their choosing and be spared from extreme deprivation in outcomes. Inequality in outcomes matters particularly, but not only, when it is due to circumstances beyond an individual's control.<sup>a</sup>

Thus, in this Report, equity includes *poverty*, defined as extreme deprivation in outcomes. Equity also comprises *equality of opportunity*: leveling the playing field so that all individuals have the same chances, independently of circumstances beyond their control. Lastly, equity covers *inequality in outcomes*, in the sense that differences in the levels of outcomes among individuals, such as income, also matter. Although the "acceptable" level of inequality in outcomes is a decision that is up to each society, the concept needs to be considered for two important reasons. First, inequality in outcomes plays a role in shaping the bargaining power among actors in society. Second, it shapes the opportunities of the next generation by reproducing power structures, and by influencing intergenerational mobility.

<sup>a</sup> This definition builds on the definition of the 2006 *World Development Report* (WDR) on Equity and Development (page 2): "By equity we mean that individuals should have equal opportunities to pursue a life of their choosing and be spared from extreme deprivation in outcomes." This WDR extends this definition to cover inequality in outcomes, as well.

## **Governance functions: Collective action and commitment are needed for policies to improve equity**

6.9 This chapter considers two policy areas that matter to equity. The first are investments to expand the opportunities, particularly investments in *human capital*—health and education. These investments require taxation and public spending. The second area refers to increasing *access to economic opportunities*. As emphasized in the 2006 *World Development Report* on Equity and Development (WDR 2006), the opportunities of individuals, to a considerable extent, arise from investments that they receive, particularly in terms of health and education. For such investments to take place, resources must be raised and redistributed. This is particularly important for the poor and disadvantaged, as they are most likely to be affected by market failures (see spotlight 6). Indeed, no high-income country has achieved improvements in terms of equity without significant taxation and public spending in order to protect individuals against shocks (such as illness, unemployment, and old age) and reduce welfare disparities within and across generations (Barr 2001; Lindert 2004). In addition, for individuals to realize the returns of such investments, they need access to economic opportunities in adulthood, especially access to assets that allow them to use the human capital that they acquired.

### ***Collective action, enabled by commitment, is essential to the expansion of opportunities***

6.10 Societies need to organize collectively for investments in human capital and infrastructure to take place, such as collecting taxes to fund investments in schools or hospitals. This Report defines *collective action* as the coordinated actions among actors based on a shared expectation about what others will do (*coordination*); and the cooperative behavior among actors, whereby opportunistic behavior—free riding—is limited (*cooperation*). Collective action, in turn, is enabled by commitment, as actors are able to trust that promises will be kept even when faced with changing circumstances.

6.11 Collective action is partly the result of the credibility of sanctions against non-compliers. For instance, ethnic networks may be able to induce cooperation, in the form of school funding, among their members because they have credible sanctions against free-riders (Miguel and Gugerty 2005). This view was tested in a lab game with players from a multi-ethnic neighborhood in Kampala. Players who are in charge of allocating resources share much higher amounts with other players when they can be seen by others, compared to when they are not seen. In both cases, other players are from their same ethnic group. These results indicate that a social sanction for individuals who are not willing to share shapes their behavior, rather than altruism toward co-ethnics (figure 6.2, panel a, based on Habyarimana and others 2007).

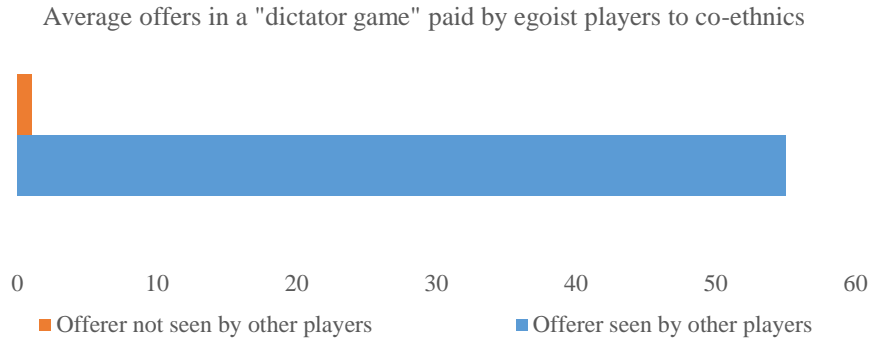
6.12 Perceptions of fairness also matter for collective action. Experimental evidence indicates that individuals adjust their behavior, and are willing to incur a cost in order to sanction behaviors that they perceive as unfair. More specifically, the fairness of the processes through which decisions are made matters. Participation in the decision process has an intrinsic value in allowing more legitimate choices (Habermas 1996; Rawls 1997). But participation may also have an instrumental value, by increasing cooperation, for instance in the form of contribution to the funding of projects, or in the form of compliance with decisions made. Experimental evidence supports this view (Goeree and Yariv 2011; Dal Bó, Foster, and Putterman 2010). A study from Indonesia indicates increased cooperation when participatory processes are in place: individuals



are more willing to contribute to projects when the whole village can cast a vote directly in plebiscites, compared to the usual decision-making meetings, run by representatives (figure 6.2, panel b, based on Olken 2010).

**Figure 6.2 Fear of sanctions and participation in decision-making processes promote cooperation**

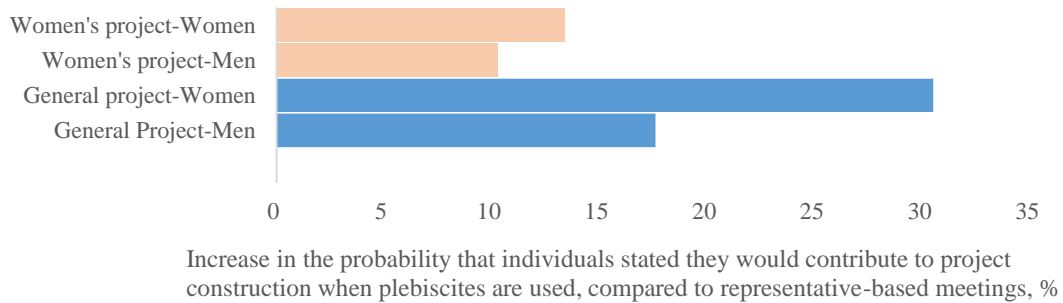
*a. In a laboratory experiment in Uganda, when individuals in charge of allocating resources are seen and fear sanctions from their co-ethnics, they cooperate more*



Source: WDR 2017 team based on Habyarimana and others 2007.

Note: The figure shows the average offer paid by egoist players (those who always employ the most selfish strategy available in all rounds of the game) in a "dictator game": a game in which a player, "the dictator," determines how to split an endowment with other players. Subjects were given ten 100 Ugandan Shilling (USh) coins and asked to divide this sum between themselves and the two other players in any way they pleased. The figure shows the "benchmark co-ethnic" measure: any pair of players that identified themselves as belonging to the same ethnic category in their pre-experiment questionnaire were coded as co-ethnics.

*b. In rural Indonesia, cooperation is higher when decision making is broadened through plebiscites in which the whole village takes part*



Source: WDR 2017 team based on Olken 2010.

Note: In an experiment conducted in rural Indonesia, villages are randomly assigned to choose development projects through either meetings where representatives decide (the majority of attendees are government officials, neighborhood heads and those selected to represent village groups) or through direct election plebiscites (where all adults eligible to vote in last national parliamentary election can vote). The villages had to select a general project and a women's project. After the project-selection process was concluded, respondents were asked about their plans for making voluntary contributions to the project (labor, money, food).

6.13 The credible and consistent enforcement of laws and regulations, including property rights, can help expand opportunities and level the playing field. “Process-legitimacy” and fairness also matter for economic opportunities. For instance, if property rights are secure only for some, those who are not protected as much as others will respond by underinvesting (Goldstein and Udry 2008). Furthermore, if individuals think that their effort will not be rewarded because of discrimination, they may exercise less effort (Hoff and Pandey 2006).

6.14 The credibility of policy makers is also key for the enforcement of sanctions and compensation when redistribution reforms take place. Consider the difficulties in reforming energy subsidies. Such subsidies are often inequitable because they benefit relatively richer households, which devote a larger share of their total consumption to energy-related goods. They are inefficient because their high fiscal cost precludes other public spending (Coady and others 2015). Therefore, eliminating these subsidies while setting up compensatory measures for the poor has the potential to improve both efficiency and equity. Yet virtually all of the countries that have attempted energy subsidy reforms have faced varying degrees of social and political unrest. This is often because policy makers are not credible in their commitment to redistribute the savings made from efficiency gains.

#### **Asymmetries in bargaining power shape the adoption and implementation of equity-enhancing policies**

6.15 Asymmetries in bargaining power among different actors shape the ability to commit and sustain collective action, ultimately affecting the adoption and implementation of policies to improve equity. A number of equity-enhancing reforms would seem to be “win-win”; and, seemingly, influential actors would not want to block them. Examples include investment in human capital for the next generation; reforms that increase the security of property rights; or reforms of consumer subsidies. Yet even such reforms are often difficult to adopt, or become ineffective once implemented, because they create losses among powerful actors—at least in the short term.

6.16 The actions of *elites*—actors that have the bargaining power necessary to directly influence policy adoption and implementation—are driven by their composition, incentives, and preferences. All of these drivers can be potentially influenced by the collective action of citizens. Additionally, elites are not monolithic, and while many members may oppose certain policies to protect their interests, others may be advocates for reforms. Incentives for reforms may come from external shocks, such as conflicts that threaten their power; or technological shocks that change their incentives.

6.17 An important element in shaping the actions of elites is the existing pattern of economic inequality. In theory, higher inequality should lead to more redistribution because richer individuals have a lower utility derived from an additional dollar in income; and thus would be more willing to fund reforms through taxes. In this sense, the middle class may resist redistribution to the poor more than wealthier individuals. Beyond such economic calculations, however, elites will consider the impact of increased equity on the power structure. Elites will consider the impact of increased equity on the current bargaining power. In deciding to finance public education, for instance, members of the elite may balance the economic gains from a more productive workforce

with the fact that more educated citizens may challenge their power (Bourguignon and Verdier 2000; Ferreira 2001).

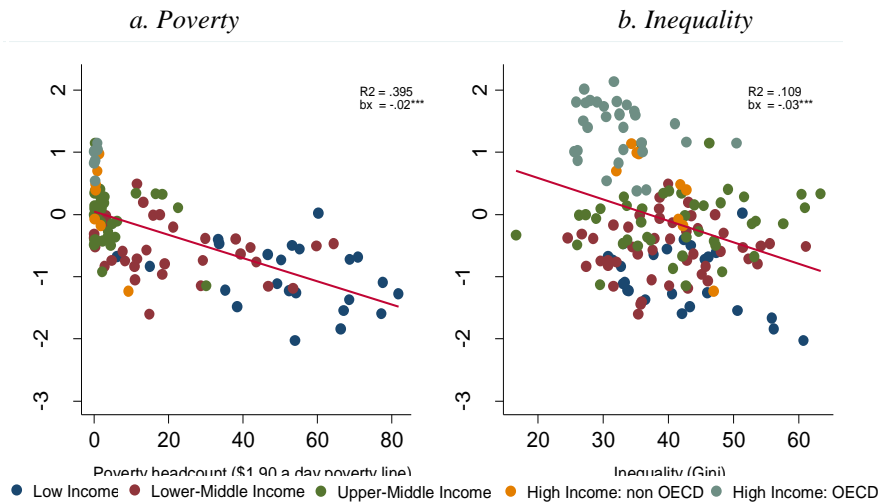
***Asymmetries in bargaining power shape policy adoption***

6.18 Depending on their composition, and their incentives and preferences, elites can adopt policies that improve equity: build state capacity; increase redistribution; or improve access to assets such as land for disadvantaged groups. Political leaders may support or undermine state capacity, depending on their interests and collective action in society. Economic groups may support increases in public spending when this corresponds to their incentives. Lastly, in the case of access to land, entrenched inequality may make reforms possible only when the power of elites is seriously challenged.

*State capacity reflects political will; political elites develop or decrease capacity depending on whether it helps them remain in power*

6.19 Weak state capacity is one of the main characteristics of the poorest countries in the world, as well as of the most unequal ones (figure 6.3). To implement policies for equity, a minimum state capacity is needed, consisting, for instance, of an able bureaucracy to collect taxes, and well-trained teachers to educate children. A professional bureaucracy has been identified as important for states to achieve development (Rauch and Evans 2000). There is an extensive political science literature on “weak states,” particularly in Sub-Saharan Africa, characterizing them by limited state presence outside of the capital and coastal areas, as well as by a limited ability to tax (Migdal 1988; Herbst 2000). Aspects of this literature are also relevant for middle-income countries with high inequality, such as in Latin America, where “truncated” welfare states exclude a large share of the population from public spending (De Ferranti and others 2004).

**Figure 6.3 Poor and unequal countries have low government effectiveness**

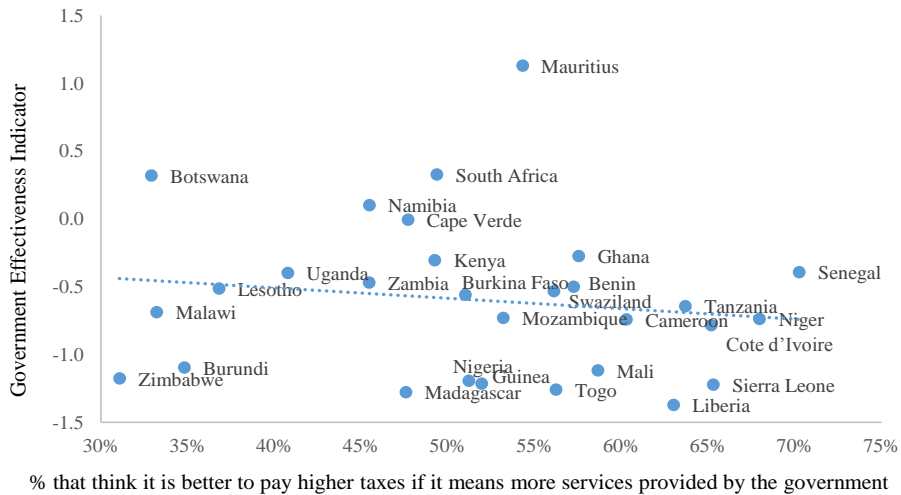


Source: WDR 2017 team using World Development Indicators and Worldwide Governance Indicators datasets.

Note: The analysis used the 2014 Government Effectiveness indicator, a subset of the Worldwide Governance Indicators that captures perceptions of the quality of public services, the quality of the civil service, and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. For each country, the Gini coefficient and poverty measure in the closest year to 2014 were used.

6.20 States with weak capacity do not necessarily reflect the preferences of their citizens. In many countries in Sub-Saharan Africa, the majority of respondents are willing to pay higher taxes for better public services. Still, government effectiveness is low, indicating that governments of these countries are not adopting policies that the majority of their citizens want (figure 6.4). In middle-income countries with high inequality, such as in Latin American, citizens may “exit”—for instance opting out of basic public education—because they obtain little from the state (Hirschman 1970; Perry and others 2007).

**Figure 6.4 Citizens are willing to pay taxes for public services: Weak government effectiveness does not reflect their preferences**



Source: WDR 2017 team using 2011-2013 data from Afrobarometer Round 5 and 2014 data from World Governance Indicators.

Note: Weighted statistics using sampling weights. The figure shows the correlation between the percentage of people in each country that agreed or strongly agreed with the statement that it is better to pay higher taxes if it means there will be more services provided by the government, and the Government Effectiveness Indicator for each country in 2014.

6.21 States with weak capacity tend to reflect the prevailing political will. Consider the case of Sierra Leone (Baland, Moene, and Robinson 2010). Sierra Leone had weak institutions when it became independent in 1961. The British colonial rulers did very little to develop institutions beyond the capital (Cartwright 1970; Clapham 1976). After independence, statesmen—in particular Siaka Stevens and Joseph Momoh—ruled using clientelism. Stevens built support by distributing jobs and using state finances for private benefits. His explicit steps to weaken state capacity included his decision to reduce the army to 1,000 soldiers to prevent future military coups—as he himself had accessed power through a coup—and the under-provision of public goods. Stevens even destroyed existing public infrastructure: he dismantled the railway leading to the area with high presence of Mende people, the strongest supporters of the competing party (Abharam and Sesay 1993; Davies 2007).

6.22 Other historical examples indicate how political elites stopped certain policies, or, on the contrary, built capacity—depending on their incentives. In an interesting parallel with Sierra Leone, Francis II of Habsburg, Emperor of Austria, was against railways “lest the revolution might come into the country” (Jaszi 1966). By contrast, other cases indicate how political will can lead

to improvements in bureaucracy, such as when elites' power is challenged by wars or other external shocks. The development of a strong bureaucracy in modern Western Europe, epitomized by seventeenth-century England, is described as the result of the need of political powers to levy taxes for military expansion due to interstate wars (Brewer 1988; Tilly 1990).

6.23 Indeed, weak capacity can be linked to unchallenged elites. If collective action in society is weak, politicians may be able to commit more credibly to narrow policies that favor specific “clients” such as their ethnic group or their caste in order to maintain their power, rather than implement broad-based policies. Some evidence suggests that collective action may be weaker when there is greater heterogeneity, linked to ethnic or caste diversity. This is the case in Sub-Saharan Africa, where the boundaries inherited from colonial rule have created states with high ethnic heterogeneity (Alesina, Eastely, and Mtuzeski 2011). In such cases, policies that are directed to “clients” can be easier to maintain to ensure their continued support. For instance, politicians can target input subsidies for farming to supporters, maintaining a threat of removing the subsidies. Such arrangements ensure that supporters credibly commit to supporting politicians, while politicians also have a credible tool to “punish” supporters if they defect (Bates 1981). By contrast, the benefits of public goods might be diluted among non-supporters and might be more difficult to reverse, making them less attractive as tools for political support. Clientelism, in the form of vote-buying, is associated with lower provision of public services (Khemani 2015).

6.24 Clientelism further weakens collective action in society, and the ability to raise resources and expand capacity in the future (box 6.2). In clientelist settings, providing few public goods can undermine economic activity and future taxation. In theory, this can be a way for politicians to maintain power with “clients” by decreasing alternatives in the private sector (Robinson and Verdier 2013). The example of Sierra Leone, where even the “presence” of the state in certain parts of the country was deliberately maintained as low, reflects this strategy.

#### **Box 6.2 Defining and measuring clientelism**

*Clientelism* is a political strategy characterized by the giving of material goods in return for electoral support (Stokes 2009). Clientelism can be viewed as a two-party encounter between a politician and a voter (Hicken 2011). It is, however, often organized in networks, which can be based on districts or regions. As a result, a central part of clientelism's organizational structure is an intermediary or a broker, whose role is to mobilize a network of local voters in exchange for financial payment or patronage jobs. The behavior and strategy of a broker and the contractual arrangement with the national politician is thus an important element of clientelism.<sup>a</sup>

A number of studies mentioned in the Chapter emphasize the negative impact of clientelism on the provision of public goods. Clientelism can entail significant welfare costs to societies (Bardhan 2002). When it is prevalent, voters act to pursue short-term benefits rather than focus on broad policy considerations, such as durable reforms.

Measuring clientelism is, however, a challenge. Distinguishing empirically between public goods and private goods can be complex: infrastructure projects, typically considered a public good, can be “locally targeted” to a specific geographic area (see review in Bouton, Castanheira, and Genicot 2016). On the other hand, redistribution promised by politicians to win votes can be beneficial to broad groups. For instance, in the cases of the Peruvian Social Fund (Schady 2000) and the investment in infrastructure in Spain from 1964 to 2004 (Solé-Ollé 2013), even though welfare-enhancing transfers were targeted for electoral gain, the policies benefited large swaths of the population, beyond those targeted to win elections.

Future work should aim to establish measures of clientelism that allow to better predict under which conditions different electoral strategies will be used and their expected impact.

*Source:* WDR 2017 team based on Wantchekon 2016.

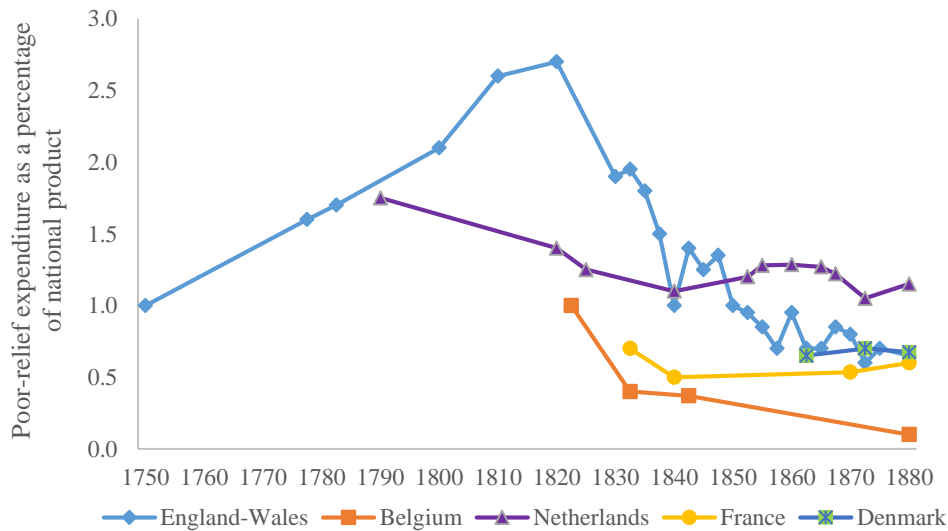
<sup>a</sup>. See Cruz 2013; Holland and Palmer-Rubin 2015; Schneider 2015; Stokes 2005.

6.25 In particular, there is evidence that direct taxation and monitoring of public spending—an important aspect of collective action—go together. The political interest of the population increases with direct taxation. In an experiment conducted in Uganda, Martin (2015) finds that individuals paying taxes in the experiment have a lower tolerance for leaders who keep public money—intended for redistribution—for themselves.

*Economic elites shape taxation and public spending; they may adopt antipoverty policies when their incentives change*

6.26 More specifically in the case of fiscal policies, potential losers from reforms may prevent their adoption, especially when they form a cohesive group. Consider the contrasting examples of a failed land tax and a successful personal income tax reforms in Uruguay. In 2006, Uruguay introduced a reform aimed at increasing the efficiency and the progressivity of its fiscal system. Its central feature was the introduction of a progressive personal income tax, aiming to improve redistribution, reduce the tax burden on the poorest taxpayers, and increase revenue collection.<sup>1</sup> The government was able to limit opposition to the reform by offering transparent information on the impact of the reform and publicizing its commitment to fight and punish evasion. Moreover, the opponents did not object with a united voice. By contrast, a few years later, in 2012, when a progressive tax on land assets was proposed, medium and large landholders, together with cattle-raisers and managers of large rural estates, rallied together against it. The reform failed to pass, and was ruled as unconstitutional by the Supreme Court. A plausible explanation for this result was the organized legal action of the two main associations representing the interests of the landed elites (Rius 2015).

**Figure 6.5 Economic elites can push for increased taxation or social spending as their incentives change**



Source: Lindert 2004.

Note: The figure shows direct assistance to the poor from government funds as a percent of nominal national product. In the cases of Belgium, France, and Netherlands, figures include private as well as government funds.

<sup>1</sup> OECD/ECLAC 2014; Barreix and Roca 2008; Martorano 2014.

6.27 The incentives of elites can affect whether taxation and public spending reforms in favor of the poor are adopted. Faced with changing economic conditions or potential fear of citizen-led regime change, even cohesive elites can push for increased taxation and social spending. As mentioned above, the first antipoverty programs in nineteenth century England and Wales were pushed for by the landed aristocracy, in order to keep cheap labor in the countryside and prevent it from migrating to urban areas, at a time when the French Revolution spurred fear of revolts (see figure 6.5, based on Lindert 2004; Ansell and Samuels 2014; Ravallion 2015). In South Africa during apartheid, white elites financed the eradication of white poverty through direct taxation, with the purpose of stabilizing segregation and preventing potential inter-racial solidarity among the poor white minority and the black majority (Lieberman 2003).

*Land reforms tend to occur when national elites are changing or when their power is challenged*

6.28 Expanding and securing access to land is an important policy area for efforts to increase economic opportunities: 75 percent of the world's poor live in rural areas and their incomes depend, directly or indirectly, on agriculture.<sup>2</sup> Thus improving and securing their access to land is important to increase investments and productivity. More equitable access to land has also been associated with both higher equity and efficiency, including because of better institutions and increased citizen participation—an important element of collective action.<sup>3</sup>

6.29 Because land inequality is often entrenched, reforms to improve access to land often take place at times when political elites are experiencing substantial change, including as a result of collective action by citizens. Land inequality tends to be higher than income inequality (Acemoglu and others 2015) and is related to historical, social, and political processes. When inequality is too entrenched to expect sales and rental markets to reallocate land, land reforms become necessary. The difficulty to reach agreement on such reforms however, means that they often take place at times of significant political changes such as the end of colonial rule, or with strong pressure from outside, as in the Republic of Korea. When no such major political changes have occurred, land redistribution has been spurred by peasant movements that increased pressure for reform, such as in Brazil (Binswanger-Mkhize, Bourguignon, and van den Brink 2009).

*Asymmetries in bargaining power shape policy implementation*

6.30 Passing reforms is only a starting point: policies may be made ineffective at later stages. Members of local elites may undermine land reform policies or shape the allocation of public spending for their benefit. Civil servants may directly influence the access and quality of public services. Additionally, elites can take advantage of measures that countervail equity-enhancing de jure reforms: for instance, by finding loopholes in tax systems.

6.31 The same conditions that matter for policy adoption hold for policy implementation: existing inequality, elite composition, incentives, and preferences. In particular, capture can be more likely at the local level than at the national level because inequality is more entrenched locally, being related to profound historical and social processes. Incentives also matter: clientelism leads to poor incentives for elites to improve service delivery. Policies may also fail to

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<sup>2</sup> Ravallion 2015; estimates for 2008.

<sup>3</sup> For micro-economic evidence in India, see Banerjee and Iyer 2005. For a comparison of North and South America, see Engerman and Sokoloff 2002.

expand opportunities, when entrenched social norms, related to gender or racial discrimination for instance, are not addressed.

*Chiefs and landed elites enjoy more secure property rights; land tenure reforms can be used for patronage*

6.32 The security of land tenure varies considerably across and within countries, depending greatly on social hierarchies or gender, and hampering the ability of disadvantaged groups to improve their livelihoods. In Vietnam, for instance, individuals who have connections to politicians and bureaucrats have much more tenure security than others. In Ghana, property rights are particularly insecure for women, who are less likely than men to hold local political or social roles.<sup>4</sup>

6.33 Interventions to change land tenure, including in cities, have often been captured and used for patronage. In many African cities, there is a range of land interventions such as land regularization or resettlement operations that have been captured by local elites and used for political patronage, including through corruption of civil servants (such as staff of the land registry). Bribes may be used to facilitate access to land, obtain formal tenure, or obtain plots for friends and political clients (Durand-Lasserve, Durand-Lasserve, and Selod 2015).

*Local elites may capture public spending in decentralization reforms, particularly when local inequality is entrenched*

6.34 Reforms to increase public spending in favor of disadvantaged individuals may also be captured by members of the local elites, who can shape expenditures to benefit their interests disproportionately (Galasso and Ravallion 2005). Capture occurs even in the case of participatory programs, such as community-driven development (CDD)—despite the fact that one of the programs' objectives is to include disadvantaged individuals in spending decisions. CDDs are a form of decentralization of spending seeking to allow decisions to be better aligned with the preferences of local communities and, through participation, foster collective action. A review of participatory programs, however, finds evidence that the poor benefit less from these programs than the better-off (Mansuri and Rao 2013).

6.35 Existing patterns of inequality and poverty shape how collective action takes place in villages. One of the reasons why CDDs may not benefit poor people as much as hoped is that even when, on paper, the poor are supposed to take part in decisions, they do so less often and to a lesser extent than more advantaged individuals. That is, in the framework of this Report, CDDs often fail to improve contestability: decreasing entry barriers for the poor in decision-making. Participants in “civic activities tend to be wealthier, more educated, of higher social status (by caste and ethnicity), male, and more politically connected than nonparticipants” (Mansuri and Rao 2013). The poor have a higher opportunity cost to participate because they have less leisure and need to work longer hours to generate income. In addition, when they participate, it is more difficult for them to influence outcomes because they are less educated or can find it difficult to debate with and contradict individuals who traditionally hold influence and authority (Abraham and Platteau 2004).

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<sup>4</sup> For Vietnam, see Markussen and Tarp 2014. For Ghana, see Goldstein and Udry 2008.



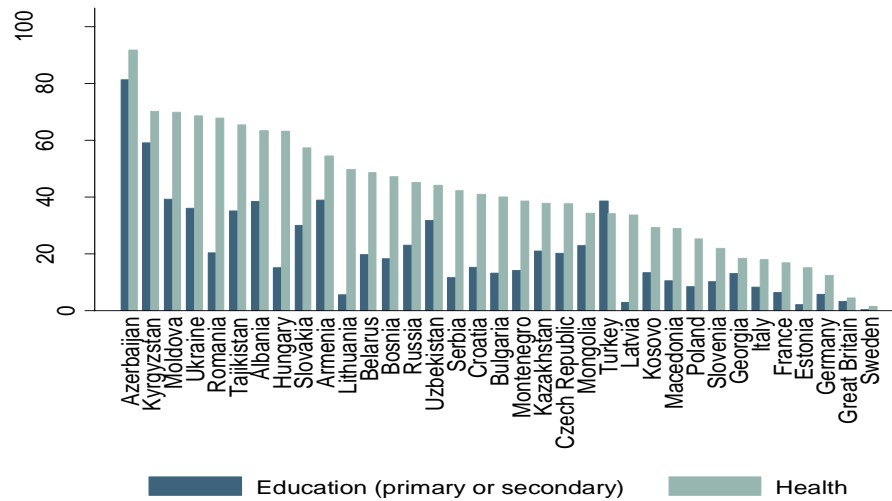
6.36 Local elites may also be better able to shape outcomes in their favor and consolidate their bargaining power when they are not divided. Inhabitants in villages in Sierra Leone that have a smaller group of potential chiefs are more satisfied with civic participation than in villages with more competition among elites. This is the case even though social and economic outcomes are worse in those villages with less competition. A possible interpretation of this result is that in villages with less competition, chiefs are able to capture civic participation (Acemoglu, Reed and Robinson 2014).

*Public sector workers are an elite in the case of service delivery; they can extract rents in clientelist contexts and capture policies*

6.37 Public spending can be captured by public sector workers in charge of providing services, such as those related to education or health; the most blatant form of capture is the diversion of financial resources. In the case of service delivery, public sector workers are “elites” under the definition used throughout this Report, since they have direct influence on policy implementation. In some cases, they can use their influence to capture resources. For instance, in most countries in Eastern Europe and Central Asia, more than a third of individuals report that informal payments (such as bribes and under-the-table payments) are made to access health services; this proportion rises to nine out of 10 individuals in Azerbaijan (figure 6.6). Corruption affects learning outcomes. In Brazil, students’ test scores in mathematics and Portuguese are higher when corruption is lower in the municipalities where the schools are located (figure 6.7, based on Ferraz, Finan, and Moreira 2012).

6.38 Capture goes beyond the diversion of financial resources: absenteeism and lack of work effort are also forms of capture. Many teachers are absent from their schools: about 19 percent, averaging across Bangladesh, Ecuador, India, Indonesia, Peru, and Uganda (Chaudhury and others 2006). Absence rates for health workers in the same countries are even higher: 35 percent. Recent data measuring teacher absence in the classroom in seven countries in Sub-Saharan Africa finds even greater rates: as much as 60 percent in Mozambique (figure 6.8). When teachers are in the classroom, often they are not teaching or not teaching well—another form of capture. Similarly, health workers often exert little effort, for instance as found in rural Madhya Pradesh in India (Das and others forthcoming; spotlight 6). In Senegal, clinicians only spend an average of 39 minutes per day counseling patients (Bold and others 2011).

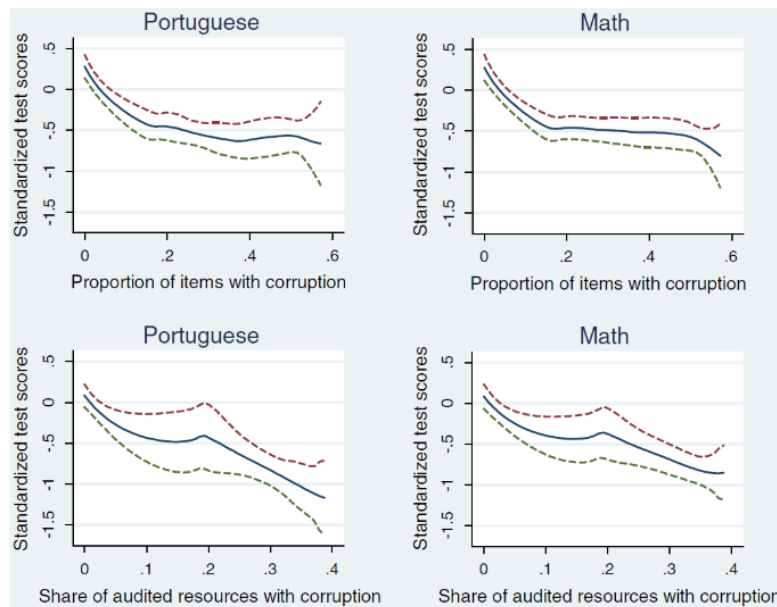
**Figure 6.6 Unofficial payments for education and health services are widespread in Europe and Central Asia**



Source: WDR 2017 team using Life in Transition Survey 2010.

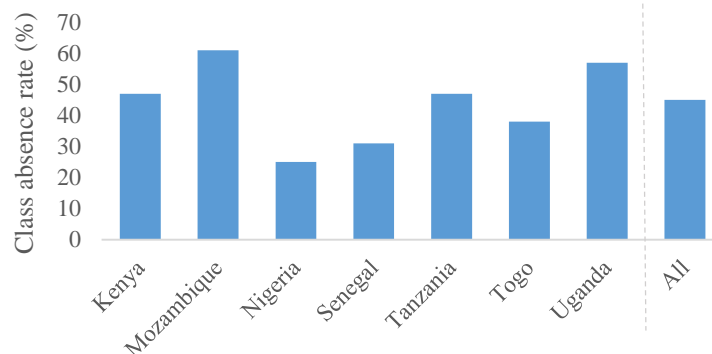
Note: The figure shows the percentage of each country’s respondents that answered "Always," "Usually," or "Sometimes" to the question: "In your opinion, how often do people like you have to make unofficial payments or gifts in these situations? Receive public education (primary or secondary)/ Receive medical treatment in the public health system?" Other possible answers are "Seldom" and "Never." Results computed using democratic weights.

**Figure 6.7 Corruption hampers service delivery: The case of education in Brazil**



Source: Ferraz, Finan, and Moreira, 2012.

Note: Each figure shows the results of a locally weighted regression with a quartic Kernel. The dependent variable is the 4th grade standardized test score for either Portuguese or mathematics and the independent variable is the respective measure of corruption.

**Figure 6.8 Teacher absenteeism is a significant type of capture in Africa affecting learning outcomes**

Source: WDR 2017 team based on Bold and others 2016b.

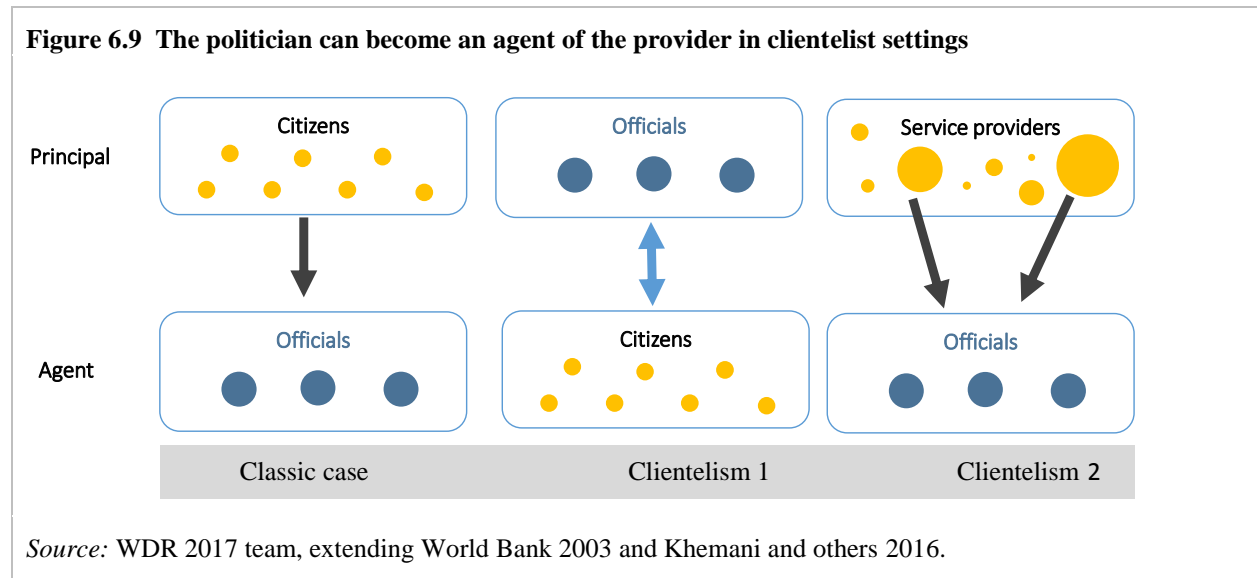
Note: Estimates using sampling weights. Cross-country mean is computed as simple average. In Mozambique, only public schools were included in the sample.

6.39 Capture reflects the lack of credibility of policy makers in monitoring and sanctioning service providers. A policy experiment in Kenya illustrates this point. It compared the impact of contract teachers in interventions managed by nongovernmental organizations (NGOs) and interventions run by the government. Test scores increased only in the intervention run by NGOs, indicating that the latter were more credible in implementing sanctions—through firing— than the government (Bold and others 2012).

6.40 The lack of credibility of policy makers in sanctioning public sector workers may result from the role that the latter play in politics in clientelist contexts: public sector jobs may be awarded in exchange for political support. In theory, a job is an attractive way for politicians to reward supporters. Politicians can exercise control over the careers of public sector workers, such as their location and promotions, and thus have a credible threat to maintain the workers' support. And it is in the interest of public sector workers to support politicians, to obtain help for their careers (Calvo and Murillo 2004; Gordin 2002, Robinson and Verdier 2013).

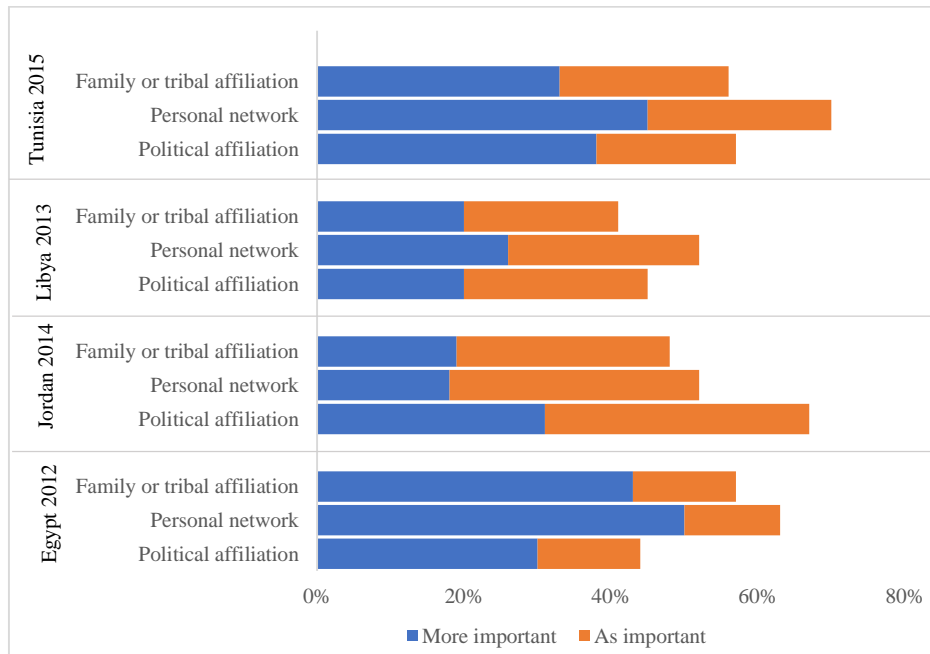
6.41 Unions, in particular, play a direct role in shaping education policies and, in some cases, they play a direct role in politics. In the Indian state of Bihar, a case study documents that a large number of deputies of the state assembly are teachers. Through their political role and ability to shape policies, teachers have improved in-work benefits; there has however been less progress for broader improvements in the education system (Kingdon and Muzammil 2009). In some cases, unions grow to play such an important role in education policies that they have a direct role in job appointments, further undermining the supervisory role of policy makers. In such settings, workers may consider that their “principal”, the actor responsible for monitoring them, is the union rather than policy makers. For example, in Mexico, as public education expanded throughout the twentieth century, a centralized union, allied with the ruling Institutional Revolutionary Party, became more important than the Secretariat of Public Education in appointing management positions. De facto, the union made holders of such positions its “agents”: loyal to the union rather than to the Secretariat (Murillo 1999).

6.42 Indeed, in clientelist relationships, where public sector workers are able to extract rents due to the influence they wield to elect politicians, those politicians can become the agents of the providers. This Report, like WDR 2004, *Making Services Work for Poor People*, views service provision as a series of relationships whereby principals must monitor agents. WDR 2004 describes two routes for service delivery. In the long route, policy makers are the agents of citizen-voters, as well as the principals of providers (World Bank 2003). In the short route, citizens are principals who monitor the providers more directly. However, politicians are initially political candidates. In order to be elected—given their difficulty in credibly committing to broad public policies that are difficult to monitor—political candidates commit to targeted benefits because they can more credibly deliver them. Thus they may become dependent on the support of certain groups, including public sector workers (figure 6.9). In such settlements, citizens expect less from politicians (because they receive some targeted benefits), while providers extract rents (because they play a role for politicians’ reelection) (Bold and others 2016a).



6.43 There is some evidence of links between political connections, government jobs, and poor service provision. In Pakistan, more politically connected doctors are more likely to be absent and less likely to be sanctioned for their absences (Callen and others 2014). In a number of countries in the Middle East and North Africa, between 40 and 60 percent of the respondents think that political connections are as important as or more important than qualifications to obtain a government job (figure 6.10). In India, despite rules that are supposed to protect the independence of the India Administrative Service, politicians frequently intervene in the careers of bureaucrats. In particular, bureaucrats of the same caste as the incoming politicians’ party base secure important positions. In states with less interference from politicians in the transfers of civil servants, suggestive evidence indicates that poverty rates declined faster (Iyer and Mani 2012).

**Figure 6.10 In the MENA region, a large proportion of citizens believe that connections are as or even more important than professional qualification to obtain a government job**



Source: Program on Governance and Local Development - University of Gothenburg 2016 for the WDR 2017.

Note: The question used is "What is the importance of a person's professional qualifications in obtaining a government job relative to other factors? Please indicate whether each is more important, equally important, or less important as a person's experience and professional qualifications? 1. A person's political affiliations 2. A person's personal network, relation to influential people 3. A person's family or tribal affiliation". The graph shows the percentage stating that each factor is more important (or as important) than (as) experience and qualifications in obtaining a government job in each country.

6.44 In some contexts, when political elites face stiffer competition as well as higher demand for public goods, they may have more pressure to deliver services, since they may need to broaden their base of supporters. There is evidence of this relationship in the case of building infrastructure in the United States (Besley, Persson, and Sturm 2010). In Brazil, there is also evidence of less corruption among mayors facing reelection (Ferraz and Finan 2011). When politicians face increased competition, they may delegate implementation decisions to better-trained bureaucrats, to whom they also give more autonomy (Rasul and Rogger 2015). That said, in clientelist settings, more competition may not always result in more public goods. Whether it does or not depends on the constituencies that politicians seek for support and whether they are easier to gain with public goods, as opposed to targeted policies. For instance, competing for the votes of the middle class—who demands public goods—can make politicians opt out of clientelism (Weitz-Shapiro 2012).

*Elites and social norms may lead to measures that circumvent or undermine policies*

6.45 In other cases, while a specific reform may pass and may not be captured, entrenched power or norms may make it ineffective. Often, de jure reforms are not enough to improve economic opportunities sustainably. A clear example is provided by the very limited improvements for the black population in the U.S. South following the Civil War in 1865, despite radical changes on

paper. Although slavery had been abolished, little else changed in the U.S. South. The white elites adopted measures to maintain low wages and restricted mobility for black workers (Ransom and Sutch 2001). A measure to grant each freed slave 40 acres of land failed to pass (Wiener 1978) and it took another hundred years for more profound changes to take place.

6.46 Indeed, elites may avoid losses from reforms to enhance equity—even when their interests are affected on paper—by taking countervailing measures. For instance, they may be able to circumvent progressive taxation by diverting taxable incomes with different degrees of legality—from tax avoidance to tax evasion. In Chile, despite a very progressive tax schedule, with a top marginal income tax rate of 40 percent, businesses could take advantage of favorable corporate taxation, with a tax rate of 20 percent until 2014. This lowered the effective personal income tax rate to 15 percent for the top 1 percent of taxpayers (Fairfield and Joratt De Luis 2015). In Morocco, formal tax laws are undermined by loopholes as well as discretionary renegotiation of tax obligations between wealthier taxpayers and tax authorities; including many tax exemptions and frequent tax amnesties (Al-Dahdah and others forthcoming).

6.47 De jure reforms are particularly at risk of not being implemented when they clash with prevailing social norms, including customary law. Efforts to expand opportunities—such as legal reforms to improve women’s rights and opportunities—can remain ineffective if norms that consolidate existing asymmetries in bargaining power are not changed (Milazzo 2016). Norms can hinder the effectiveness of land titling programs in improving women’s access to land, for instance. Women may be afraid to claim their titles for fear of social sanctions and backlash from their husbands and families, as occurred in Bolivia and Lao PDR (World Bank/FAO/IFAD 2009; Giovarelli and others 2005).

### **Lessons for improving policy effectiveness by taking into account asymmetries in bargaining power**

6.48 Policies can be blocked, captured, or rendered ineffective because their design did not account for asymmetries in bargaining power. Assuming that some actors want to adopt reforms that improve equity—be it because of modified incentives, competition, or preferences—for these reforms to be effective, their design needs to take into account the bargaining power of the main actors whose interests may be affected. To expand the set of policies that can be adopted, the policy arena may need to change: allowing new actors to contest policies, or shifting the incentives or preferences of those who bargain over policies. This chapter assumes that these processes of change, discussed in Part 3 of the Report, have taken place.

6.49 A cross-cutting message is the need to understand the existing patterns of inequality, as well as the current bargaining power among actors. In particular, understanding the incentives needed to get influential actors to adopt and implement policies that will benefit the poor and disadvantaged is key to improving equity. It is also necessary to understand how existing inequalities may be modified by reforms. For instance, increasing resources that aim to fund pro-poor policies may increase the incentives of local elites to be involved in policy making in order to capture these new resources (Mansuri and Rao 2013).

***Moving towards policy making that takes into account bargaining power***

6.50 Assuming that some actors want to implement reforms that improve equity, how can these be passed and implemented effectively? For example, in the case of the Maharashtra villages that opened this chapter, two issues can be identified. First, policy decisions, in particular the implementation of targeting, are left to village councils in a context of entrenched inequality. Second, the safety nets for agricultural workers are insufficient, leaving areas of intervention for local elites. Given entrenched inequalities, leaving it to village councils to implement policies that benefit the poor—and that may cause losses among the landed elites who lead the councils—can be problematic. There is also an issue with the set of policies themselves. While they offer some form of protection against income shocks during slack seasons—through the Employment Guarantee Scheme, offering a legal guarantee for work all-year round at the minimum wage for members of rural households—this protection is not enough. It leaves room for the local elites to provide protection against bigger life events, in exchange for political support.

6.51 *Project design can partly improve the performance of community projects and decrease the adverse impacts of local inequality.* For example, in 99 rural communities in northern Pakistan, projects that required more labor inputs (which villagers can contribute directly and hence monitor) and less capital (which is more difficult to monitor) were better maintained, even in communities where land inequality is high (Khwaja 2009).

6.52 *It is important to take into account how national and local elites shape policies when considering at which level reforms should be implemented.* While on paper, decentralization or participatory development may seem promising, elites may be more entrenched at the local level than at the national level (Bardhan 2002). One of the founding documents of the United States, the Federalist Papers, argued for the need for federal intervention because of the risk of capture of local governments by vested interests, leaving minorities to be less protected (Hamilton, Madison, and Jay 1787). Decentralization can also create spaces where de jure power and de facto power conflict, potentially undermining policies. In a number of Sub-Saharan African countries, opportunities for bribes partly stem from incomplete decentralization; central authorities try to retain power over land allocation in practice despite decentralization de jure (Durand-Lasserve, Durand-Lasserve, and Selod 2015).

6.53 *Beyond national and local elites, weighing how the effective implementation of policies will be shaped by different groups in society also matters.* In the case of social safety nets, failing to take into account the different bargaining power of the actors involved, at every stage of their design, may lead to the failure of reforms. For instance, while targeted policies for the poor may help win the support of certain groups, by arguing for their cost-effectiveness, they may be opposed by those who do not benefit from them (box 6.3).

6.54 *Bundling reforms that improve equity with other reforms that matter to opposing elites may increase their buy-in.* For example, in the case of tax reforms, earmarking can help garner support. Earmarking has been criticized for generating rigidities in the fiscal system, but it has been used often to improve commitment and convince elites to accept reforms (Fairfield, 2013), including in ancient Greece (box 6.4). Colombia, for instance, managed to pass a wealth tax levied on the richest 1 percent of the population because it explicitly devoted tax revenues to security and crime reduction. Although security is a public good, it was perceived as being particularly beneficial by

the business community, which was heavily represented in the top 1 percent of the population. *Credible commitment helps enable reforms*: the reform was credible because of the president’s reputational risk, as well as his linkages with the business communities. To increase commitment, an ad hoc committee including members of the business community, was set up to monitor the administration of the funds (Flores-Macias 2014).

**Box 6.3 Designing social safety nets to account for asymmetries in bargaining power**

Asymmetries in bargaining power matter at every stage of the design of social safety nets. Policy makers and development practitioners need to decide, among other things, whether to target a particular group, how to target it, how to operationalize the programs, and the nature of the benefits.

Considering the influence and bargaining power of actors matters at the earliest design stages: when deciding *whether to target a particular group at all*. Given financial constraints, targeting the poor may be the most cost-efficient policy to reduce poverty. This can be the “first-best” approach in the case of the reform of consumer subsidies, to protect the poor from price increases. However, in order to pass the reform, compensation may be needed for other groups who may be more connected to political elites or better able to organize to demonstrate. For instance, in the case of the gasoline subsidy reforms in the Dominican Republic, the transport industry was influential enough to obtain compensation for the reform. This may not be cost-efficient, but failing to compensate the industry may have stopped the reform from passing altogether. Similarly, the compensatory cash transfers for the electricity subsidy removal also covered part of the middle class, to thwart opposition (Gallina and others 2016).

The choice of *targeting methodology* also needs to take into account the existing structure of bargaining power among actors. Indeed, when it is not easy to target the poorest, putting communities in charge of allocating benefits may appear to be the best technical solution. However, in practice, it may allow members of the elites to block or capture programs or to use them for political gain.

For a given design of the reform, *the operationalization is also subject to taking into account asymmetries in bargaining power*: who registers applicants, who validates applications, who is present during the process. Politicians may want to be involved at every step for political gain. Although there is no clear evidence about the extent of the bias, when they do, this may distort the benefits toward political supporters (Weitz-Shapiro 2012).

In choosing the *amount and nature of benefits*, the approach that is technically first-best may not be the preferred tool of policy makers. Giving cash to households is, in most cases, the technically first-best approach, as it allows households to better allocate their total expenditure. Incumbent authorities, however, may prefer to distribute food because it is easier to publicize and exploit for political gain. This loss of efficiency may be further aggravated if they prefer food for more lucrative motives—because it may benefit influential food-importing and transporting groups (Graham 1994).

All the initial choices in program design can have longer-term or spillover negative consequences by further entrenching power relations. These choices, on the other hand, may help pass reforms in the short term. Reforms, by improving the livelihoods of the poor and their investment in human capital, can ultimately help rebalance power in their favor. Some cash transfer programs in Latin America are credited with contributing to the empowerment of the poorest as citizens. However, these trade-offs may also reinforce vested interests, such as food importers when benefits are in kind, or local elites when the only way to implement reforms is to involve them in the allocation of benefits. Such trade-offs need to be carefully considered when designing reforms.

*Source*: Aline Coudouel of the World Bank Social Protection and Labor Global Practice and the WDR 2017 team.

6.55 *Strategic use of information can help build coalitions*. In the case of tax reforms, individuals may misinterpret how a redistributive reform would affect them, and they may oppose it even if they would gain from it (Cruces, Perez-Truglia and Tetaz 2013). For example, Bolivia tried to introduce a progressive personal income tax in the form of a flat rate of 12.5 percent and a no-tax threshold of twice the minimum wage. The announcement of the reform led to massive public protests, including by certain professionals that perceived that they would bear the largest cost of the reform, even though their salaries fell in the no-tax area. The government’s inadequate



effort to explain that the tax would have affected only a small group of high-earners, and mistakes in communicating the reform, such as addressing the group of potential losers as the “middle class,” contributed to the demise of the tax (Fairfield 2013). By contrast, in Uruguay, during the successful personal income tax reform in 2006 discussed earlier, the government effectively communicated that only wealthier individuals would be affected.

6.56 In the case of education policy, information can also help to sequence and pass difficult reforms. Publicizing assessments of student learning outcomes is a first step to start discussing changes in education policies between policy makers and teachers (see spotlight 6; Bruns and Luque 2014).

#### **Box 6.4 Success and failure of progressive tax reforms: Lessons from ancient Greece**

In ancient Greece, the wealthy were responsible for the financing of public services and public goods especially festivals and military campaigns—through a practice called *liturgies*. As a reward for their cooperation in fiscal affairs, the wealthy liturgists enjoyed the prestige of being appointed to public offices and could claim leniency if tried in court. One of the incentives for them to fund war expeditions was that they benefitted most from the expansion of Athen’s empire.

However, as Athens’s supremacy in the Mediterranean was coming to an end in the midst of an economic crisis in the fourth century BC, the wealthy liturgists became increasingly reluctant to pay taxes. They tried to conceal their wealth or transfer the role of paying taxes to wealthier individuals (a practice called *antidosis*).

The success and decline of Athens’s ability to tax its wealthy elites provides some useful lessons for difficult tax reforms today. First, it is important to provide an appealing set of tax expenditure policies that can promote tax compliance. Some of the taxpayers in Athens began contesting the kind of public goods that their taxes were financing: instead of frivolous festivals, they would rather finance the fleet, or even relief for the poor. Second, appealing to horizontal equity can also help pass reforms, by committing to fighting tax evasion and avoidance. In Athens, many of the complaints came from the perception that individuals with the same level of wealth could end up being subject to a very different tax levels. Finally, the introduction of formal rules may undermine social norms and voluntary compliance. In Athens, liturgies changed from being voluntary to compulsory. This change resulted in a diminished social recognition of the taxpayers, who could no longer claim privileges before the judges on the basis of their cooperation.

Source: WDR 2017 team based on Christ 1990.

#### ***The impact of changing the policy arena***

6.57 Designing policies that are based on the existing bargaining power among actors may be more likely to make them successful in the short run. Ultimately, however, it might be necessary to modify the policy arena in order to increase the set of policies that can be successfully adopted and implemented.

#### ***Enhancing contestability***

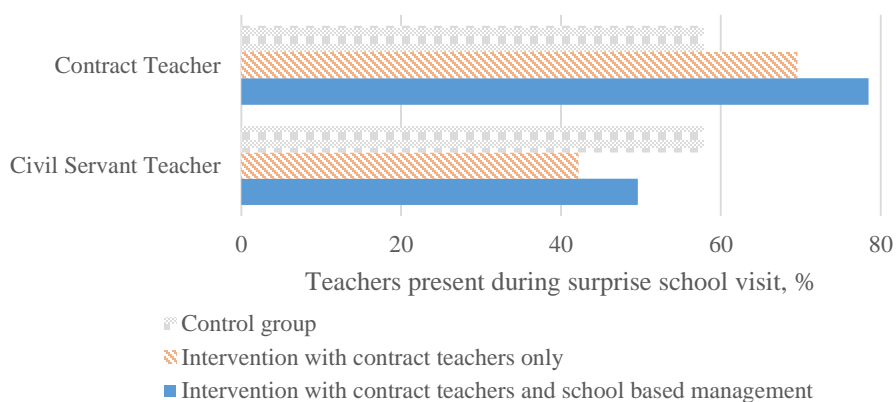
6.58 *Increasing the direct representation of disadvantaged individuals in legislative assemblies and other political bodies can improve policy makers’ commitment to reforms that improve equity.* The proportion of women in national legislative assemblies has increased significantly in the past 20 years (even though currently below 30 percent, it still remains low). The case for this increase is that it can help bring about policies that are more aligned with women’s preferences. Women may also feel more accountable to other women because of their shared identity. Indeed, in India, women taking part in village councils vote for public goods that are more aligned with their

preferences and that improve health, such as greater investments in safe drinking water (Chattopadhyay and Duflo 2004). Other studies find that political reservations (electoral quotas) for scheduled tribes and castes lead to higher social welfare spending for scheduled tribes, and to more jobs for scheduled castes (Pande 2003). Ultimately, the political representation of disadvantaged groups seems to be effective in reducing poverty (Chin and Prakash 2011).

6.59 *Marginalized groups can also be more directly involved in the design of specific policies, such as taxation.* One promising example is explicitly taxing the informal sector in developing countries.<sup>5</sup> In Ghana, informal public transport workers were successfully incorporated in formal tax policy starting in 1981, thanks to the delegation of tax collection to informal sector associations. This arrangement is believed to have increased tax revenues (Joshi and Ayee 2009), and it was extended to 32 other informal sector associations (Joshi, Prichard, and Heady 2014). More importantly, it introduced a culture of tax compliance in a sector previously neglected by the tax authorities. An important element behind the success of this policy is that it improved taxpayer services, providing incentives for cooperation. Ultimately, the associational form of taxation moved, in 2003, to a more cost-efficient presumptive tax regime, where drivers are requested, every quarter, to buy a sticker and display it on their vehicle’s windshield (Prichard 2009).

6.60 *In the case of service delivery, “empowering” users by involving them in management can help improve services and reduce capture.* For example, when parents’ councils at schools are well trained and have credible sanctions, they can improve school results (Bruns, Filmer, and Patrinos 2011). In a reform experiment in Kenya to hire contract teachers, capture by civil service teachers was lower by one-third in the subgroup of schools where school committees received training in school-based management. In this subgroup, the school committee was better able to monitor the hiring of contract teachers, and capture—in the form of absenteeism and hiring of relatives—was reduced (figure 6.11, based on Duflo, Dupas and Kremer 2015).

**Figure 6.11 Empowering parents with school-based management training helps decrease capture (teacher absenteeism) in Kenya**



Source: WDR 2017 team using Duflo, Dupas, and Kremer 2015.

Note: Bars show the percentage of teachers present in school during a surprise visit. In schools that did not receive a school-based management (SBM) training, civil servant teachers were less likely to be present than in schools of the control group: their presence decreases in response to the availability of additional contract teachers.

<sup>5</sup> The informal sector may already be indirectly affected by taxation on intermediate goods or trade taxes (Stiglitz 2010).

6.61 *Measures to empower users may work best if they are linked to political authorities, in order to change the power dynamics with providers.* In Indonesia, for instance, a field experiment compared various mechanisms to strengthen school committees. The results suggest that linking school committees, which are considered relatively powerless, to elected village councils—through joint meetings and action-plans—was the most cost-effective method to increase test scores. Linking school committees to village councils allowed alleviating some of the power constraints that committees faced on their own (Pradhan and others 2014).

6.62 If the credibility of sanctions by parents and communities is limited, “empowering” parents may be ineffective and may increase inequality. In the absence of formal sanctions to hire and fire (such as in well-trained school councils), school-based management may exercise influence by exerting social pressure on providers. However, when teachers or health workers are wealthier or more influential than users, the latter may not be able to exercise social pressure. Interventions to “empower” communities to monitor health clinics in Uganda are less successful in areas with higher ethnic heterogeneity and, to a lesser extent, higher inequality (Bjorkman and Svensson 2010). In Mexico, grade failure and drop-out rates were not reduced in poorer communities after a school-based management program was rolled out (Gertler, Patrinos and Rubio-Codina 2012).

6.63 *Given the limits of local actors, what matters for more significant reforms is the balance of power between providers and politicians and how they bargain.* Some reforms that managed to include unions and balance their power have succeeded. For instance, in Chile, ambitious education reforms were passed thanks to the inclusion of unions, in a setting of high credibility of the executive, in order to increase spending in exchange for performance pay reforms (Mizala and Schneider 2014).

#### *Changing actors’ incentives in the policy arena through voting and information*

6.64 In the Kenya example, even though involving parents in school monitoring helped improve the outcomes from the hiring of contract teachers, the whole experiment ultimately failed to be scaled up because the government lacked the credibility to implement sanctions. This illustrates the need to *change the incentives of elected leaders.*

6.65 *The engagement of disadvantaged groups through voting can change the incentives of political leaders.* In the United States, laws that extended women’s suffrage were followed by increases in public health spending and door-to-door hygiene campaigns (Miller 2008). In Brazil, the effective enfranchisement of poorer and less educated voters, thanks to improvements in voting technology with electronic ballots, led to an increase in the number of prenatal visits by health professionals, and possibly to a decrease in the prevalence of low-birth weights among the less-educated voters (Fujiwara 2015).

6.66 *To overcome clientelism, new experimental evidence indicates that communication and deliberation can help.* Increased avenues for communication can allow politicians and voters to uncover common interests. They also allow voters to learn about each other’s preferences and expectations and to update beliefs about candidate quality. The effects may be ambiguous, however, since increased communication may also allow better identifying targeted short-term benefits. Experimental evidence from Benin suggests that town hall meetings reduce the prevalence of clientelism (Fujiwara and Wantchekon 2013).

6.67 *Information is, in theory, a critical tool to monitor elites—including service providers—results, however, are limited and contrasting.* An experiment on primary healthcare in Uganda, mimicking traditional community-driven development approaches, finds that the quality of care or health outcomes improved only in the subgroup where communities were also provided with information on the relative performance of the facilities. Such relative information helps identify what is within the control of policy makers or service providers (Bjorkman, De Walque, and Svensson 2014). Another promising result on the impact of information comes from Pakistan, where a randomized experiment that provided information to parents on the performance of private and public schools increased test scores, decreased private school fees, and increased primary enrollment (Andrabi, Das and Khwaja 2015). On the other hand, there are cases in which the provision of information on its own did not improve delivery. In an experiment in Kenya, providing information on children’s performance in schools and how parents could take action did not increase their participation in monitoring (Lieberman, Posner, and Tsai 2014). The authors emphasize the many implicit assumptions that link the provision of information to improving services; two important ones in this case are whether parents think that monitoring services is their responsibility and whether they can do anything about it.

6.68 In particular, *information in local interventions may improve outcomes only when constraints related to asymmetries in bargaining power are alleviated.* While solid evidence is lacking, some information-related interventions may have been more successful because they did not face constraints related to a lack of bargaining power among actors. For instance, two information campaigns on the performance of local schools in northern India had contrasting outcomes. One campaign that was supported by the Department of Education was successful in improving outcomes (Pandey, Goyal and Sundaraman 2009). Another campaign that was supported by an NGO did not improve the performance of schools (Banerjee and others 2010). One interpretation is that in the case of the campaign supported by the Department of Education, constraints related to the top-down delivery of services had already been alleviated (Khemani and others forthcoming). When such constraints are still present, information may have little or no impact.

#### *Shaping preferences to increase cooperation*

6.69 *Collective action—particularly cooperation—can be enhanced by building common interest,* as opposed to stressing the identity of policy makers. Stressing the identity of certain groups and improving their participation in policies may improve outcomes for these groups but this may come at the expense of other groups, or at the expense of longer-term benefits. For instance, in the case of political reservations in India, reservations for scheduled tribes increase social welfare spending in their favor, but decrease education spending (Pande 2003). Scheduled tribes may perceive that they will receive low returns to their education and thus may decide to invest less in it. While increasing social welfare spending is beneficial to them, it comes at the expense of redistribution that could benefit other groups and that may be more beneficial in the long term. External conflicts have played a role in development by helping build common interest against a common enemy (Besley and Persson 2010).

6.70 *Rigorous work and evidence on how to build common interest in times of peace is lacking but education can play a role.* A study of border regions in Kenya and Tanzania that were “artificially” divided by colonial powers and thus share many common characteristics. It finds that

ethnic fractionalization does not lead to under-provision of public goods on the Tanzanian side of the border as much as it does on the Kenyan side of the border. Miguel (2004) attributes this to the practice in schools in Tanzania to foster a national identity to a much greater extent than schools in Kenya, thus improving cooperation for public goods.

### **Processes to shift power dynamics**

6.71 This chapter has described various mechanisms to adopt and effectively implement equity-oriented policies, but these mechanisms only come into play if processes for change have already started. Part 3 delves into these processes. Chapter 7 examines when and how elites allow for the participation of new actors to bargain over policies, including due to changes in incentives or preferences. When elite bargains are not conducive to more accountability to citizens, disadvantaged groups may mobilize in order to have more voice in society; this is discussed in chapter 8. Furthermore, chapter 9 examines the role of international donors and processes in influencing the domestic policy arena.

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## **Spotlight 6 Service delivery: Health and education**

S6.1 Improving access to health and ensuring that students learn are essential to expand opportunities. Various market failures explain the need for collective action to deliver these services. However, in many cases, power asymmetries prevent the successful implementation of policies that improve health and education.

### **Public interventions are needed for investments in human capital**

S6.2 Various market failures may make individuals underinvest in health and education. First, certain parts of health and education are public goods: many individuals can benefit from the investment without paying for it. For instance, spraying against mosquitoes in a given neighborhood benefits all residents; those who do not pay for spraying cannot be “excluded.” As a result, some residents may free ride and not pay for the spraying because they will benefit from it anyway. If all residents adopt this logic, spraying will ultimately not be funded.

S6.3 Second, such investments present externalities: the benefits to society from educating or promoting the health of individuals can be larger than their private benefits. Some may, for instance, argue that education does not only matter because of the economic gains from it but that it also contributes to shaping civic behavior (Andrabi, Das and Khwaja, forthcoming). In addition, some levels of education may only be optimal if all actors move together. Individuals may not invest in skills if they think that firms are not investing in complementary technologies, and firms may not invest in new technologies if they think they will not be able to find workers (Acemoglu 1998). In some cases, such as the fight against communicable diseases, an individual has no incentive to invest in his or her own welfare if others do not invest, as well.

S6.4 Third, failures in other markets affect investments in human capital: individuals may not be able to borrow to make investments or they may be misinformed about the gains from them. This is especially true for poorer or disadvantaged individuals. For instance, given credit constraints, only those who have enough wealth may be able to invest in education. In the case of information, poorer children can be more likely to underestimate how wages increase with education, as a study in the Dominican Republic found (Jensen 2010).

### **Education: Challenges of delivering learning for all**

S6.5 The problems outlined in chapter 6 hamper education systems from achieving their goals. Bureaucratic forms do not necessarily play their intended functions, often because power relationships prevent systems from promoting student learning equitably and efficiently; while norms consolidate power further and prevent laws and policies from being implemented as written.

S6.6 In Mozambique, for example, in 2014, 45 percent of the primary school teachers and 44 percent of directors were absent from school during an unannounced visit by the Service Delivery Initiative (SDI). However, even if schools managed to reduce teacher absence to zero, pupils would not be able to learn what their teachers do not know. In Mozambique, the survey found out that only 60 percent of mathematics teachers could subtract 86 minus 55 and just 17 percent of teachers were able to develop a sound lesson plan.

### ***How power dynamics undermine education reforms***

S6.7 In many cases, while policies seem to be in place to improve outcomes—for instance, governments train teachers or carry out national assessments of student learning—they are nevertheless not effective in improving outcomes.

S6.8 Reforms have failed because they were thwarted by power dynamics. This has happened a number of times with reforms hiring contract teachers. The idea behind hiring contract teachers is to decrease class size and employ teachers who are easier to discipline (thanks to the threat of firing or at least contract nonrenewal) and thereby face stronger incentives.

S6.9 However, teachers and their unions form a potent political force. Contract teachers, allied with civil service teachers, are able to form a potent political force and lobby to be absorbed into the civil service. Over the past decade or two, large numbers of contract teachers have been "regularized" (given civil-service status) in Kenya, Peru (Webb and Valencia 2006), Indonesia, and other countries. As discussed in Chapter 6, this power dynamic reflects that while policy-makers should monitor teachers to ensure that they deliver better learning; policy makers may in fact be dependent on teachers for political support. This dependence decreases the willingness of policy-makers to monitor and enforce performance.

S6.10 The contract teacher example shows that if policy design ignores power dynamics, a reform can leave the system worse off than it had been before the reform. Teachers hired on contract are often less qualified than civil-servant teachers are, at least in terms of formal qualifications. Yet schools, communities, and governments are willing to hire these contract teachers because they are willing to trade qualifications for effort. Yet in the end, they have gotten the worst of both worlds, from a service delivery perspective: once the less-qualified contract teachers have been incorporated into the civil service, the country ends up with the same low effort, lower skills and higher budgetary cost.

### ***How can difficult education reforms be effectively adopted and implemented***

S6.11 How can reforms change power dynamics to improve the outcomes of education systems? Despite the gloomy picture overall, change can happen, most likely when reforms are successful in changing incentives of teachers and policy makers; involving new actors in the policy bargaining arena; and changing norms.

#### *Changing the incentives of policy makers and teachers through public awareness*

S6.12 Information is often viewed as a way to allow policy makers to better monitor providers. However, information as pure technical tool may not be enough. Rather, information is useful when it can be easily understood and is targeted to those with incentives to act.

S6.13 Improving public awareness of the unacceptably low levels of learning in many areas of a country has proven to be a successful policy for changing the incentives of teachers and policy makers, and improving education quality. This theory underlies citizen-led assessments of student learning, such as the ASER program in India and the Uwezo program in East Africa, both of which aim to improve data on and public awareness of the levels of learning. The same theory inspired initiatives such as the Service Delivery Indicators initiative (SDI) in Sub-Saharan Africa. SDI



gathers data on both inputs and outcomes in representative samples of schools in many countries, and its data are useful for diagnosing problems and targeting support. But ultimately, the SDI effort is not just about fine-tuning an education system by turning technocratic dials, but about shifting the equilibrium by marshalling public awareness to support reform.

*Combining information and sequencing to build support for reforms*

S6.14 Many important education reforms have taken place over the past two decades, including in settings in which teacher unions play important roles. Policy makers who want to implement reforms can reach out to build support from other actors by first using information on student performance and directly communicating with the public. In some cases, including in Ecuador, Mexico, and Peru, confrontation has been unavoidable. On the other hand, in Chile, where policy makers had high credibility with respect to unions because they were traditional allies, a process of continuous negotiation paved the way for the passage of important reforms, such as bonus pay, including by bundling them with increased spending on education (Bruns and Luque 2014).

*Bringing new actors in education policy: The role of parents*

S6.15 Directly involving parents in school policies is another way to change power dynamics. It can only work, however, when parents can credibly enforce sanctions. For instance, why did giving more power to parents through school based management (SBM) reforms work in Honduras and fail in Guatemala? Ganimian (2016) argues that in Honduras, teachers' unions were focused on higher order problems such as wages and the investment from the national government was small, especially in the beginning, and as a result SBM was able to endure through different administrations. In Guatemala, by contrast, the high cost of maintaining the program made it more vulnerable to special interest groups, who managed to organize and successfully advocate to revert the reform.

*Changing norms*

S6.16 Changing education systems also means promoting norms that support better behavior and promoting teachers who share these norms. Many teachers throughout the developing world make heroic efforts to educate children in extraordinarily difficult circumstances, contending with a lack of learning materials, student absenteeism, and threats to their safety. When they do this, it is sometimes because of altruistic concern for children, but sometimes it is also because they subscribe to a norm of teacher professionalism and a sense of duty. Ensuring that more such teachers are selected into public service and rewarded appropriately can help shift the composition of the teacher body and change power dynamics.

**Health: Challenges for improving access**

S6.17 Ensuring that everyone has access to a quality health care is essential to expanding opportunities. Yet in many developing countries, and especially in low-income countries, the quality of health care is poor: as discussed in chapter 6, doctors are absent, and when they are present, they exert low effort or make mistakes in diagnosing and treating patients. In addition, household out-of-pocket expenditure dominates health financing in low-income countries and in many middle-income countries (World Bank 2007).

***An illustration of poor quality of care: India***

S6.18 The poor availability and quality of care is evident in India. In a representative sample of rural areas of Madhya Pradesh, 40 percent of doctors in public health facilities are absent at any given time. Doctors in public facilities spend on average 2.4 minutes with a patient and complete only 16 percent of a checklist of examination item and questions on medical history. The same doctors perform better when they are in the private sector—indicating the importance of incentives. However, virtually no doctors conducted all the examinations indicated when a child had diarrhea. Patients are much more likely to receive an unnecessary treatment than a correct treatment. Only 3 percent gave only a correct treatment (Das and others, forthcoming).

***An illustration of out-of-pocket expenditures, including informal payments: Ukraine***

S6.19 Ukraine illustrates the problem of out-of-pocket expenditures—including a gap between formal rules and actual practice. Like several other countries of the Former Soviet Union, everybody has the constitutional right to access free health services. Nevertheless, direct payments by patients account for more than 40 percent of total health expenditures and are a heavy burden for the majority of Ukrainians.<sup>1</sup> *De facto*, patients pay an informal fee for almost every service offered by public health providers. These informal payments seem to be partly pocketed as informal income and split between the care providers (physicians and nurses), other health care personnel (chief doctors, hospital administrators), and political authorities at various levels. They are also used to finance recurrent expenses of health facilities, such as various supplies, refurbishment, and reconstruction (Belli, Dzygyr and Maynzyuk 2015).

**How to reform health care**

S6.20 Poor quality of care and high out-of-pocket payments are partly the result of a political equilibrium between the different actors involved in the process of adopting and implementing health policy.

***Change the actors involved in health policy adoption and implementation***

*Involve more actors in hiring practices to break patronage*

S6.21 In Ukraine and other countries, patronage plays a decisive role in the recruitment and placement of doctors, especially for attractive positions: those where it is possible to extract more and larger informal payments. This consolidates networks of personal connections and erects high entry barriers. Several Ukrainian health workers reported they had to pay to secure a job or to retain their positions, and also needed to maintain their discipline and loyalty to their line managers (Belli, Dzygyr, and Maynzyuk 2015).

S6.22 Reforms should try to change the patronage system, especially among doctors. In Ukraine, for instance, broadening the set of actors involved in the process to hire doctors holds promise.

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<sup>1</sup> In 2010, for instance, about 60 percent of individuals had at least partially forgone health care services because they could not afford them (Tambor and others 2014).

Some cities have introduced the requirement that the municipal health care department should approve any appointment and dismissal of medical staff, to stem the power of chief doctors.

*Involve users, including through good use of information and monitoring*

S6.23 Involving communities can work to strengthen the quality of care and decrease absenteeism, provided that they have clear mandates and tools to monitor providers. An intervention designed to strengthen local accountability and community-based monitoring in the primary health care sector in Uganda was remarkably successful in improving both health services and outcomes in the participating communities (Björkman and Svensson 2009). The intervention consisted of a series of community meetings facilitated by a nongovernmental organization, using report cards on the quality of services, and resulting in action plans. Utilization of outpatient services increased by 20 percent, and there were significant improvements in treatment practices, waiting time, examination procedures, and absenteeism. Most importantly, the weight of infants increased significantly and the under-five mortality rate fell by one-third in the treatment villages.

*Change the incentives of politicians and providers*

S6.24 However, there are limits to how much local control can achieve—in part because there are important components to the quality of service delivery that are not determined locally. It may be necessary to change the incentives at a higher level or through top-down approaches to improve the delivery of health services.

*Better incentives for policy makers can work, if effectively implemented through decentralization*

S6.25 Decentralization is often seen as an attempt to increase accountability because users/voters may better observe the efforts of policy makers. In Brazil, the public system, managed and funded by states and municipalities, is the main source of health care for the poor. Given competition for the votes of the uninsured (poor) who want public health care and the insured (richer) who do not, spending on health care is higher in municipalities where the proportion of poor is higher and where voter turnout is higher (Mobarak, Rajkumar and Cropper 2011).<sup>2</sup>

S6.26 However, decentralization may also be ineffective, simply adding a bureaucratic layer. This is what happened in Ukraine. In the 1990s, following the disintegration of the centralized Soviet Union and the collapse of central revenues, most public services financing and administration, including health, was decentralized to region, district, and municipal levels. However, only the Municipal level was governed by elected officials, while all other levels were governed by officials appointed from the center, thus limiting the representativeness of local authorities. In addition there was no clear assignment of new accountability arrangements. The process increased fragmentation, since several levels of government financed, owned, and ran health facilities. Decentralization ended up “crystalizing” the status quo: for example, making it impossible to streamline the excess infrastructure, since health services became a source of

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<sup>2</sup> Although voting is supposed to be mandatory in Brazil, penalties for noncompliance are low and the average voter turnout is much lower than 100 percent: it was 77 percent in the 1996 elections, for example. The authors assume that variation in turnout is more likely to be driven by voter turnout by the uninsured, since those who are insured are more likely to be formal workers, on whom it is easier to impose penalties.

patronage and informal revenue for local elites and senior doctors (Belli, Dzygyr and Maynzyuk 2015).

*Better incentives for providers can work if effectively implemented*

S6.27 The introduction of performance-based budgeting schemes may improve the level and distribution of key health outcomes and change incentives of health providers by making them more accountable. There is need for more research to assess the effectiveness of these schemes, and their impact may depend on existing conditions. For instance, in Ukraine, the introduction of a program-based budgeting collided with the existing detailed spending requirements and just added a layer of bureaucracy. On the other hand, in Argentina, the introduction of performance incentives to finance a provincial insurance scheme for maternal and child health care (Plan Nacer) improved not only the number of prenatal care visits, but also the quality of prenatal care and delivery. The incidence of low birth weight and neonatal mortality decreased (Gertler, Giovagnoli and Martinez 2014).

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## Part III

# Building Coalitions For Change





## Part 3 Introduction

### Building coalitions for change

1. As discussed in Part II, to improve policy effectiveness and ultimately to expand the set of possible implementable policies it is necessary to reshape the policy arena where actors bargain. This can be done by enhancing contestability, that is, by enabling the entry of new actors into the bargaining space; by changing the incentives of the actors involved; or by reshaping their preferences and beliefs. While the dynamics of governance can be very persistent and are highly endogenous, change is possible over time. Part III of the Report explores the dynamics of how change occurs from the perspective of elite bargains, citizen engagement, and international influences. In the end, change is manifested by bringing about new formal rules that reshape *de jure* power.

2. *Elite bargaining.* Elite actors constantly face the need to adapt to changes, as the development process alters their relative power, incentives and preferences. Bargains between elites or between elites and citizens reflect this dynamic process of adaptation. In some cases, bargains may collapse when powerful interests resist change and negotiations are unable to accommodate new interests. However, cooperative agreements, where elites adapt by generating more capable, contestable, and accountable institutions, can lead to successful long-term transformation. Examples abound where elites adopt rules that limit their own power. Self-interested elites may agree to bind their own hands as a means of sustaining power in the long term, and as a form of political insurance. When the potential for conflict arises, elites may choose to broaden coalitions by bringing new actors into decision-making spaces to improve stability. This may lead to new dynamics over time, as new actors become increasingly able to influence policy making. When elites recognize threats to their power, they may introduce rules to constrain power, such as fiscal transparency, right to information, or an independent judiciary, hoping that they will bind not only themselves, but also their successors. How polarized elite preferences are, how competitive is the context in which bargains take place, and the presence of effective leadership all play a role in whether elites adopt rules-based mechanisms, and how sustainable the changes are.

3. *Citizen engagement.* Mechanisms of engagement such as voting, or political or social organization, allow individuals to coordinate and cooperate with one another, increasing their bargaining power to engage with elites and affect change. Elections can help change the incentives of elected officials, as individuals, acting in coordination, may cast their votes depending on whether or not those officials deliver on electoral promises. Electoral processes, however, are not a sufficient condition for responsive and accountable governments. Political parties serve as a complementary mechanism to represent and articulate citizens' collective interests. These parties help integrate different groups into the political process, aggregating citizens' preferences, and channeling their demands in the policy-making process. However, parties sometimes fail to reflect citizens' preferences, acting instead as "gate-keepers" to protect vested interests and existing power structures. Engagement through social organization—including through social movements and public deliberation—provides an alternative entry point for change and can enhance contestability. The interaction between elites and citizens is a two-way dynamic, with both sides playing decisive roles in enabling change.

4. *International influences.* Governance dynamics are not limited to the frontiers of sovereign nations. Elite bargains and citizen engagement are increasingly subject to the interaction with transnational flows—of ideas, capital, goods, technology and people. These flows directly affect domestic governance, presenting both challenges and opportunities for developing countries. International factors influence change through two main channels: norms and regulations, and international cooperation (including overseas development assistance). These instruments influence the bargaining dynamics by altering the relative power of different actors and by bringing new goals to the table. These mechanisms can be used to enhance the contestability in the policy arena, effectively changing the incentives of actors and eventually reshaping preferences in society through “demonstration effects.” By referring to international norms, ordinary citizens can strengthen the legitimacy of their claims and successfully challenge prevailing norms, putting pressures on governments to transform state institutions and reform public policies. On the other hand, these influences can reinforce existing balances of power, sustaining outcomes that are socially undesirable. For example, in the context of overseas development assistance, some financial instruments tend to strengthen the bargaining position of the actors in government. When aid is used without taking the development objective of the recipient country as the priority, it might result in a development assistance failure, reinforcing local power dynamics that favor entrenched elites. Such failures can be avoided by taking into account how different instruments can also help legitimize policies and coordinate collective action to broaden the policy arena and lead to better, more sustainable, outcomes.

## **Chapter 7 Elite bargaining and adaption**

### **Understanding elite bargains**

7.1 For the past four decades, China has been the world's fastest growing country and has lifted over 700 million people out of poverty. According to many commonly used indicators, China's institutional environment during this period remained static. Yet a deeper understanding shows that the adaptive policy decisions and enhanced state capacity that enabled China's economic and social transformation were facilitated by deep changes to the policy arena.

7.2 China, despite maintaining a one-party state without elections at the national level, and restrictions to information flows and association, has nevertheless significantly broadened the space for contestability at both central and local levels, leading to greater adaptability that has enabled improvements in growth and equity. In the years following Deng Xiaoping's 1980 assertion that "over-concentration of power is liable to give rise to arbitrary rule by individuals at the expense of collective leadership," the Communist Party of China (CPC) broadened horizontal accountability and institutionalized collective leadership through norms on leadership transitions, rules on selection and retirement, consultative decision making, greater Party institutionalization, bureaucratic professionalization, and the introduction of village elections. The growth of state and Party bureaucracies, as well as organized business and societal interests, combined with decentralized economic power, has led to a proliferation in the number of organizational bases with bargaining power (Lampton 1987). All these reforms reflected the incentives and preferences of those in power: broadened accountability and a more rules-based space for contestability helped solve commitment and collective action challenges within the ruling elite, and thus enhanced the stability of the ruling party.

7.3 No country has sustained long-term economic growth without broadening the space for rules-based contestability and accountability, although countries have done this in very different ways. Some have broadened accountability within dominant political parties or opened the space for contestation only in specific domains or local administrative levels; others have introduced free and fair competitive elections and broad corporatist consultative arrangements. The forms that are selected to solve commitment and collective action challenges at particular development junctures may produce tradeoffs: growth with higher inequality; more redistribution or less violence accompanied by lower long-term growth; successful growth episodes with increasing environmental costs; or growing levels of injustice or exclusion, despite good growth outcomes. The introduction of contestability and accountability mechanisms can help countries adapt when tensions related to these tradeoffs arise.

7.4 When powerful interests resist change, governance institutions that stunt inclusive development can persist. Yet history is rife with examples of countries that improved rules that constrained powerful interests and facilitated developmental progress. All of today's high-income countries were once poor and had unaccountable governments. These countries sustained economic growth over long periods of time while improving social welfare and preventing violence. Sustained inclusive growth was facilitated by evolving institutions and rules of the game that constrained arbitrary action of decision makers, enhancing contestation in policy making and holding decision makers to account.

7.5 The institutions and rules these countries established facilitated nonviolent and equitable development. *Why* did these durable institutions develop? Changes to the “rules of the game” that determine policy formulation and implementation reflect bargaining outcomes that result from elite actors acting in their own interests. Reforms that limit the arbitrary exercise of power today may be necessary for maintaining or enhancing power or providing insurance against a future loss of power. Formal institutions—moving from deals to rules—can enhance the credibility of commitments, overcoming coordination challenges between elite actors and strengthening the stability of elite bargains. In cases of long-term successful transformation, elite actors have adapted to changing circumstances by generating more capable, contestable, and accountable institutions; these institutions themselves helped enable further development.

7.6 Elite bargains are dynamic processes that are constantly adapting to changes in the relative power, incentives, and preferences of elite actors. The development path is bumpy: shocks (such as terms of trade shocks and natural disasters) and gradual developments (such as urbanization or a growing middle class) alter elite power and preferences, often benefitting one group of elites at the expense of another. In the face of these changes, many deals-based bargains that cannot accommodate new actors or demands collapse. In other countries, elite bargains can adapt to changes in the relative power, incentives, and preferences of societal interests by accommodating new demands through credible rules for elite-elite and elite-citizen interactions (see chapter 2).

7.7 Long-term developmental progress is predicated on this ability to adapt to changing circumstances. When adaptation takes place through rules-based mechanisms, virtuous cycles of continued adaptation and developmental progress are more likely. However, the conditions under which such rules-based adaptation occurs are limited: in most of the world and most of human history, unstable deals-based bargains have dominated.

### ***Who bargains?***

7.8 Who bargains? Actors in the policy arena bargain over the design and implementation of policies and the definition of rules. In this chapter, the focus is on “elites”—those actors with the ability to directly influence outcomes within a given sector or issue. But identifying these elites may be difficult (box 7.1).

#### **Box 7.1 Expert survey to identify elites**

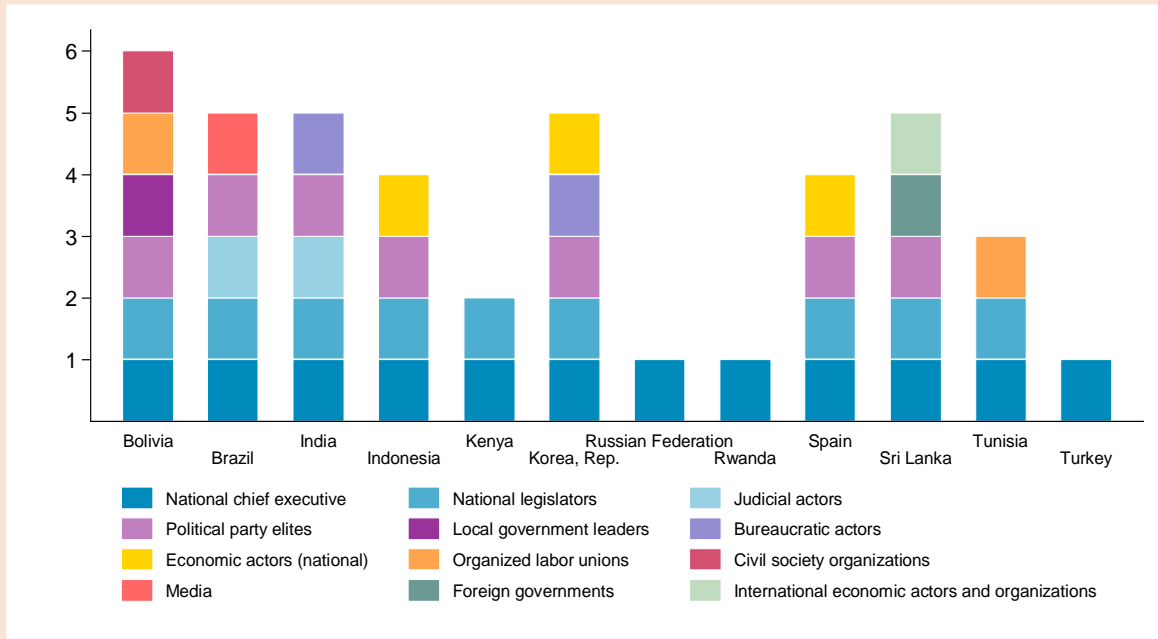
All social science disciplines and development practitioners recognize the importance of elite actors in determining development outcomes: from Aristotle’s “oligarchy” to early twentieth century “elite theorists,” including Michels [1911] 1966, Pareto (1971 [1927]), and Mosca (1939), to recent grand theories of economic and institutional co-evolution, including North, Wallis, and Weingast (2009), and Acemoglu and Robinson (2012). The international donor community increasingly looks at the consequences of different “political settlements,” which can be understood as elite bargaining equilibria that emerge at critical junctures in a country’s development (Khan 2010; Di John and Putzel 2009; Parks and Cole 2010). Yet the set of conceptual research tools available to scholars of elite bargaining and to development practitioners remains limited, as does agreement on who exactly are elites.

To help fill this gap, as part of *World Development Report 2017*, the World Bank, in collaboration with the V-Dem Institute, has conducted expert surveys to generate cross-national indicators that enable comparison of who holds power and how they wield this power. The surveys cover over 100 years of data in 12 countries across 6 regions. Resulting data help to identify how elite distribution maps onto national power structure and the formulation and implementation of laws governing the exercise of power.

The survey reveals that the identity of the powerful elite actors within a ruling elite coalition that makes national policy decisions differs greatly over space, time, and issue area. For instance, panel a of figure B7.1.1 shows that although national chief executives are part of the elite ruling coalition in all 12 survey countries in 2015, the other actors vary greatly, both in number and representativeness. Although in Russian Federation, Rwanda, and Turkey, the national chief executive monopolizes decision making, in Bolivia, the ruling coalition is much more varied, consisting of legislators, party elites, local governments, labor unions, and civil society organizations.

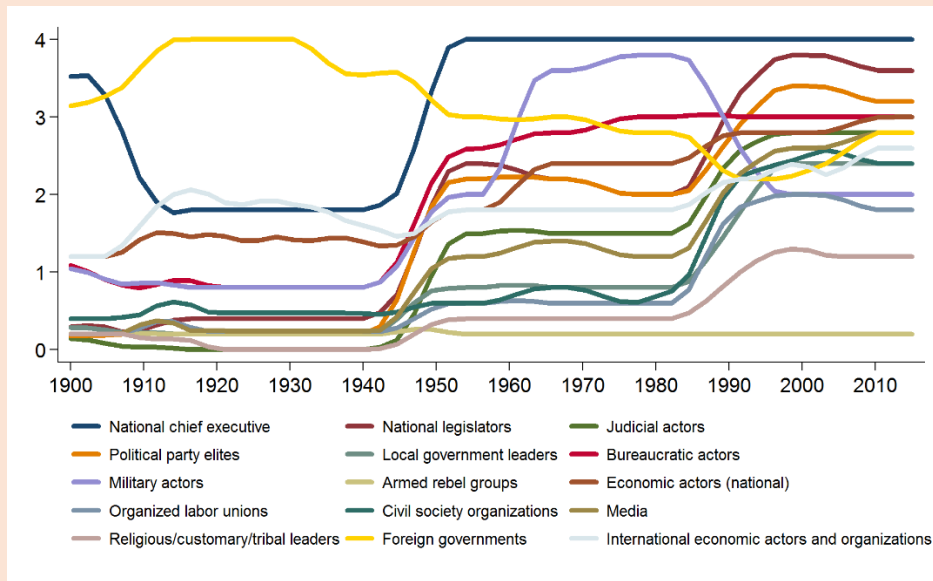
**Figure B7.1.1 Elite actors within national ruling coalitions vary greatly across countries and over time**

a. Twelve-nation comparison of number of groups in ruling coalition in 2015

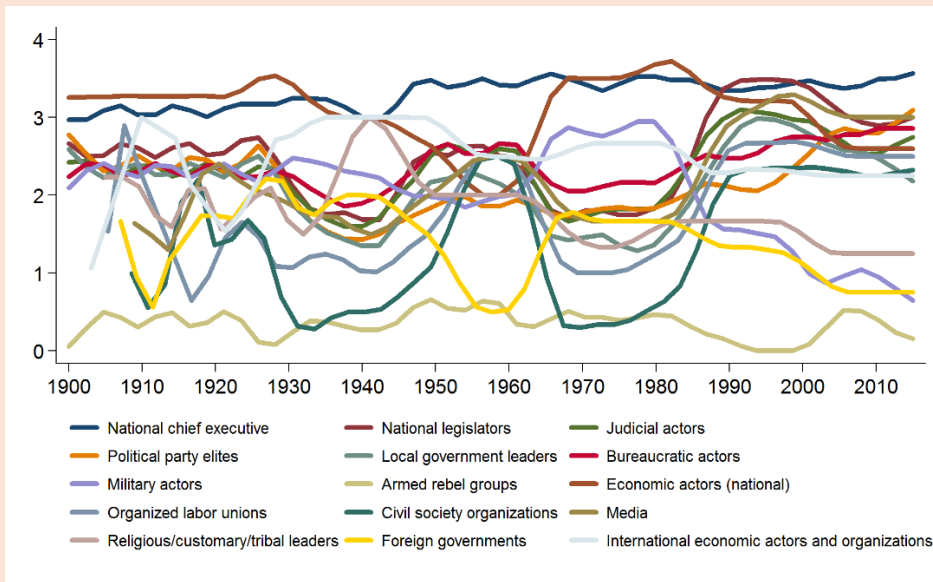


Ruling elites also differ within countries over time. In the Republic of Korea, during the Park regime, the bargaining strength of military actors, bureaucratic actors, and economic actors increased steadily (panel b). The post-1987 transition to democracy resulted in greater strength for new actors, particularly political parties, legislators, and the judiciary, but economic and bureaucratic actors remained highly empowered. In contrast, Brazil has experienced much more volatility in empowered elites, particularly before the 1990s (panel c).

b. Relative strength of elite actors in the Republic of Korea, 1900–2015



c. Relative strength of elite actors in Brazil, 1900–2015



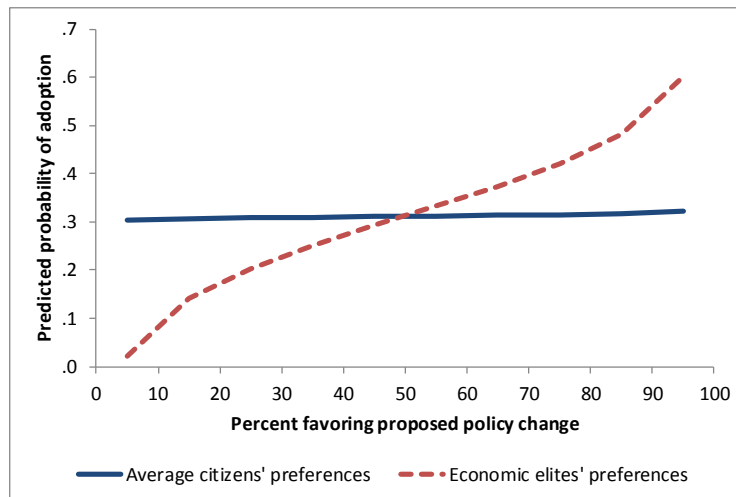
Source: WDR 2017 team.

Note: Panel a shows the number of elite groups that have relative strength greater than 3 (on a 0-4 scale), but does not show the relative strength of these groups.

7.9 This chapter focuses on *national elites*—those who have direct influence over national policy formulation and implementation, as well as the *rules of the game* by which national power is allocated, exercised, and constrained. Even at the national level, elites differ by sector: those with agenda-setting or veto control over health policy may not have control over constitutional reforms. At the national level, political (state) elites are of particular importance. However, formal political elites wield variable amounts of de facto power. In highly institutionalized countries,

political power may flow from official positions, but in most countries—developed and developing alike—nonstate elites also directly influence bargaining outcomes. In the United States, a high-income institutionalized democracy, policies are much more likely to match the preferences of economic elites than they are to match the preferences of average citizens, despite a *de jure* commitment to equal representation (figure 7.1) (Gilens and Page 2014). Elsewhere, relational or ideological informal power may trump economic or military might: Rasputin, despite his peasant background, was the most powerful man in Nicholas II’s tsarist Russia.

**Figure 7.1 Preferences of economic elites predict policy adoption more than citizen preferences in the United States**



Source: Gilens and Page 2014.

Note: Analysis is based on 1,779 policies in the United States between 1981 and 2002 in which public opinion polls were carried out.

7.10 Organizations empower elites and also help elites overcome collective action problems and enable them to credibly commit to one another. Elites differ in their capacity to organize: can they credibly commit to those they seek to influence and thus coordinate their behavior? Certain wealthy oligarchic elites may not depend on internal organization directly, but money is fungible, and it can buy collective action when necessary. For instance, during periods of political unrest in Thailand, economic elites bought “protestors” to occupy public spaces and demand a change in government (Winters 2011). Similarly, intellectual or charismatic leaders may become powerful elites due to their ability to generate large mass followings by shifting preferences. In this sense, elites are elite by virtue of their capacity to organize collective action and thus exercise influence (Mosca 1939, Mills 1956).

7.11 *Elite bargains* are the processes through which elite actors and the organizations that support them coordinate and commit to each other to determine outcomes. Using an elite bargaining framework helps move beyond the black box of the state. “The state” is not monolithic, but rather a reflection of bargaining outcomes among groups of empowered economic and political actors. All regimes have some sort of power-sharing arrangement, whether they are dominant or competitive (Bueno de Mesquita and others 2003). Even in many regimes seemingly dominated by single individuals, the ethnic compositions of ministerial cabinets are inclusive and proportional

to the population, reflecting political bargaining rather than “Big Man” rule (Francois, Rainer, and Trebbi 2012). Within elite bargains, actors not only have different degrees of relative power, but they also have different incentives and preferences.

7.12 For the broad sweep of human history, elites have bargained using deals-based mechanisms. The incentives that elites face often militate against transitions toward more rules-based governance: maintaining or maximizing *utility*—be it wealth, influence, or reputation—depends on preventing expropriation and exploitation by other powerful actors, but given coordination and common agency challenges, the ability of elites to credibly commit not to expropriate from one another is limited, leading to unstable and nonadaptable short term bargains. When elite bargains are deals-based, there is a natural tendency to keep coalitions small (Riker 1962). Borrowing from the economic literature on oligopolies, when incumbent elites seek to prevent entry into the ruling coalition by currently excluded (opposition) elites, they have three potential strategies: blockade (to prevent entry); deterrence (modifying incumbent behavior to deter entry); and accommodation (other elites enter, and behavior of incumbents and new elites is modified).

7.13 Greater concentration of decision making enables greater commitment at the cost of less accountability. It is easier to coordinate preferences among a small group, as bargains become less efficient with many actors (Mailath and Postlewaite 1990), and closer relationships make commitments more credible. Commitment within the elite bargain may be credible because of the low threshold for small group coordination, but this credibility depends on maintaining the exclusivity of the bargain.<sup>1</sup> Yet despite this tendency for deals-based limited bargains, under certain circumstances, elite bargains may expand and generate formal rules to help overcome collective action and commitment challenges.

***How do bargains adapt to changes in the relative power, incentives, and preferences of elites?***

7.14 Most elite bargains are deals-based and “exclusive,” and tend to resist adaptation. Bargains with few actors that are less open to external influences have less accountability, and this can undermine future adaptability as new actors become powerful. The nonadaptability of deals-based bargains helps explain why regimes in low- and middle-income countries are tenuous, experiencing violent transitions every eight years on average (Cox, North, and Weingast 2015).

7.15 In these states, rent distribution tends to be the glue that provides political stability and enables development (North, Wallis, and Weingast 2009). Commitment to distributing rents to those within the coalition may suffice to generate security and tie the state together, but such a state faces difficulties incorporating new elites that may be necessary to generate growth and equity (see discussion on security in chapter 4). Indeed, these stable bargains can quickly deteriorate when the source of rents breaks down. For instance, in South Sudan from the period of the Comprehensive Peace Agreement (CPA) in 2005 through the formation of the state in 2011, the distribution of rents held together heterogeneous factions and structured power relations that were reflected in patronage networks, including well-connected (but unproductive) “tenderpreneurs” who survived on government contracts. However, these rents proved elusive, and undoing them proved problematic: although the 2012–13 austerity period led the emergence of some

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<sup>1</sup> This leads to the “limited access orders” described in North, Wallis, and Weingast (2009) and the “extractive” political institutions described in Acemoglu and Robinson (2012).



“developmental” traits in support of returning diaspora entrepreneurs, the same traits undermined South Sudan’s patronage-based elite bargain, making the country one of the most fragile in the world (Twijnstra 2015).

7.16 However, under certain circumstances, elite bargains adapt to changing circumstances by improving state capacity and moving from deals-based agreements to formal rules-based mechanisms for contestability and accountability. In these bargains, elites institutionalize increasingly broad commitments to one another; they move from narrow deals to broad rules.

7.17 Elites adapt to change through the adoption of rules-based mechanisms for two general reasons: to increase and sustain power, or to provide insurance against future loss of power. When changes strengthen excluded actors, elites in the ruling coalition may be able to strengthen their grasp on power or increase their rents by changing the rules of the game under which they bargain: bringing new actors into credible institutions for contestation may be less costly than repressing these actors, and expanding the formal accountability space may help provide internal commitments that facilitate agreement. As Tancredi says in *The Leopard*, "If we want things to stay as they are, things will have to change."<sup>2</sup> In addition, when ruling elites are no longer confident of their hold on power, the introduction of rules may lower future costs by providing “insurance.”

7.18 The introduction of rules-based mechanisms will coincide with elite self-interest only under certain circumstances. All else equal, when the costs to ruling elites of losing power are high, they will be less inclined to increase the space for contestability and accountability. High costs of losing undermine institutions by reducing the credibility that elites will cede power: if ruling elites believe that expropriation or violent punishment will result from ceding power, they will reject electoral results that support the opposition (figure 7.2). The most important determinant of the costs of losing is the level of polarization between the preferences of elite groups, as starkly opposed preferences raise the likelihood of violence and instability (Vu 2007). When elites have similar or overlapping preferences—low levels of polarization—this tends to facilitate coordination across different elite groups. When polarization is high, accommodating new groups becomes more challenging, as concessions may be too costly to ruling elites. In this sense, when elite polarization decreases, countries are more likely to institutionalize elite interactions and generate rules for contestation and accountability.

7.19 The context in which bargains take place also differs according to how much competition or political uncertainty the ruling coalition faces: that is, how stable the ruling coalition is. This relates both to the “contestability” of access to decision making as well as to the degree of internal cohesion in the ruling coalition. When ruling coalitions face competition, or when they have only a weak hold on power, political uncertainty about who will be in power in a future period is high; thus threats to losing power are credible.<sup>3</sup> Uncertainty does not necessarily imply instability, but rather simply the unpredictability of who will hold power in the future. When uncertainty is high, ruling coalitions are more likely to implement reforms that will serve as “insurance” to protect them in the event of losing power. Alternatively, when uncertainty is low and ruling coalition elites

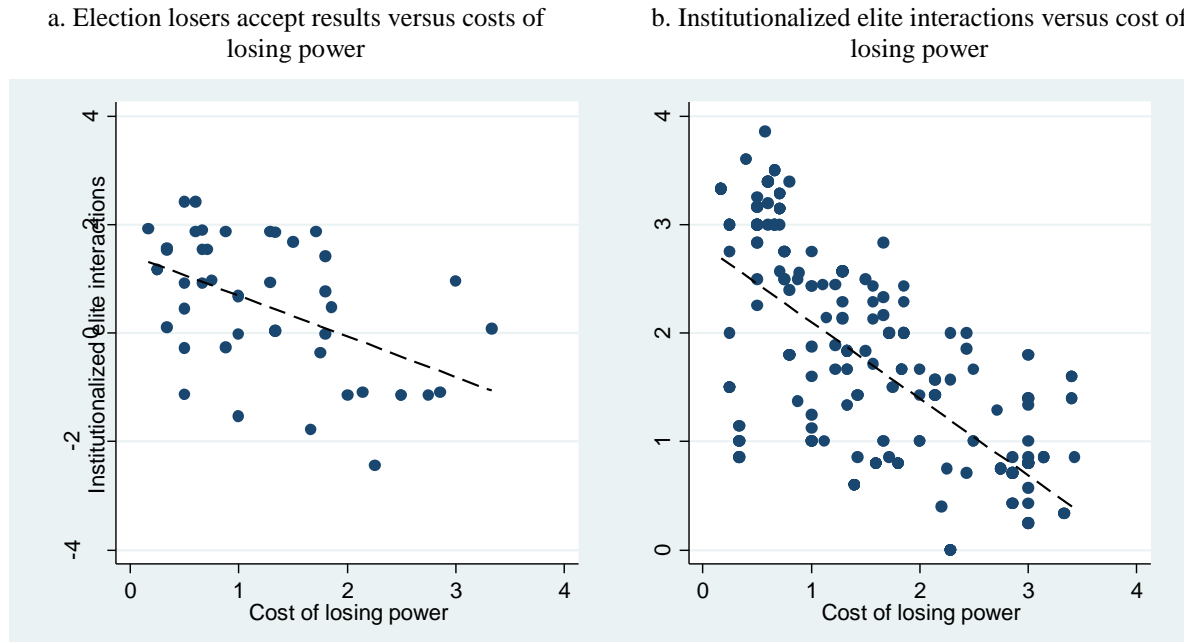
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<sup>2</sup> From the Italian novel by Giuseppe Tomasi di Lampedusa, published in 1958. The quotation is from the Colquhoun translation, Pantheon edition, page 40.

<sup>3</sup> This can happen in both autocratic and democratic settings. In autocracies, elites face a “dictator’s dilemma”: their hold on power is tenuous, and they usually get overthrown from within (Svolik 2012). In democracies with significant oppositions, voting institutionalizes uncertainty, as a change of administration entails a loss of power for incumbents.

are confident in their power, they may take a longer-term perspective and accommodate the demands of other elites through the introduction of new rules that can increase or sustain power.

**Figure 7.2 When the costs of losing power are high, elites are more likely to reject electoral results that support the opposition and less likely to move-towards rules-based contestability and accountability**



Source: WDR 2017 team based on Elite Bargaining Survey and V-Dem 2015.

Note: Costs of losing power, election loser accepting results, and institutionalized elite interactions are all measured on an ordinal 0 to 4 scale, as determined by expert surveys.

7.20 The costs of losing power and the degree of political uncertainty interact to help determine the likelihood that elites will generate rules for contestability and accountability (box 7.2). Historical contingencies and specific country circumstances help determine whether positive outcomes will result, although low costs of losing, and thus low polarization, may be a necessary but not sufficient condition for the emergence of bargains that adapt through the adoption of rules. The discussion that follows provides examples of institutions and rules that ruling coalition elites introduced to enhance power or insure against loss. In some cases, elites were able to generate more capable states; in others, they expanded the formal space for contestability and accountability. The concluding section of the chapter discusses when and why these rules persist through continuous adaptation.

**Box 7.2 Political uncertainty and the costs of losing power influence whether elites generate rules for contestability and accountability**

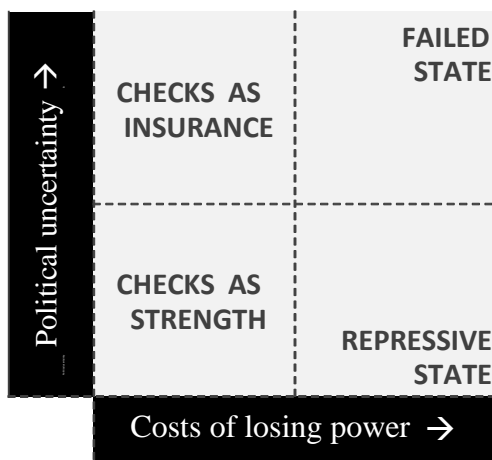
The costs of losing power, largely determined by the polarization of elite preferences, and the degree of political uncertainty act together to shape elite incentives for introducing rules for contestability and accountability (figure B7.2.1a). Combining high and low values of these two dimensions yields four broad possibilities:

- When uncertainty is high, elites may implement “insurance” reforms to protect themselves in the event of losing power (upper left quadrant).

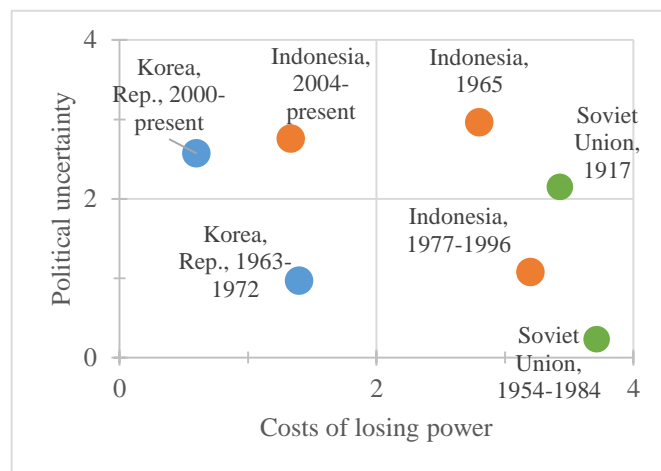
- “Insurance” reforms are unlikely to happen, however, if the costs of losing are too high, as in this case, commitments of one group of elites to another through either deals or rules are not credible. The result is frequently state collapse or a cycle of violence (upper right quadrant).
- When uncertainty is low and ruling coalition elites are confident in their power, they may take a longer-term perspective and accommodate the demands of other elites through the introduction of new rules that can increase or sustain power (lower left quadrant).
- Yet when uncertainty is low but the costs of losing are high, repressive states may arise, in which the preferences of opposition elites are in stark contrast to ruling elites, but repression sustains a large power imbalance between the ruling coalition and the opposition (lower right quadrant). In this context, it is unlikely that credible rules to regulate contestation and accountability will be introduced.

**Figure B7.2.1 The interaction between political uncertainty and the costs of losing power**

a. Theoretical interaction between uncertainty and costs of losing power



b. Empirical interaction between uncertainty and costs of losing power



Source: WDR 2017 team based on Elite Bargaining Survey.

Note: Political uncertainty in panel b is calculated as the average of four variables, each ranging from 0 to 4: elite cohesion in the ruling coalition, elite ideological unity, the relative strength of opposition elites, and the de facto competitiveness of multiparty elections. The costs of losing power variable ranges from 0 to 4.

Results from the Elite Bargaining Survey conducted for the WDR 2017 offer empirical evidence to help demonstrate how the costs of losing and political uncertainty can change elite incentives to institute rules-based contestability and accountability. Figure B7.2.1b shows selected historical data points for three countries in the survey: the Republic of Korea, Indonesia, and the Russian Federation (which shows up as the Soviet Union from 1922-1991 in the data).

Indonesia in 1965 and the Soviet Union in 1917 both lie in the top right quadrant: both the costs of losing and political uncertainty were high. In both countries, elite polarization was extremely high and elite conflict became violent. Neither state had a ruling coalition willing or able to institute credible rules.

Both Indonesia and the Soviet Union slowly transitioned towards more stable repressive states (bottom right quadrant), one ruled by a dominant individual (Suharto in Indonesia) and the other ruled by a dominant political party (the Communist Party of the Soviet Union). Although both states proved capable of generating economic growth and reducing political uncertainty, neither broadened contestability or developed strong institutions for accountability. When shocks hit and societal demands increased in Indonesia during the Asian Financial Crisis and the Soviet Union in the late 1980s, neither system could adapt.

The Republic of Korea during the presidency of Park Geun-hye was also highly stable and non-democratic, but low elite polarization, identified by high degrees of elite cohesion across political, military, bureaucratic, and business realms,<sup>a</sup> reduced the potential costs of losing to opposition elites, enabling the gradual development of rules-based

institutions. This institutionalization included broader space for civil society and media and institutionalized interactions between business and the state.

Finally, in the past two decades, both Indonesia and the Republic of Korea have transitioned towards increased democratic competition. The Republic of Korea did so while maintaining low degrees of elite polarization. As Indonesia moved away from a personalistic system to more rules-based decision-making, a winner-takes-all mentality declined and reduced elite polarization. Both systems have experienced turnover of political parties and the establishment of rules by outgoing parties that seek to constrain their successors' hands ("insurance").

Source: WDR 2017 team.

a. As discussed later in the text, elite cohesion in Korea is often explained by both external threats (ongoing tensions with North Korea) and internal threats (fear of a rural communist uprising) (Doner and Ritchie 2005; Campos and Root 1996).

### **Elite bargains and uneven state capacity**

7.21 Capacity is over time a function of power; the ruling coalition invests in the capacity of governing structures when it is in its interest to do so—and neglects those investments when it is not (see chapter 2). Such investments tend to improve institutional functions and development outcomes, but undertaking them is largely a problem of redistributing political power. Increasing the strength of bureaucratic actors is risky, creating the possibility of institutional champions that can contradict ruling elite preferences. And bureaucracies often serve purposes of patronage and rent-distribution. Undermining these arrangements is not only politically challenging, but can also destabilize elite bargains. Despite these challenges, elite bargains may strengthen the state through bureaucratic and civil service reforms and party institutionalization in search of what this Report calls outcome legitimacy: that is, enhancing cooperation and coordination by delivering effectively on commitments.

7.22 Administrative reforms may be easier when there is fusion between political and bureaucratic actors. In Botswana, where a large degree of bureaucratic influence in the policy-making process was key to success, increased bureaucratic influence resulted from shared socioeconomic backgrounds of politicians and bureaucrats (Acemoglu, Johnson, and Robinson 2001) and the fact that most politicians had risen from the ranks of the civil service (Charlton 1991). The bureaucracy was empowered because doing so empowered individuals who supported the goals of the regime. Similarly, in Mexico, the bureaucracy under the Partido Revolucionario Institucional (PRI) was highly empowered because the president consistently rose from the ranks of the bureaucracy from 1970 to 2000, with no previous elected office (Heredia and Schneider 2003).

7.23 Reforms to limit patronage frequently arise from top-down initiatives or elite accommodation (Grindle 2012). At times, broad meritocratic reforms may be initiated as part of an effort to strengthen the ruling coalition. In China, Deng Xiaoping's "Four General Principles" calling for more revolutionary, younger, more professional, and more educated cadres was a politically motivated and politically savvy move: the inclusion of a "revolutionary" (*geminghua*) requirement made the reform difficult to oppose among older Party elites, while enabling Deng to force into retirement older cadres who often formed the political opposition to his intended reforms.

7.24 Although high levels of education and histories of strong states may make meritocratic reforms easier, there are no foregone conclusions. Throughout post-independence Africa,

individual capacity (education levels) increased while institutional capacity declined as civil service recruitment policies were placed under presidential authority, leading to politicization and deprofessionalization (Van de Walle 2001). The Republic of Korea, often assumed to have a “Confucian tradition” of meritocratic civil service, undertook massive improvements in bureaucratic quality during the 1960s and 1970s. During the Syngman Rhee era, the bureaucracy was legally meritocratic, but between 1949 and 1961, only 336 bureaucrats passed the High Civil Service Examination, while 8,263 received “special appointments” (Cheng, Haggard, and Kang 1998). Until the late 1960s, Korea’s bureaucrats were sent for training to Pakistan and the Philippines (Chang and Evans 2005).

### ***Bureaucratic pockets of effectiveness***

7.25 Although at times broad administrative reforms are possible, elites are more likely to devote scarce resources and political capital only toward those agencies that help achieve specific goals, resulting in uneven development capabilities. An elite bargaining framework can help explain the emergence of these bureaucratic *pockets of effectiveness*—public agencies that effectively operate and carry out agency objectives despite existing within an environment in which most other agencies are ineffective and subject to predation (Leonard 2008). In these cases, influential elite actors have incentives to ensure the effectiveness of the agency and use their own political capital to shield the organizations from external interference (box 7.3).

#### **Box 7.3 Islands of excellence in Nigeria**

Political support from powerful elite actors is a necessary condition for the emergence of “pockets of effectiveness.” The professionalization and autonomy of an individual government agency often precedes wholesale reform of the bureaucracy as political elites may seek effective management of a particular sector. High-level political interest in and commitment to the agency’s success and political insulation from other elites whose interests the autonomous agency may harm are essential for effectiveness. Agency autonomy is most likely to be supported when the agency provides benefits that are immediate, identifiable, and beneficial to an important group of elite actors who “have a conception of the state as a public good, rather than simply as a target of predation or a tool for gaining advantage over others” (Leonard 2008). But autonomy and political support are not enough: bureaucratic pockets of effectiveness require adequate resources as well managerial factors that support rational decision making, including meritocratic recruitment, internal discipline, and performance-based management.

Consider the National Agency for Food and Drug Administration and Control (NAFDAC) in Nigeria (Pogson and Roll 2014). The agency was created in 1999. In 2001, then-President Olusegun Obasanjo had a personal interest in combating counterfeit and dangerous drugs as a way to improve Nigeria’s international image, partly to seek debt relief, but also to boost his personal reputation and international prestige. He selected Dora Akunyili to head NAFDAC because of her reputation for incorruptibility. NAFDAC was then granted autonomy from the Ministry of Health to recruit staff, have an independent budget, and operate free of political control. Under Akunyili’s leadership and Obasanjo’s direct support and clearance, NAFDAC returned to Nigerian ports, from which it had been banned in 1996, and NAFDAC clearance of imported goods again became compulsory, which broke the clearance monopoly of the Customs Service and plugged a major leak for imported counterfeit products. Challenging the interests of these powerful elite interests (the Customs Service) would not have been possible without agency autonomy and direct support of the president. In 2007, NAFDAC ranked first in a national poll of agency effectiveness (at 70 percent, it was 12 percentage points higher than the second-place agency).

Sources: Leonard 2008; Pogson and Roll 2014.

7.26 Agency performance can help strengthen the capacity of the state. The need to extend the state’s presence to new areas or gain legitimacy through economic growth may be particularly compelling reasons for developing noncoercive state capacity. For instance, the need for states to

know the extent and make-up of their own population (increase “legibility”) led to greater investment in statistical and census capacity (Scott 1998). In particular, economic goals may be essential for regime legitimacy. In Brazil under its military dictatorship, industrial promotion agencies were turned into islands of excellence to ensure growth (Schneider 1991). In Korea, General Park installed technocrats in ministries related to economic development, but filled nondevelopment ministries (such as home affairs, construction, and transportation) with military cronies (Kang 2002).

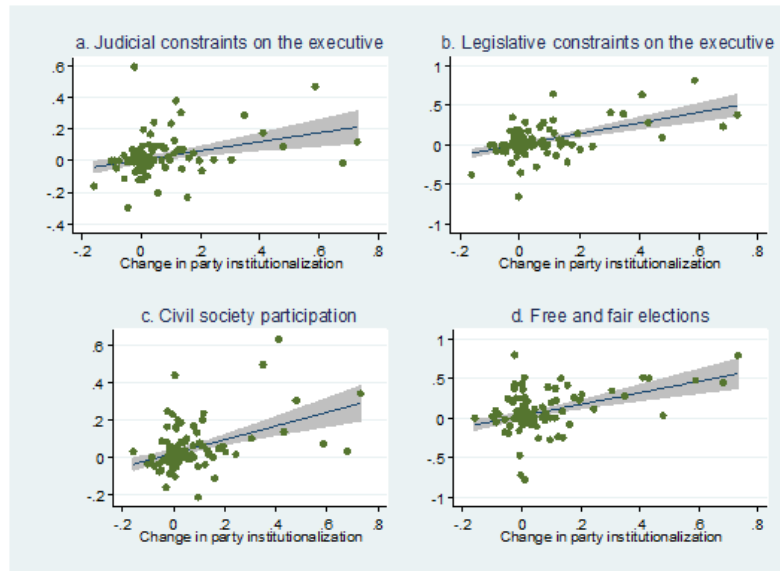
7.27 Elites can also enhance agency capacity as insurance against a loss of power, particularly by reforming agencies to enhance autonomy and reduce capture. In competitive states in which economic elites fear that subsequent regimes may impede income generation and/or redistribute wealth, autonomous agencies are a way to commit to stable policies. In these cases, autonomy serves as an insurance mechanism, enhancing the possibility that the goals that current elites hope to achieve will still be served when they leave office.

### ***Political party development***

7.28 Often, the institution that elite groups choose to invest resources in and institutionalize is a political party. Chapter 8 looks at political parties as mechanisms for *citizen* collective action, but parties are also key channels to resolve coordination and commitment challenges among elites. Institutionalization constrains party elites from arbitrary decision making by making them more accountable to party subordinates and constituents. The development of political parties can also be risky, as parties facilitate collective action by elites, which can help generate an effective opposition (Wright and Escribà-Folch 2012). But by constraining leaders, formality helps solve the internal commitment problem, making parties more effective (Panebianco 1988). And when parties become more institutionalized, other formal accountability mechanisms also tend to emerge (figure 7.3).

7.29 In one-party systems, the institutionalization of the party facilitates collective action by supporters of the regime, helping lead to credible commitments and greater private investment (Gehlbach and Keefer 2012.) In this sense, party institutionalization binds leaders’ hands, but enables greater effort from subordinates. In doing so, parties contribute to the durability and longevity of the regime (Brownlee 2008). In Malaysia, Mahathir Mohamad constrained his own personal power to empower the United Malays National Organization (UMNO) against the opposition by providing incentives to party outsiders to join by giving them a stronger say in the party. Conversely, in the Philippines, Ferdinand Marcos successively undermined party institutions, leading to personal rule. Malaysia today is still run by the UMNO, long after Mahathir stepped down; Marcos was overthrown in 1986.

**Figure 7.3 Horizontal and vertical accountability become more common as party institutionalization increases**



Source: V-Dem 2015.

Note: The data are for 2010 and cover 166 countries. All variables range from 0 to 1. Change in party institutionalization is calculated as the difference between the 2010 and 2000 value.

### Broadening the policy arena to enhance elite power

7.30 In 16<sup>th</sup> century France, Jean Bodin advised absolutist French monarchs to voluntarily relinquish power, arguing that “limitations placed upon [a monarch’s] caprice markedly increase his capacity to govern and to achieve his steady aims” (Gandhi 2009: 186). Many elites have followed this advice, institutionalizing bargains among elites through greater contestability and accountability in order to increase and sustain power. Elites in these cases make concessions in order to enhance their own position. This can be done by co-opting newly powerful actors into formal institutional mechanisms for contestation or by increasing horizontal and vertical accountability.

#### *Institutionalizing horizontal contestability*

7.31 To maintain their own power, ruling coalitions may provide payoffs to rising elites or co-opt potential opposition by creating formal mechanisms to channel their preferences. Sustaining coalitions requires that elites provide benefits to coalition partners, but despite a preference for keeping coalitions small, politicians may broaden coalitions when the potential for conflict rises (Riker 1962). Indeed, broadened coalitions help improve regime stability, though there are difficulties quantifying this effect. In Africa, the addition of one additional cabinet member lowers the risk of a coup by 23 percent to 25 percent, all else equal (Arriola 2009).

7.32 Broadening the bargaining arena by including new actors in formal decision-making bodies of the state—*institutional co-optation*—may be cheaper and more sustainable than increasing payoffs. When rising elites are paid off rather than included in decision making, systems may

become overly dependent on the source of rents, making them unable to withstand shocks that undermine this rent source, as described in the case of South Sudan earlier in this chapter.

7.33 Ruling coalitions may be strengthened by bringing local or communal elites into the ruling coalition, often by co-opting existing informal institutions into more formal structures. The persistent power of traditional institutions can impede the formulation and implementation of policy. Co-opting local elites rather than replacing them can increase the power of the ruling coalition, with major consequences for future development. In Somaliland, the 1993 Boorama *shir beeled* (clan conference) brought 500 elites from modern and traditional sectors and institutionalized these clans and elders into formal governing bodies, a “*beel*” (clan) system that has led to 20 years of stability in a fragile region (Kaplan 2008). In Sub-Saharan Africa more broadly, when ruling authoritarian coalitions incorporated local authorities rather than replacing them, these authoritarian incumbents had more support and were able to be much stronger during democratic transition (Riedl 2014).

7.34 However, the participation of new actors is a two-way street: it mitigates conflict and creates “insiders” who support the ruling coalition, but in providing commitments to new actors, it also tends to empower these actors and the sectors they represent at the expense of the current elite. Co-optation may create incentives for new elites to support the ruling coalition, but it also gives them the ability to influence the formulation and implementation of state policies. Decision-making elites likely see co-optation solely as a means of staving off opposition demands, rather than a means of changing the balance of power within the arena, but both processes inevitably occur. In this sense, new elites can in some ways be considered Trojan Horses for expressing new demands internally.

7.35 Often, co-opted parties are new economic interests that have grown more powerful over the course of development. The inclusion of business interests in formal institutions can lead to improved economic outcomes through more successful state-business coordination. Formal rules for inclusion provide a credible commitment that noninstitutionalized efforts at coordination would not achieve. In Chile, Pinochet’s co-optation of business elites to lead ministries and agencies during the 1980s arose out of fear of these elites turning to the opposition. However, their entry into the state led to systematic consultations with peak industries, benefiting these business elites themselves, while also improving coordination and strengthening the state beyond Pinochet’s rule (Silva 1996).

7.36 In China, the Communist Party (CPC) in the early 2000s co-opted the private sector through the “Three Represents.” Adding entrepreneurs to the CPC’s ranks signaled an increased commitment to the private sector, helping spur subsequent growth, but also leading to further changes in regime policy and legal development, including constitutional change in 2004 that legalized private property. Indeed, there is evidence that entrepreneurs in China are demanding more direct political power: for example, by pushing in local People’s Congresses for private entrepreneurs to be allowed to run in local elections (Kennedy 2005).

7.37 Ruling coalitions may also introduce formal institutional “checks” on their behavior to maintain power and sustain rents. Dominant ruling elites may have a political logic for introducing these de jure checks. Often this logic has to do with improving economic outcomes to maintain sources of rents and stability.



7.38 Consider the case of authoritarian legislatures. They are not mere window dressing: they provide a safety valve to vent political pressures; they co-opt opposition; they signal regime strength; they help regimes withstand leadership transitions; and they distribute rents.<sup>4</sup> However, authoritarian legislatures not only serve the political purposes that spawn their creation, but also often lead to positive feedback loops. For example, the existence of legislatures in authoritarian regimes increases investment by raising the cost of expropriation (Wright 2008, Gandhi 2009), helping foster negotiations among private actors (Jensen, Malesky, and Weymouth 2014), and providing useful policy information that improves allocation (Boix and Svolik 2013).

### ***Institutionalizing vertical accountability***

7.39 The introduction of elections or electoral reforms may be a rational elite strategy to maintain power or privilege, particularly in the face of rising demands from the opposition elite. When there are splits among elite actors, the introduction of vertical accountability mechanisms and citizen responsiveness may enhance the power of one faction. For instance, authoritarian regimes may introduce local elections to appease local interests, gain information, and solve principal-agent control problems of local elites by recruiting citizens to monitor local elites on the behalf of central elites. These local elections may strengthen the regime, but may also lead to better social outcomes, as is the case with the introduction of village elections in China (Martinez-Bravo and others 2011).

7.40 When bottom-up citizen movements (discussed in chapter 8) threaten elite interests, elites may introduce mechanisms to respond to societal demands before such pressure reaches a tipping point. In this sense, elections can stave off revolution. Former President of Tanzania Julius Nyerere's response when asked "Why liberalize?" is informative: "When you see your neighbor being shaved, you should wet your beard. Otherwise you could get a rough shave" (Levitsky and Way 2010). In the case of Europe, evidence suggests that extension of suffrage was predicted by the threat of revolution, proxied by revolutionary activity in neighboring countries Aidt and Jensen 2014 and by strikes in the home country (Kim 2007). In a broader sample after World War I, electoral reforms were strongly predicted by threats proxied by riots and strikes (Przeworski 2009).

7.41 Even without a direct threat from below, many democratic transitions are initiated from a position of strength to ensure maximum benefits for empowered elites. In a "conceding-to-thrive" scenario, the ruling coalition realizes that there may be a future threat to the regime, but maintains enough strength relative to the opposition not to fear losing an election (Slater and Wong 2013). When ruling elites are strong, there is no relationship between democracy and post-transition economic redistribution, but as they become weaker, there tends to be more redistribution as a result of transition (Albertus and Menaldo 2014). Therefore, it may be rational for elites to engage in democratization *now* in order to maintain power. For instance, in Spain after the autocratic Franco era, the left had been undermined, so conservative elites did not think that the advent of democracy would threaten property rights (Alexander 2002).

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<sup>4</sup> For safety valves, see Malesky and Schuler 2010. For co-optation, see Gandhi 2009; Gandhi and Przeworski 2006; Kim and Gandhi 2010. For signaling, see Geddes 2006. For leadership transitions, see Ezrow and Frantz 2011. For rent distribution, see Lust-Okar 2006.

7.42 In cases where elections are introduced to strengthen an elite bargain, electoral rules may serve to favor continued dominance.<sup>5</sup> Many East Asian countries have ensured that rural interests have greater representation following democratization. In Japan, rural voters had twice the voting power of urban voters during the early post-war period (Hata 1990). In Korea, Japan, and Taiwan, China, the combination of single nontransferable votes with multimember districts undermined the power of emerging parties by creating nationwide coordination challenges for smaller parties, allowing dominant parties to maximize legislative seats (Brady and Mo 1992, Cox 1996, Cox and Niou 1994). More broadly, countries with more inequality in terms of wealth and income tend to have higher levels of legislative malapportionment and lower levels of income taxation during periods of transition, indicating that when transitions are initiated by wealthy elites, they are able to better maintain policies that reflect their own interests (Ardanaz and Scartascini 2013).

### **When binding rules for accountability serve as political insurance**

7.43 Sometimes, ruling coalition elites, acknowledging threats to their continued dominance, introduce power-constraining rules that they hope will bind not only themselves, but also their successors. Thus, in particular circumstances, the adoption of cohesive and constraining institutions will increase with the likelihood that incumbents will be replaced (Besley and Persson 2011).

7.44 Increasing de facto levels of competition may increase the likelihood that elites introduce binding rules, but the credibility of these new rules depends critically on the continuation of competition. When power imbalances grow between ruling elites and opposition forces, lowering the potential for competition, rules may fail to bind. For instance, in Bangladesh in the 1990s, equal power between ruling and opposition parties led to the thirteenth amendment to the constitution in 1996 that established a neutral caretaker government to be set up at the end of each term, headed by the last Supreme Court chief justice, in order to facilitate rules-based transitions. However, this constitutional arrangement collapsed in 2007 when the BNP interfered with Supreme Court retirement dates, resulting in a violent standoff (Khan 2013).

### ***Horizontal accountability as political insurance***

7.45 Competition between elites is particularly useful in explaining the emergence of horizontal checks and autonomous institutions in new or weak democracies. Competitive systems facing political uncertainty are more likely to adopt independent judiciaries, as current ruling elites know they will be better off subject to independent actors than to the machinations and retaliations of political rivals. Judicial independence in Argentina's Supreme Court was granted by a president who sought to control the opposition after he had ceded power (Finkel 2004). The court was most effective at overruling legislative and executive decisions between 1862 and 1946, when competition within and among parties was high. During this time, there was no court packing or removal of justices (Chávez, Ferejohn, and Weingast 2011). But from 1946 to 1983, the president's party gained effective control of both executive and legislative branches, and the court became both less independent and more weak (Ferejohn and Rosenbluth 2009).

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<sup>5</sup> Elites in advanced democracies frequently change election rules to maximize power. Every French administration from 1789 to 1957 reformed electoral rules in their own favor, as did Francois Mitterand and his Socialist party in 1986, when they were faring poorly in pre-election polling (Knight 1992).

7.46 Other judicial reforms, including judicial review, also become more common when greater competition increases the likelihood of ruling coalition elites losing power. In new democracies, the constraint on arbitrary power imposed by judicial review can serve as insurance to potential electoral losers, providing support for democracy, as in some new East Asian democracies such as the Republic of Korea and Mongolia (Ginsburg 2003). The adoption of constitutional review in 204 countries from 1781 to 2011 was largely driven by electoral politics, serving as political insurance when the ruling party was in jeopardy (Ginsburg and Versteeg 2014).

7.47 The same logic holds with regard to accountability, oversight, and transparency laws. In Eastern European economies in transition in the 1990s, governments were less likely to extract resources from the state when political competition was high, and they were more likely to introduce institutions of accountability and oversight, particularly those related to civil service, accounting, and anticorruption (Grzymala-Busse 2006). In Brazil, audit courts are more effective in localities with greater turnover of elites (governors), as these localities delegated authority to independent auditors as an insurance mechanism (Melo, Pereira, and Figueiredo 2009). Fiscal transparency ties not only the hands of current elites, but also those of successors (Alt, Lassen, and Rose 2006). In Mexico, state-level Freedom of Information laws are more likely to be passed when opposition parties are stronger and when there is greater executive office turnover (Berliner and Erlich 2015).

### ***Vertical accountability as political insurance***

7.48 While elites sometimes introduce elections from a position of strength, as discussed, at other times they may do so to insure themselves against exploitation from other elites. Movements toward democracy may result as new economic elites seek to safeguard (ensure commitment to) their new position and wealth and protect against expropriation by the state. Under authoritarian regimes, commitment to protect resources and property is often weak.<sup>6</sup> Broken commitments can lead empowered economic elites to part ways with the ruling coalition and support the democratic transition, as it is seen as more likely to prevent further exploitation. For instance, PRI expropriation of banks following the 1982 financial crisis in Mexico led to a mass defection to the opposition party (the Partido Accion Nacional), weakening the PRI and resulting in the PRI's loss of the majority in the lower house in 1997 and the presidency in 2000.

7.49 Somewhat counterintuitively, the introduction of elections can also help economic elites insure against redistribution. Indeed, there is evidence that income *inequality* actually makes democratization *more* likely, to the extent that democratization is a response to demands of rising economic sectors to get protection from expropriation by the state (Ansell and Samuels 2014). The history of Western Europe is characterized by a slow process of democratization that reflected interests of economic elites that feared redistribution (Ziblatt 2006). In Latin America, economic elites allowed democratization when conservative parties were in charge and could protect their interests (Rueschemeyer, Stephens, and Stephens 1992).

7.50 When elites introduce elections as a way to insure themselves against exploitation by other elites, the electoral rules are also likely to reflect the interests of these declining powers. When

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<sup>6</sup> For instance, from 1950 to 2002, the majority of Latin American countries under autocracy engaged in at least one large-scale expropriation of private finance, land, or natural resources (Albertus and Menaldo 2012).

power is weakened, the manipulation of the terms of democratization can serve as a source of political insurance. In its democratic transition in 1958, the three main political parties of Venezuela signed the “Punto Fijo Pact” that established respect for constitutions and elections, but also determined that electoral winners should put members of all three parties into positions of power to create national unity governments (excluding the Communists); the pact helped ensure the survival of democracy, but also made democratic results less likely to directly reflect the will of the people.

### **When do elites adapt through rules-based mechanisms?**

7.51 In the cases previously discussed, elites enhanced state capacity or introduced rules to manage contestation and increase accountability to adapt to changes spurred by the development process, which changed the relative power, preferences, and incentives of actors (see part 1 of this Report). Such adaptation is essential for long-term development. However, elite bargains usually do not adapt through the introduction of rules; indeed, most do not.

7.52 Adaptation is not a one-off trait; rather, it is a continuous process, as the needs and demands of society change over the course of development. At low-income levels, deals may be sufficient to overcome elite coordination and commitment challenges; patronage can be an effective way to provide credible commitment and give cohesion to elite ruling coalitions.<sup>7</sup> At middle-income levels, however, rising societal demands make the transactions costs of coordinating interests greater, potentially undermining deals-based bargains. Countries that are successful in terms of medium- and long-term economic growth tend not to have governments that are appreciably cleaner than comparator countries at low-income levels. However, upper-middle-income countries that grow to high-income levels experience a sharp decline in perceived corruption relative to those that stay “stuck” at middle incomes; they also have greater horizontal and vertical accountability than upper-middle-income countries that remain “stuck” (see spotlight on middle-income traps in chapter 5).

7.53 Bargains that can adapt to evolving elite interests may nevertheless struggle to adapt to growing citizen demands. Many countries experiencing rapid growth spells have engaged in rights violations, particularly of student and labor organizations, as a way to support the interests of state, bureaucratic, and business elites in the ruling coalition (Leftwich 1995). In these cases, tensions have increased between growth outcomes and equity outcomes, and between legitimizing outcomes and legitimizing processes.<sup>8</sup> Even effective growth policies may alienate the population if public voice in the policy process is lacking (Underhill and Zhang 2008). Regimes may be delegitimized when decision-making processes are insufficiently inclusive, even when other developmental outcomes appear successful: process legitimacy may become more important than

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<sup>7</sup> When voters/citizens cannot believe the promises of politicians, a “political development trap” can arise that enshrines a low-level equilibrium with no commitment between rulers and ruled. Patron-client relationships can provide a way out of this trap (Keefer and Vlaicu 2008). However, these ties may constrain future transition. For instance, the varying degrees of success of democratic transitions in Africa can be explained by the political legacy of patrimonialism (a hierarchical system in which state resources provide the basis for patron-client ties between state actors and the broader population) (Bratton and Van de Walle 1997).

<sup>8</sup> For instance, in a process Albert Hirschman has called the “tunnel effect,” unequal growth at initial stages may please everyone, but when some groups continue to grow while others stagnate, discontent may increase (Hirschman and Rothschild 1973).

outcome legitimacy. As discussed in part 1, cooperation and coordination—collective action—are weakened as a result of a “legitimacy deficit.”

7.54 Overcoming delegitimization necessitates greater inclusion in the political process. As elite ruling coalitions grow in size, coordination difficulties increase, making elite splits more likely and thus broadening the space for citizen groups to enter. Here, the interaction between citizens and elites becomes key, particularly in the development of social movements. When bureaucratic interests diverge from political interests, for instance, they may attempt to organize citizens in their support. But this co-optation of citizens follows the same logic as the institutionalized co-optation of other elites: once citizens gain a seat at the table, vertical accountability increases and citizen interests are articulated and reflected in elite bargains. The interaction between elites and citizens is thus a two-way dynamic with both sides playing decisive roles: elites in seeking citizen support and opening up new spaces for contestation; and citizens in organizing to overcome collective action problems and apply pressure on elites, as discussed in chapter 8.

7.55 Adaptability in elite bargains requires feedback mechanisms, as well as an ability to accommodate rising and falling powers. The free flow of information and greater freedom of association make such accommodation more likely. Many of the reforms described previously are complementary and make further reform more likely, leading to a virtuous circle. For instance, the likelihood of democratic transition increases if elites develop constitutions that protect their interests after exit (Alexander 2002).

7.56 Institutional forms can self-reinforce and maintain long-term effectiveness by creating institutional champions. Many reforms that tie the hands of elites are embodied in new organizations, including independent bureaucracies, anti-corruption agencies, and legislatures. The actors in these organizations have agency: reforms make them elites, and as elites they can directly contest in the policy bargaining arena. Stronger organizations want institutional improvements that support themselves, leading to a self-reinforcing virtuous circle (North, Wallis, and Weingast 2009). Increasing bureaucratic autonomy, resources, and meritocracy may create an independent demand for government commitment (that is, they empower new elites).

7.57 Many of the reforms previously described also tend to lead to further adaptation because the degree of institutionalization of the policy bargaining arena itself influences the level of uncertainty and the costs of losing. The rules under which elites formally bargain help them overcome common agency problems and also provide venues for repeated interactions that can lead to credible commitments. Credible institutions can lower the costs of losing by tying the hands of competing elites, decreasing polarization and making change more likely. Conversely, informal patrimonialism makes regimes resist democratic reforms, as the costs of transition are higher (Bratton and Van de Walle 1997).

7.58 Although the conditions that determine whether elites will adapt through rules are historically contingent and highly context-specific, there are a few circumstances that make such adaptability more likely. In particular, when elites have exogenous reasons to find common ground, bargains can expand and adapt; when national institutions produce leaders who effectively shape the incentives and preferences of other elites, countries are more capable of long-term development; and when countries have more balanced, diversified, and organized business interests, they may be more capable of reforming institutions to adapt to changing economic conditions.

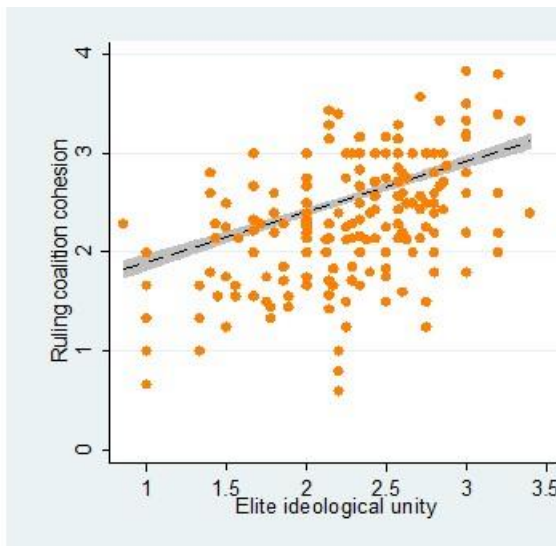
### ***Reducing polarization by maximizing shared elite interests***

7.59 When elite preferences converge and polarization decreases, coordination and cooperation become less challenging. There are often exogenous reasons for such reductions in polarization. External threats or internal threats from nonelites increase the fusion between ruling elites and opposition elites. When citizens are united against elite interests, the opposition and ruling coalition can more easily find common ground—the cost of losing to the opposition becomes smaller. In Southeast Asian countries that feared class revolution, elite groups with opposing class and ethnic backgrounds made “protection pacts” with one another to establish a bulwark against mass mobilization (Slater 2010). For instance, in Malaysia, the threat of urban communists enabled ethnic Chinese businesses to unite across ethnic and ideological lines with traditional Malaysian elites.

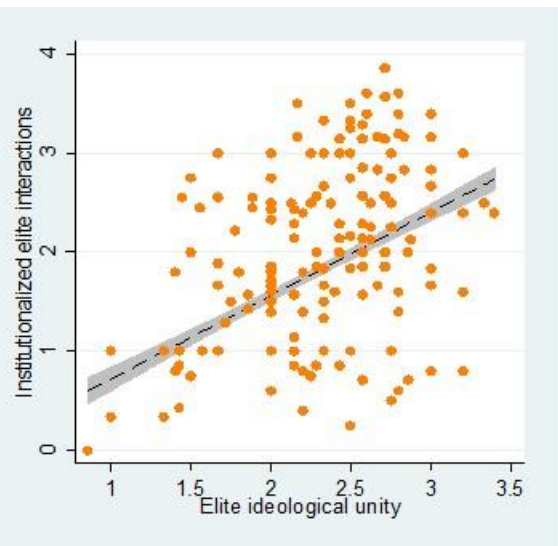
7.60 Polarization can also decrease through shared ideologies and shared experience. When elites share an ideology, they can more readily solve internal collective action challenges, enhancing cohesion and making rules-based bargains more viable (figure 7.4). Shared backgrounds help to achieve such unity. For instance, shared military and revolutionary backgrounds help to explain the cohesion and long-term stability of Mexico’s PRI and China’s CPC (Knight 1992). Shared schooling can achieve similar outcomes. Public schooling with nationally determined curricula can generate a national identity that may help overcome underlying schisms. However, education can also increase polarization; ideologically diverse societies may prefer school choice, which can result in greater ideological and cultural segmentation over time (Kremer and Sarychev 2000).

**Figure 7.4 Ideological unity among elites is associated with greater ruling coalition cohesion as well as more institutionalized elite interactions**

a. Level of ruling coalition cohesion versus elite ideological unity



b. Level of institutionalized elite interactions versus elite ideological unity



Source: WDR 2017 team based on Elite Bargaining Survey.

Note: All variables are ordinal and range from 0 to 4, based on expert survey responses. The charts plot non-overlapping decadal observations for 12 countries.

7.61 For elite bargaining, specialized “elite” schools may be able to decrease the polarization of elite preferences and facilitate bargains. In Somaliland, elite secondary schools played a crucial role in generating a unified leadership; in particular, the highly selective Sheekh Secondary School, which takes only 50 students each year, nevertheless included students from all clans and produced three out of four presidents and numerous vice presidents and cabinet members. According to one graduate: “The graduates of Sheekh School have had a huge influence on Somaliland, on its development, its politics... The students had a high quality of analysis, organisation and management skills... Elite leadership was trained in us there” (Phillips 2013, 70).

### ***Effective leadership***

7.62 Effective leadership can change the parameters of elite bargains. In an elite bargaining framework, the importance of leaders is not in selecting the “right” policy, but in spurring “new ways of interacting within and between organizations” (Andrews 2013). Leaders are instrumental in determining outcomes by solving coordination challenges or by transforming the beliefs and preferences of followers (Ahlquist and Levi 2011). The ability to solve coordination challenges corresponds to a “transactional” role of leaders.<sup>9</sup> Using an array of bargaining tactics and strategies, these leaders can coordinate among elite actors to overcome common agency problems and reach positive sum outcomes. They may change the incentives of other elites, taking into consideration the intertemporal dimensions of who wins and who loses.

7.63 By overcoming information and coordination challenges, transactional leaders, through “good politics,” can reduce the polarization of elite preferences *without* shifting norms. Lyndon B. Johnson, as the Senate Majority Leader in the United States before becoming the president, pushed through the Civil Rights Act of 1957 despite opposition from the opposition as well as the anti-civil rights southern bloc of his own party. He overcame a natural tendency of congress to avoid risk by taking personal risks to force a resolution (Schofield 2006). And he did this less by changing beliefs than through good politics, including deals, trades, threats, and ego stroking (Caro 2002).

7.64 “Transformational,” or “charismatic,” leaders can change elite preferences or gain followings by shaping preferences. They are entrepreneurial in coordinating norms and can effect large changes in society by changing the environment in which politics are played, often by reducing the polarization of elites. These leaders are elites by nature of their followings, and they influence elite bargains through pressure on other elites. Continuing the example of civil rights in the United States, Lyndon Johnson would not have been able to push through the more far-reaching Civil Rights Act of 1964 had not Martin Luther King, Jr. and fellow civil rights activists successfully shifted the contours of the conversation on race, nonviolence, and human rights in the United States through self-sacrifice, civil disobedience, nonviolent struggle, moral courage, and oratorical brilliance.

7.65 Transformational national leaders can indelibly alter the nature of the state itself, including the space within which the policy bargaining game is played. Perhaps most notably, successful leaders have been responsible for nation-building efforts that have increased cooperation in many countries with successful development experiences, many of which did not all begin as ethnically

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<sup>9</sup> For the distinction between “transactional” and “transformational” leaders, see Burns 1978.

homogenous united nations. Ideological nation-building efforts can create political and social stability and identity that can lead to greater trust, cooperation, and commitment to ethnically neutral policies (Gellner 1983).<sup>10</sup> In Tanzania, Julius Nyerere's *ujamaa* ("extended family") socialism served as the ethnically unifying basis for national development: although economic development did not initially improve, mass compulsory education and widespread use of Swahili helped overcome tribal cleavages and produce a more unified and stable state. In Indonesia, Sukarno introduced the Five Pillars (*Pancasila*) to unite disparate elements of society during the process of state formation; the concept survived a military coup as well as the transition to democracy, helping to maintain a coherent national state during destabilizing times (Fukuyama 2014).

7.66 National institutions help determine leader quality both through selection (ex ante accountability) and punishment (ex post accountability) (Maskin and Tirole 2004). The institutional environment also helps determine the effectiveness of leadership. Rules and norms for selecting leaders can help produce effective leaders. When subsets of the population—for example, women (box 7.4)—are excluded from leadership positions, competitive selection is less likely to produce effective leaders. In democracies, political leaders must be elected. Federalism may potentially produce more effective leaders, as local competition as an initial screening process may encourage proven candidates to vie for national office (Myerson 2015). Even without elections, local competition can prove a fertile ground for demonstrating capacity for higher office. For instance, in China, local leaders who have successfully generated economic growth are more likely to be promoted (Li and Zhou 2005). Even informal means of selection can help ensure commitment through policy continuity. In Mexico, "*dedazo*" ("the tap of the finger"), the process by which the outgoing president informally but bindingly selected a successor, enabled stable PRI dominance for 71 years until 2000, and minimized conflict within the party (Langston 2006). Regardless of whether citizens or a small elite "selectorate" choose leaders, transparency and information provision are critical for screening good candidates. This is discussed in chapter 8 in the context of elections.

7.67 For leaders to be effective, there is a need not only to generate well-meaning leaders, but also for them to be constrained by strong norms or formal institutions, including parties and legislatures (Ezrow and Frantz 2011). In competitive settings, term limits can deter "self-aggrandizing agents from seeking office" and increase opportunities for others. They also tend to encourage party-based decisions rather than personalistic decisions, while encouraging the cultivation of successors (Ginsburg, Melton, and Elkins 2011). In authoritarian settings, term limits help with informal coordination by signaling to rivals; indeed, in autocratic settings, "success" cases in terms of economic and human development have higher leadership turnover (Besley and Kudamatsu 2007).

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<sup>10</sup> Baseline ethnic heterogeneity is not predictive of ethnic fault lines. Indeed, politicians may seek to make ethnic divides salient in order to increase power. For instance, in Zambia, depending on whether the ruling coalition was comprised of a single party or multiple parties, different ethnic divisions were politicized and made salient: tribal groups in the case of the single party, and language groups in the case of multiple parties Posner 2005.



#### **Box 7.4 Female elites and female leaders**

When half the population is excluded from leader competition, political processes are half as likely to generate good candidates. Although gender gaps are narrowing around the world in several domains, women remain underrepresented in the political sphere, corporate boards, and the justice system. The proportion of seats held by women in national parliaments is 22.5 percent worldwide (WDI 2015); in the world's largest 200 companies in 2014, women accounted for only 17.8 percent of board of director members (CWDI 2015); and the average share of female justices in constitutional courts worldwide is 22.4 percent (Women Business and the Law 2016).

Some of this gender gap can be explained by supply-side constraints. There is some evidence that women are less likely to think they are qualified to run for office (Fox and Lawless 2011), are less competitive than men (Niederle and Vesterlund 2007), and are less likely to succeed in tournament-based competitions (Gneezy, Niederle, and Rustichini 2003). Such gender differences in the attitudes toward competition may be shaped by specific cultural features dictating different roles and responsibilities for men and women. For instance, although women are less likely to compete than men among the Maasai, a patriarchal society, they are *more* likely to compete than men among the Khasi, a matrilineal society where women hold economic power (Gneezy, Leonard, and List 2009). Deeply rooted social norms and beliefs about women's ability to be effective political leaders are in fact associated with lower representation of women in national parliaments.

Even when women do gain positions of power, they are often constrained in their behavior. For instance, when women are appointed ministers (in a sample of 117 countries worldwide), they are largely assigned to less strategic and more "feminine" policy areas (Krook and O'Brien 2012). In Africa, the influence of female ministers depends on the degree to which women have equal economic rights at the country level (Arriola and Johnson 2014).

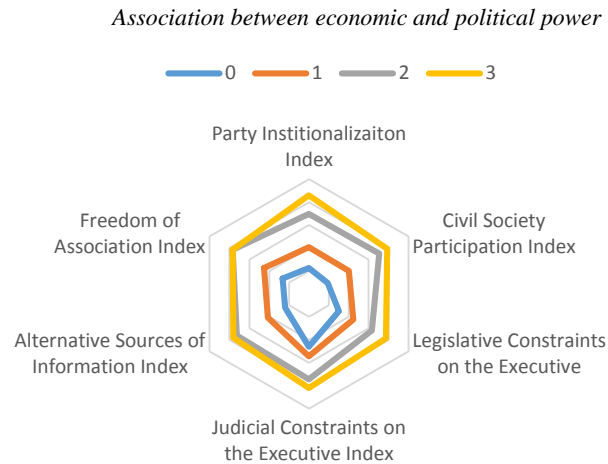
The lack of female elite representation has negative effects on the introduction of inclusive policies (see chapter 6), as the preferences of female leaders may be systematically different than male preferences. In the context of elite bargaining, female leaders are also more likely to engage in inclusive decision making processes. In the United States, female city managers are more likely to take citizens' inputs into account in decision making (Fox and Schuhmann 1999); female mayors tend to favor cooperation rather than a hierarchical approach to governing (Tolleson-Rinehart 1991); and female chairs of state legislature committees act more as facilitators in committee hearings than male chairs, who instead use their power to control the direction of the hearings (Lyn 1994).

There is also evidence that female leaders are less prone to patronage politics and corruption. In Africa, women are less likely to become ministers in settings where incumbents use patronage to support ethnic constituencies (Arriola and Johnson 2014). In India, the 1993 constitutional amendment that mandated the reservation of one-third of local government council positions to women in India also led to reduced incidence of corruption (Beaman and others 2010). In Brazil, random audits of government administrations showed that female municipal mayors were less likely to be corrupt than male mayors, and were also less engaged in patronage (Brollo and Troiano 2015). More broadly, countries with a higher representation of women in parliament have lower levels of corruption (Dollar, Fisman, and Gatti 2001).

*Source:* WDR 2017 team.

#### ***How economic concentration and diversification influence adaptability***

7.68 A high concentration of economic power can undermine the adaptability of elite bargains. Which economic sectors dominate an economy and how concentrated business and economic actors are has a large influence on developmental outcomes. Where productive business interests dominate, ruling coalitions are likely to be more dynamic and adaptive; where monopoly interests dominate, policies are more likely to prevent the emergence of new economic elites. Economic concentration has important political consequences: more concentrated economic power tends to lead to concentrated political power that reflects this economic distribution; and when economic power translates into political power, accountability institutions are less likely to develop (figure 7.5).

**Figure 7.5 When economic power maps onto political power, there are fewer institutional checks on power**

*Source:* WDR 2017 team, based on V-Dem 2015.

*Note:* The variable indicating how economic power maps onto political power comes from V-Dem, based on expert surveys. A score of zero means that economic elites have a monopoly on political power; a score of four means that all citizens have equal power, regardless of economic position.

7.69 Concentrated economic power makes adaptability to external shocks and internal change less likely. In elite bargains dominated by a small group of economic interests, greater development and growth opportunities may serve to constrain inclusive development and accountable institutions. In Zambia, reforms in the 1990s “systematically broke the organizational power of key economic interest groups in society (business, unions, agricultural cooperatives) and also their relationships with the state” and thus stymied both political and economic development in the country (Rakner 2003). Similarly, reforms that concentrate economic power without institutions in place to deal with new powerful interests may be ineffective, as in many post-communist countries, where initial beneficiaries of market reforms became economically and politically powerful enough to block further reform (Hellman 1998).

7.70 In other cases, economic developments can have a positive impact through their effect on productive and diversified business interests. When diverse productive interests gain in strength because of external shocks and internal change, they can positively impact elite bargains. For instance, during the conflict between the English parliament and the monarchy during the 17th century civil war, traders introduced financial assets and provided shares to parliamentary moderates who lacked mercantile interests, creating a broad parliamentary majority that overcame monarchic rule and changed the mechanisms by which parliament operated (Jha 2015).

7.71 Business associations can help diverse business interests overcome collective action problems and gain influence in elite bargains. They can push for institutionalized consultations that can enhance coordination and serve to decrease elite polarization. Chile’s movement from particularistic state-business relations in the 1970s to peak industry relations in the 1980s improved economic efficiency, and by aligning the interests of political insiders and business elites, also helped pave the way for a smoother democratic transition (Silva 1996). Business associations can also act as to balance the power of entrenched political elites. For instance, in Korea, the nature of

empowered businesses led to a form of business-state collusion that was pro-development, in contrast to corrupt anti-development business-state relations in the Philippines (Kang 2002). In these cases, the key to effective business associations is the representation of diverse interests, rather than concentrated ones: When business associations represent a diversity of interests, they are more inclined to push for universalistic rules and institutional reforms (Maxfield and Schneider 1997).

### **Entry points for change through elite adaptation**

7.72 What are the implications of change stemming from elite-bargains? First, changes to the rules of the game of the policy arena are driven by the relative power of self-interested actors. Trying to impose reforms for contestability or accountability is not likely to gain traction. This chapter focused on national elites, but the same analysis can also consider the subnational level and agency-specific reforms. In all of these cases, reform of the rules by which actors interact can only change successfully when they reflect the actual distribution of power and interests. Rules that do not reflect this power distribution or empower actors will not stick. Second, under certain circumstances, elites do choose to bind their own hands, so there is room for optimism. Trying to create these circumstances by altering contestability, incentives, and preferences at the margins may be an effective way to help change rules. Although there are not many entry points, there are ways to facilitate this process and support development of homegrown rules.

7.73 The discussion in this chapter highlights three entry points for changing elite bargains:

- *Making the policy arena more contestable.* When more actors are allowed to contest in the policy arena, elites are more likely to move from limited deals-based bargains to broader rules-based bargains. When newly powerful elites are allowed to contest in formal institutions, bargains can adapt to the changing balance of power. Empowering agencies by increasing their resources or the technical skills, information, and data available to them can enable them to bargain more effectively. And helping groups of elites or citizens overcome collective action challenges can also lead to newly powerful actors who can directly influence the policy arena (see chapter 8). Chapters 8 and 9 discuss the potential influence of other actors (citizens and international actors) to change the nature of elite bargains.
- *Effectively changing the incentives of elite actors.* Even when the relative power of actors remains the same, the nature of elite bargains can change when elites in power face changed incentives. These changed incentives are frequently the result of shocks: for instance, financial crises, changes in the terms of trade, or the discovery of natural resources. More gradual processes of economic diversification can also undermine rent-based elite bargains, changing the incentives of ruling elites to support more broad-based policies. At other times, effective “transactional” leaders engage in “good politics” to change the incentives facing other elites in the policy arena. When citizens overcome their collective action challenges to pressure elites, they change the incentives of elites to respond to their demands (see chapter 8). External actors can help to change elite incentives when they present inducements or threats, for instance conditional development assistance or the possibility for European Union or WTO membership. In Mexico, NAFTA led ruling elites

to accept liberalization in order to gain access to a large market. However, these changes will last only as long as the inducement or threat remains credible (see chapter 9).

- *Reshaping preferences in the policy arena.* The nature of elite bargains can also change when actor preferences evolve. Often, changes in preferences occur slowly over extended periods, such as multi-century global trends to view the practices of slavery and torture as immoral. In the shorter term, “transformational” leaders can coordinate norms and change beliefs. Increasing the frequency and depth of interactions between elite actors can help them find common ground. And increased cross-border flows of ideas and information can change the preferences of domestic actors through norm diffusion and interactions between communities of experts (see chapter 9).

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## Spotlight 7 Decentralization

### Local experimentation and innovation

S7.1 At their most effective, decentralized systems can spur experimentation that helps localities adapt proactively to changing circumstances. In the United States, Supreme Court Justice Louis Brandeis famously referred to the 50 states as “laboratories for democracy” that could “try novel social and economic experiments without risk to the rest of the country.”

S7.2 By multiplying the number of more or less autonomous arenas within which public authority is exercised, decentralization increases the opportunities for policy innovations and the emergence of effective leaders (Tendler 1997; Campbell 2003). Often, these innovations are spurred by political outsiders who may not have access to the national policy arena, but are more likely to acquire citizen support locally and spur local institutional reforms. For instance, after direct mayoral elections were introduced in Colombia in the 1990s, municipalities led by “political outsiders” invested heavily in upgrading their administrative capacities (Fiszbein 1997).

S7.3 Although decentralization increases *opportunities* for innovation and the entrance of political outsiders, only certain arrangements provide the correct *incentives* for experimentation. To generate adaptive and innovative local governance, it is essential to have a well-defined assignment of responsibilities across levels of government and a clear expectation that subnational governments will be held responsible for their performance. To prevent clientelism or capture at the local level, citizens or central elites must have both the ability to hold local elites accountable, and the incentives to do so.

S7.4 Decentralized governance can create incentives for competent individuals to pursue political leadership, societal groups to invest in building political parties, or existing subnational governments to adopt innovative policy solutions. Competitive local elections can enable entrance of political outsiders and provide incentives for incumbent administrations to strive to show competence in governance. In India, with a decentralized system, several regionally based parties have grown to form national coalitions, whereas two dynastic parties have dominated the politics of Bangladesh, a more centralized state. As a result, India has introduced a far greater range of policy innovations in spheres such as language and management of internal conflict than Bangladesh (Norris 2008).

S7.5 If the career prospects of subnational officials depend on their performance in running subnational governments, this can serve as a strong incentive for them to seek policy innovations to address local governance challenges. In China, local policy autonomy has served as an incentive for local institutional innovations, while personnel decisions remain under central political control, in an arrangement dubbed “experimentation under hierarchy” (Heilmann 2008).

S7.6 The nature of decentralization and the nature of central-local relations shape local incentives for innovation. For instance, different incentives and pressures arise when local parties are in opposition to central parties. In Lagos, Nigeria, the opposition leadership could not rely on intergovernmental transfers from the center, and thus put in place innovative approaches to secure greater internally generated revenues. Because new actors needed to be persuaded to cooperate in

order to secure these revenues, this led to more contestability in the local policy bargain (Watts 2016).

### **National diffusion of local innovations**

S7.7 Even when successful, idiosyncratic local innovations in isolated local governments may not translate into systemic adaption; these innovations must be diffused across jurisdictions. Decentralization can increase policy experimentation, but it may also increase the number of veto players. In some cases a nimble unitary state may be more agile in policy adaptation, compensating for the reduced number of opportunities for experimentation and outsider entry.

S7.8 Certain governance environments and power relationships encourage efficient diffusion of local innovations. Diffusion through “demonstration effects” requires both competition among local governments in different jurisdictions and relatively free flows of information, so that elites and citizens can identify innovations in other jurisdictions. In Brazil, participatory budgeting started in a handful of municipalities in southern parts of the country and eventually spread to hundreds of local governments. In this case, diffusion followed more or less partisan lines, demonstrating the effectiveness of political parties as institutional mechanisms to transmit information (see chapter 8).

S7.9 Diffusion may also be facilitated by strong central control. In China, where subnational governments have acquired significant levels of autonomy over fiscal and economic affairs but are subordinated to central political control, individual jurisdictions have emulated successes from other jurisdictions. When provinces faced a challenge of controlling local inflation soon after market-oriented reforms were introduced in the late 1980s, more effective approaches (such as a market-oriented measure adopted by one of the reform frontrunners, Guangdong) drove out less effective ones (such as a price control policy introduced by more conservative Heilongjiang bordering Siberia) (Montinola, Qian and Weingast 1995).

S7.10 Local innovations can translate into nationwide reforms through processes of political renewal when local leadership—whether through parties or as individuals—wins national power and leads the country in a new direction. Subnational political leaders are more likely to “step up” to the national level in a political system where decentralization is institutionalized, and political leaders have opportunities to demonstrate their competence and deliver performance in numerous subnational governments (Myerson 2011). In recent years, Mauricio Marci of Argentina, Narendra Modi of India, and Joko Widodo of Indonesia all demonstrated effectiveness as state/provincial governors before winning national office.

S7.11 Decentralized democracies allow opposition political parties to gain support in specific localities or regions and eventually challenge the dominant national party. In India, Bharatiya Janata Party (BJP), which carried Modi into the national government, gained strength over time by winning several elections at the state level. Chandrababu Naidu won state election on the basis of a good governance agenda, and his successful reforms led him to win a landslide reelection. A number of aspiring political entrepreneurs in other states drew on Naidu’s model to design their own good governance campaigns (Rudolph and Rudolph 2001).

## **The politics of decentralization**

S7.12 The decision to decentralize can be spurred by many different combinations of incentives and arrangements of relative power among various actors. A split may arise among central actors; to gain strength, they may turn to supportive local actors. Sometimes ruling elites have attempted to diffuse popular discontent with the performance of the national government by decentralizing roles and responsibilities to subnational governments. The military regime that governed Brazil from 1964 to 1985, for instance, formed tacit alliances with subnational political elites to maintain both a modicum of political legitimacy and coalitional support (Hagopian 1996). In other instances, elites have tried to preempt rising demands for regional autonomy through greater decentralization (Bolivia in the 1990s; Indonesia in the early 2000s); or have introduced more decentralization to signify a move away from authoritarian centralization of power and resources (Philippines after the fall of Marcos). Formalization of a decentralized governance structure can also be a form of “settlement” after the end of prolonged internal conflict (see chapter 4).

S7.13 Even after a political system decides to decentralize, the central-local relationship constantly develops; it is not linear. Changing power dynamics can generate pushes for recentralization if national and subnational elites are in competition. For instance, in the Philippines, during legislative consideration of the Local Government Code in 1991, members of the House of Representatives, who were elected from electoral districts (typically smaller than a province), opted to weaken the fiscal resource base of provincial governments because they saw provincial governors as potential rivals as dispensers of local patronage. Senators, who were elected nationally, were more willing to devolve more power to provinces (Eaton 2001; Matsuda 2011).

S7.14 As these cases demonstrate, political incentives shape important aspects of the design of intergovernmental relations, with lasting consequences for the ability of the decentralized governance arrangement to adapt to emerging challenges. Decisions to decentralize (or recentralize) are primarily politically motivated and involve bargains among multiple stakeholders in which technocratic criteria often take a back seat. Outcomes reflect the relative bargaining powers of competing interests, mediated by existing political institutions. Understanding how these bargains take place can help lead to more effective, adaptive, and context-specific decentralization designs.

\* \* \*

*This spotlight is based on a special contribution to the WDR 2017 from Yasuhiko Matsuda.*

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## **Chapter 8 Citizen engagement**

### **Understanding elites-citizen bargains**

8.1 Clientelist practices were the norm in Uruguay for most of the nineteenth and twentieth centuries. The overall quality of public services was low, and political “connections” were the main vehicle to access goods and services provided by the state. Today the country ranks as the world’s twenty-first least-corrupt, according to the latest Transparency International corruption index. The government performance in Uruguay has steadily improved, making the country one of the few cases of “contemporary over-achievers”—societies that have succeeded in curbing corruption and promoting virtuous cycles of institutional changes toward better governance (Mungiu-Pippidi 2015; Buquet and Piñeiro 2016). This successful transformation, as is the case for all countries in their historical trajectories, is the result of a complex set of circumstances. Among those, the creation of programmatic parties after the civilian rule was re-established in 1985 may have played an important role. Social groups made efforts to build coalitions with interest groups sharing the same preferences—such as the urban sector hit by the economic crisis—and channel popular demands through a new political party (Frente Amplio), that became a new political option besides the traditional coalition of parties. The new political party increased contestability and managed to bring into the policy arena new demands for equitable access to public resources, accountability, and better quality services. Eventually, elections rewarded politicians who delivered the announced reforms, changing the incentives of the elites and increasing the opportunity costs of old clientelist practices. Over time, political, administrative, and economic reforms increasingly reduced politicians’ opportunities to capture state resources for private purposes.

8.2 The experience of Uruguay illustrates how multiple mechanisms of engagement (elections, political parties, social movements) can help ordinary citizens influence the policy arena by changing contestability, incentives, and preferences to generate more equitable development. Since all these expressions of collective action are imperfect, they complement, rather than substituting for, one another. As the case of Uruguay shows, it is their strategic combination that makes governments more responsive to citizens’ needs and open up opportunities for sustainable change.

8.3 Elites and citizens can bargain and create coalitions for change, but that process does not take place in a vacuum, and it is often shaped by existing institutions of vertical and horizontal accountability defining the “rules of the game” in the policy arena. As discussed in chapter 7, these “rules” are often the result of elite-elite bargains and are primarily designed to serve elites’ interests. This chapter takes a step further, and shows that certain accountability institutions can perform new functions and create the “enabling environment” for citizens’ agency, opening up opportunities for enhanced contestability and elite-citizens interaction in ways often not anticipated by the actors who originally designed them. The outcomes of such institutional reforms, however, are not predetermined. Citizens’ agency is needed to translate favorable conditions into drivers of change in societies.

8.4 This chapter focuses primarily on conditions for citizen engagement to be more likely a driver of positive change, while recognizing that each mechanism of engagement has inherent limitations. Through elections, for examples, citizens can sometimes legitimize socially

undesirable policies. Likewise, political and social organizations can also lead to undesirable outcomes, violence, rent-seeking practices and can also be captured by clientelistic elites. They play, however, a fundamental role in the process of interaction among state and non-state actors to design and implement policies and to bring about changes in formal rules, particularly on areas that affect minority groups, and consequently would be unlikely to emerge through majority-based mechanisms such as elections. The main objective of successful citizen mobilization is to bring about change through non-violent means. Violence is a socially undesirable manifestation of a governance failure (see chapter 4).

### **Bringing change through the ballot box**

#### ***Elections are a well-established—though imperfect—mechanism of vertical accountability***

8.5 Opportunities for citizens to engage in the public decision-making process through voting have increased substantially over the past half century.<sup>1</sup> At the beginning of the so called “Third Wave” of democratization in 1974, there were only about 40 electoral democracies in the world, mostly confined to the industrialized “Western” world (Huntington 1991). Today, the number has more than doubled (to about 100), with more than half of the world’s countries choosing their leaders through elections in which a change in government is a real possibility. Elections have become a fast-spreading norm to legitimize state authority and organize human societies (Diamond 2008) Even in places where open contestation at the national level is absent or restricted, elections have been introduced at the local level to improve oversight of local officials, opening opportunities for participation and contestation of public policies (Gandhi and Lust-Okar 2009).

8.6 Elections are among the most well-established mechanisms available to citizens to strengthen accountability and responsiveness to their demands. By doing so, they can help improve the level and quality of public goods and services provided by the state. This effect can be particularly strong at the local level, where voters might be better able to coordinate and shape the incentives of local politicians to deliver—including by curbing corrupt behavior. In China, for example, the introduction of village-level elections increased total local government expenditures on public goods by about 50 percent, marking a significant policy shift in favor of citizens’ preferences. Moreover, elections helped curb rent-seeking behavior of local officials and reduce inequality by promoting land redistribution to local villagers (Martinez-Bravo and others 2011). In Indonesia, for example, districts in which governors were directly elected experienced more efficient revenue collection and spending compared to districts ruled by centrally appointed governors (Skoufias and others 2011; Martinez-Bravo 2014).

8.7 Elections can also curb ethnic favoritism in the allocation of public resources by posing constraints on executive power. In Kenya, for example, during the authoritarian period, districts that shared the ethnicity of the president received three times as much public investment in roads. However, under multiparty electoral democracy, this effect has disappeared, suggesting that elections successfully constrained the ability of leaders to divert public resources for partisan goals (Burgess and others (2015) (figure 8.1). Likewise, a comparison of fertility rates across 28 countries in Sub-Saharan Africa shows that multiparty elections and leadership changes associated

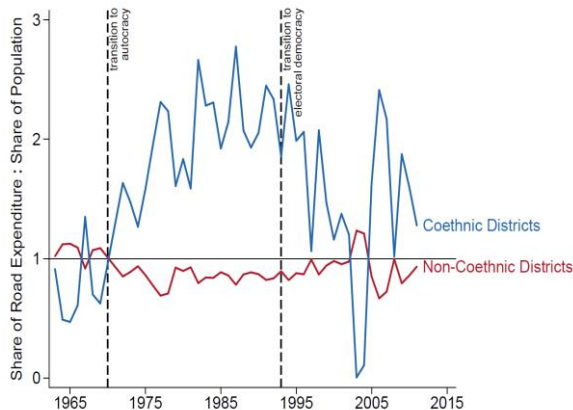
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<sup>1</sup> This section builds upon Khemani and others (2016).

with electoral mechanisms significantly reduced infant mortality rates through improved health care (Kudamatsu 2012).

8.8 Despite the global spread of electoral democracies, the space for effective citizens' engagement is compromised by the fact that, according to perceptions, the quality of the electoral process is declining (figure 8.2). Newly established democracies in low-income countries are especially vulnerable to episodes of electoral manipulation. Indeed, the experience of many developing countries suggest that the principle of "one person, one vote," while upheld in principle, is often undermined in practice by the incumbent leaders' desire to minimize the risk of losing power. Elites can resort to multiple strategies of manipulation that undermine the integrity of the electoral process, including the use of legal instruments that ban certain political parties or individual candidates from joining the electoral contest, the adoption of complex voting registration regulations that effectively disenfranchise certain groups of voters, the resort to electoral fraud, and, in extreme cases, voter intimidation and physical repression of political opponents (Schedler 2002). Chauvet and Collier (2009) provide empirical support for this claim, showing that regular elections can improve the overall level of economic policies by disciplining leaders, but this structural effect is conditional on the quality of those elections.

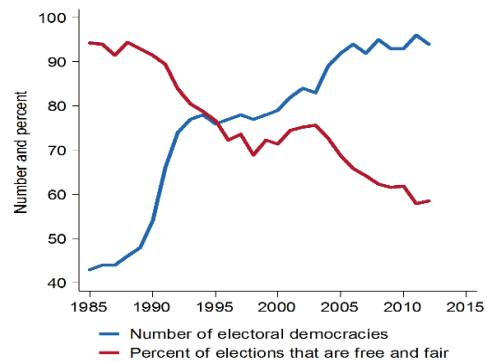
**Figure 8.1 In Kenya, elections have changed incentives of ruling elites, reducing the scope of ethnic favoritism**



Source: WDR 2017 team based on Burgess and others 2015.

Note: The share of road development expenditure and the share of population are relative to district populations in 1936. A district is defined as co-ethnic if more than 50 percent of its residents are from the same ethnic group as that of the president in the given year. A ratio above one indicates the presence of ethnic favoritism.

**Figure 8.2 Electoral democracies are spreading, but the integrity of elections is declining**

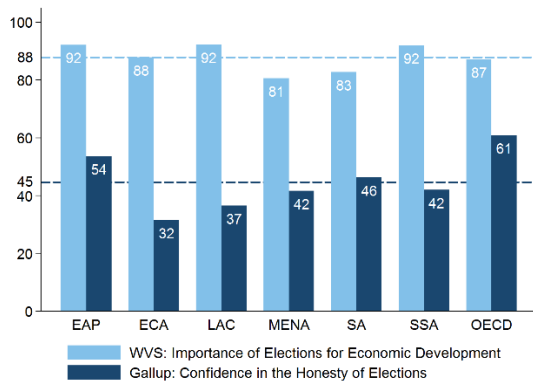


Source: WDR 2017 team based on Polity IV (number of electoral democracies) and Bishop and Hoeffler 2014 (free and fair elections).

8.9 The decline in honesty and fairness of elections is reflected in widespread disappointment among citizens, as reported in latest public opinion data covering different geographic regions and income groups. While on average almost 90 percent of respondents worldwide view free and fair elections as an important instrument to improve economic conditions in their country, they often do not trust their quality. Less than half of respondents to the latest world Gallup survey, on

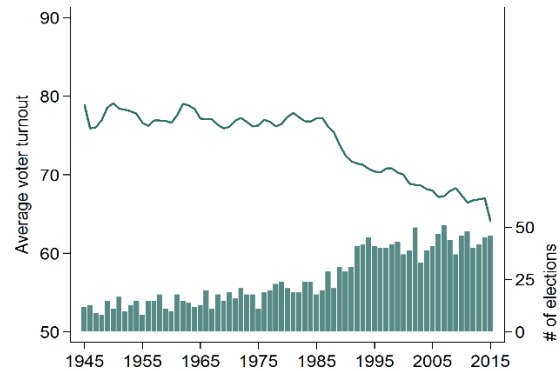
average, have confidence in the integrity of the electoral process; mistrust is especially high in Eastern Europe and Central Asia, Latin America and Caribbean, and Sub-Saharan Africa (figure 8.3). These perceptions matter, as they shape citizen engagement and their propensity to vote (Birch 2010). Figure 8.4 is consistent with this claim, showing that voting turnout is declining worldwide. Moreover, the lack of electoral integrity and a persistent climate of mistrust over time undermine the legitimacy of the political system, fueling protests, mass demonstrations, and, in extreme cases, outbreaks of electoral violence and civil war (Norris, Frank, and Martinez 2015; Bekoe 2012; Collier and Vicente 2011). The 2007 Kenyan election, with an estimated 1,200 deaths and the displacement of more than 300,000 people, dramatically illustrates this point.

**Figure 8.3 While citizens value elections as an important channel to bring economic development, less than half of respondents worldwide have confidence in the integrity of elections**



Source: WDR 2017 team based on World Value Survey Wave 6 (2010–14), covering a sample of 41 countries, and Gallup World Poll 2010–15, covering a sample of 142 countries. Dotted lines indicate global averages.

**Figure 8.4 Voting turnout is decreasing worldwide, indicating unequal citizen participation and risk of biased representation of policy preferences**



Source: WDR 2017 team based on IDEA Voter Turnout Database 2016.

Note: The line refers to average voter turnout using locally weighted smoothing, while the bars indicate absolute number of elections in a given year. Voter turnout is based on the percentage of the voting-age population.

*De facto enfranchisement of voters: Enhancing contestability*

8.10 The extent to which citizens engage in the electoral process also matters because voter turnout is not uniform and often biased toward certain income groups. This in turn can lead to unequal influence in the policy arena. A large body of literature on turnout inequality in high-income democracies finds that income and literacy rates predict turnout, suggesting that poor voters face constraints that reduce their propensity to vote (Gallego 2010; Mahler, Jesuit, and Paradowski 2013; Fumagalli and Narciso 2012). The lack of engagement of disadvantaged groups in turn shapes politicians’ incentives to adopt pro-poor, redistributive policies, reducing social spending and reinforcing existing inequalities (see also chapter 6 in this Report). This logic implies that the de facto enfranchisement of disadvantaged voters can improve accountability by better capturing their policy preferences. In Brazil, for example, the introduction of electronic voting technology has simplified the process of casting ballots and substantially reduced the number of

error-ridden and undercounted votes among the poor. The intervention effectively enfranchised 11 percent of the electorate, mainly the less educated, and led to increased spending toward public health care, increasing poor pregnant women's access to prenatal care, and reducing incidence of under-weight births (Fujiwara 2015).

8.11 Enfranchising poor voters, however, is hardly a sufficient condition to bring changes in public policies. As a matter of fact, poor people in developing countries are *more* likely to vote. This implies that higher levels of turnout might not necessarily reflect greater political mobilization by the poor, but rather their tendency to be more receptive to clientelist practices used by elites to mobilize them (Pande 2011; Beramendiz and Amat 2014). Consistent with this logic, Kasara and Suryanarayan (2015) find that in poor societies rich voters are less likely to vote because the state's extractive capacity is low, and the threat of wealth redistribution through taxation is not credible. As the bureaucratic capacity of the state improves and political competition becomes primarily programmatic in nature, however, the rich are more likely to engage and influence fiscal policies through voting. In other words, the effect of poor voters' enfranchisement on public policies is contingent on the nature of political competition, the specific mobilization strategies adopted by political parties, and the presence of "credible political alternatives for marginalized citizens" (Kasara and Suryanarayan 2015, 624). Programmatic political parties and social movements play an important mediating role in this respect, as discussed later in this chapter.

#### *Information and the media: Changing incentives*

1.5 The average voter might not have the information required to properly assess government performance and clearly assign responsibilities. The provision of accurate and credible information to voters—which comes from trustworthy sources such as independent media or oversight institutions—can change prevailing social norms, reducing information asymmetries and increasing voters' willingness to punish incumbents for poor performance and bad practices such as corruption. For example, in 2003 the federal government of Brazil launched a national anticorruption program that targeted municipal governments with random audits by the national audit agency, whose results were publicly disseminated through media (radio, television, and newspapers). When audit reports disclosed information about corrupt practices, corrupt mayors were punished at the polls, while mayors with no irregularities were rewarded with reelection. These effects have been stronger in municipalities with local radio stations, pointing to the important role played by the media in amplifying and disseminating campaign messages (Ferraz and Finan 2008). Similar results have been reported in Puerto Rico and Mexico, using information disclosed in audit reports (Bobonis, Cámara Fuertes, and Schwabe 2015; Larreguy, Marshall, and Snyder 2015); and in India, using report cards on the performance of incumbent politicians (Banerjee and others 2011). The role of information, discussed at length in Khemani and others (Forthcoming), is fundamental to strengthen the quality of citizen engagement, even in environments where partisan loyalties are strong and a dominant party has been entrenched for some time. In Sierra Leone, for example, increased access to information about local politicians through radio campaigns had a significant effect in shaping behavior and increasing voters' willingness to "cross the ethnic-party lines" to vote for a politician of a different party and outside their own co-ethnic group (Casey 2015).

8.12 However, as discussed in the 2016 *World Development Report: Digital Dividends*, when the content of the information disclosed is not salient to voters, or attributing individual

responsibility is harder, the incentives of politicians to respond with better service provision remain low, and transparency can have no effect on vertical accountability. In Uganda, for example, the provision of scorecards on the performance of members of parliament did not have any impact on politician's selection or performance (Humphreys and Weinstein (2012). Likewise, radio-based information campaigns on public health and primary education in rural Benin had no effect on shaping politicians' incentives to improve health and education services, despite reducing voters' support for patronage practices (Keefer and Khemani 2014). Sometime, politicians can respond to the disclosure of information by increasing their vote-buying efforts, thereby preempting its potential effect on voting behavior. In the Philippines, for instance, the an initiative led by a nongovernmental organization (NGO) to share information about large public spending program ahead of the municipal elections led incumbent politicians to increase vote buying; in the end, the campaign had no discernible effect on voting behavior (Cruz, Keefer, and Labonne (2015).

8.13 In the presence of preexisting preferences and entrenched social norms, transparency alone is unlikely to trigger change and might even lead to more polarized preferences (see spotlight 8 on the media). In these circumstances, citizen engagement through sustained processes of policy deliberation might increase the likelihood of better results.

#### *The challenge of persistent preferences*

8.14 Citizen's expectations of what politicians can and should deliver, can also be shaped by social norms and "mental models" (World Bank 2015),<sup>2</sup> leading to inefficient demands. As discussed in chapter 6, many societies are organized around patron-client (or clientelist) exchanges, in which voters expect politicians to deliver private benefits in return for political support, and reward or punish politicians based on these expectations.<sup>3</sup> Moreover, any attempt by each of the parties involved to break the terms of the exchange is costly and likely to fail: in the terminology of this Report, these relationships often constitute self-reinforcing equilibria. A field experiment during the 2001 presidential elections in Benin illustrates this point. National candidates who adopted clientelistic messages were more effective in mobilizing electoral support than competitors who used broad-based policy messages (Wantchekon 2003).

8.15 Recent empirical studies on voting behavior in the United States illustrate the perverse effects citizens' beliefs can have in shaping public policies, challenging the conventional logic of democratic theory. Achen and Bartels (2016) argue that the average citizen has little incentive to study complex political issues, engaging in what public choice theorists define as "rational ignorance." As a result, voting behavior is hardly based on policy preferences; instead, it mostly reflects citizens' social identities and partisan loyalties. Caplan (2008) goes a step further and argues that citizens demand policies based on ideological positions without considering the tradeoffs and costs they might entail. In Caplan's view, voters not only lack information; they actually hold systematic biases in favor of economic policies that have been proven wrong empirically. The persistence of popular demands for energy and fuel subsidies despite their proven

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<sup>2</sup> "Mental models" include categories, concepts, identities, prototypes, stereotypes, causal narratives, and worldviews. Without mental models of the world, it would be impossible for people to make most decisions in daily life...Mental models differ from social norms. Mental models, which need not be enforced by direct social pressure, often capture broad ideas about how the world works and one's place in it. In contrast, social norms tend to focus on particular behaviors and to be socially enforced" (World Bank 2015, 62).

<sup>3</sup> Stokes 2005; Schaffer 2007; Kitschelt and Wilkinson 2007; Stokes and others 2013.

fiscal and environmental costs illustrate how these behavioral dynamics are also relevant for many developing countries, undermining the opportunity to bring change through elections alone (Clements and others 2013).

### ***Why elections alone are not enough to bring change***

8.16 These analyses suggest that the common belief that elections are a sufficient mechanism to produce responsive and accountable government rests on questionable assumptions. Even when elections are more effective in changing voters' preferences and the incentives of politicians, voting is a limited instrument of control. Voting is an individual action, and citizens face significant coordination challenges when considering whether or not to remove poorly performing governments, limiting the credibility of the threat to punish elected officials (Manin, Przeworski, and Stokes 1999). Moreover, even when citizens manage to remove politicians when their performance is poor or diverge from their preferences, elections alone offer no credible guarantee that, once elected, new leaders will not shirk from their electoral promises and credibly commit to the citizens' demands.

8.17 As the sections that follow will discuss, organizations representing citizens' collective interests such as political parties, interest groups, and civic associations are required to overcome the limits of collective action and electoral representation, potentially strengthening citizens' ability to monitor government performance and—in so doing—increasing the costs for politicians to shrink on their electoral promises (Ashworth 2012; Keefer 2013). As Achen and Bartels (2016) indicate, “ordinary citizens' interests are likely to matter only insofar as the organized groups representing those interests...are themselves politically engaged, well-resourced, and internally accountable.” It is to these organized groups that this chapter now turns.

## **Bringing change through political organizations: The role of political parties**

### ***Political parties: Why do they matter?***

8.18 Voting is a way in which individuals shape a collective outcome through individual action. It is important, however, to understand the role of citizens acting collectively, for example, through political organizations. Political parties represent a mechanism to solve collective action problems and can represent and articulate citizens' collective interests, aggregate their preferences, and channel their demands in the policy-making process (Kitschelt and Wilkinson 2007; Sartori 1976).<sup>4</sup> By solving citizens' coordination problems and providing them with information cues needed to evaluate the performance of incumbents, political parties play a critical role in strengthening vertical accountability (Aldrich 1995). By recruiting and socializing political leadership, political parties also play an important social function to integrate citizens into the political process and to allow different social groups to have a stake in supporting the system, thereby promoting a culture of compromise and reducing societal tensions (Diamond and Gunther 2001, 7–8; Randall and Svåsand 2002). In Tanzania, for example, the power-sharing agreements within the Chama Cha Mapinduzi party has been instrumental in accommodating the demands of various ethnic and religious groups, allowing an alternation in power between Christian and Muslim leaders (Ezrow and Frantz 2011). This arrangement helps explain why the country has not

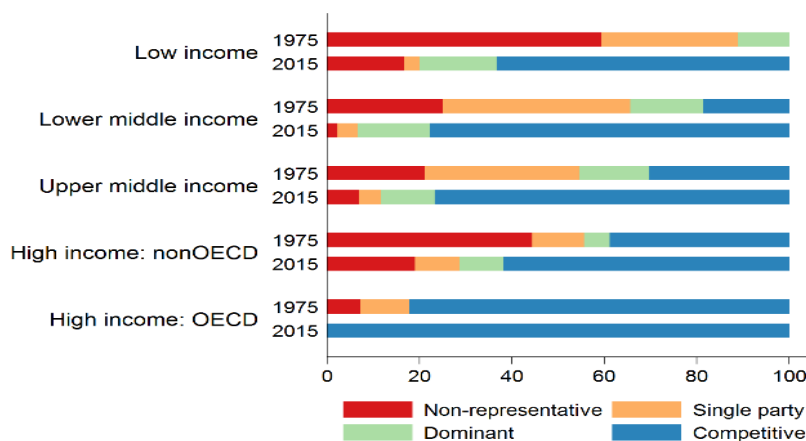
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<sup>4</sup> As discussed in chapter 7, political parties can also be an instrument to solve coordination and commitment problems among elites.

been plagued by the ethnic conflicts that prevailed in many countries in the region, despite the presence of more than 140 distinct ethnic groups.

8.19 Over the past 40 years, the global landscape of political party systems has changed: across all income groups, unelected legislatures and single-party systems have become increasingly rare, and multiple political organizations are now allowed to enter the policy arena, articulating societal interests and citizens’ demands. However, a closer look reveals important differences: in many developing countries, formal competition for power is de-facto constrained by the dominant nature of the party system (figure 8.5). In contexts where one party dominates the legislative and executive offices, the ability of citizens’ to influence the policy-making process through representation is reduced (Sartori 1976; Manin, Przeworski, and Stokes 1999: 48) As discussed in chapter 7, this situation does not preclude bargaining among elites, and might even be more effective to promote cooperation and commitment among them. From the citizens’ perspective, however, it undermines collective action by reducing the attractiveness of electoral politics as a mechanism to alter power asymmetries and bring about change. Over time, the exclusionary nature of this bargaining might undermine the legitimacy of the political system and lead excluded groups of citizens to channel their demands through noninstitutionalized channels. Surveys have also shown the disenchantment of citizens with political parties, which rank low in perceptions of institutional trust.

**Figure 8.5 While the spread of multiparty systems has increased opportunities for citizens’ engagement, dominant parties pose de facto limits on electoral competition**



Source: WDR 2017 team based on the Database of Political Institutions (Cruz, Keefer, and Scartascini 2015). Income groups reflect the latest categorization by the World Bank. A party system is classified as “dominant” when incumbents control 75 or more of seats in parliament.

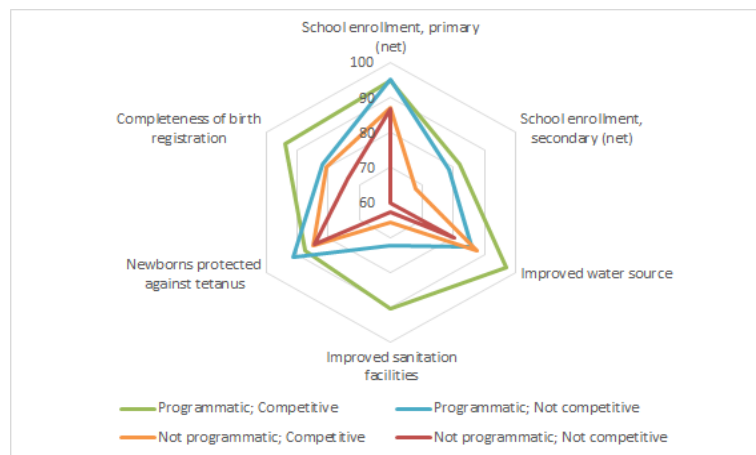
8.20 The strategies adopted by political parties to mobilize voters have important implications for development, as they directly shape the nature of elites-citizen bargaining. On one end of the spectrum—as discussed in chapter 6—*clientelistic political parties* mobilize support through targeted transfers, cash payments, “pork barrel” public investment projects, patronage jobs, and other private goods (Kitschelt and Wilkinson 2007). On the opposite end of the spectrum, *programmatic political parties* maintain a coherent position over key policy issues, stick to these



policy commitments over repeated electoral rounds as their main appeal to attract votes, and deliver on them once in office.<sup>5</sup>

8.21 Because the electoral success of programmatic parties—and their own political survival—depends heavily on the credibility of their policy commitments, these parties are more likely to develop organizational arrangements that prevent free riding and shirking by party members and are therefore more likely to deliver on their electoral promises. For example, the quality of public services is significantly higher in countries where the main parties (government and opposition alike) exhibit programmatic characteristics, and the effect is larger under conditions of electoral competition (figure 8.6). Likewise, programmatic parties increase the chances to adopt and successfully implement public sector reforms (Keefer 2011, 2013; Cruz and Keefer 2013).

**Figure 8.6 Programmatic parties perform better than clientelist ones in improving the quality of public services, especially in competitive party systems**



Source: WDR team based on Keefer 2011, 2013; Database of Political Institutions (Cruz, Keefer, and Scartascini 2015); and World Development Indicators (WDI).

### ***What does it take for programmatic parties to emerge? How “hard” and “soft” conditions interact***

8.22 The level of programmatic parties is highest in developed economies, with most developing countries lagging behind (figure 8.7). This pattern seems to suggest that structural factors (“hard” conditions), make programmatic parties less likely in developing countries. The underlining logic is that the nature of the interaction between political parties and voters varies under different structural conditions. At low levels of economic development, average voters tend to reward clientelist practices rather than supporting uncertain programmatic platforms because they lack alternative means to secure basic services and are most vulnerable to adverse economic shocks. However, as societies develop, the marginal impact of targeted benefits on the welfare of the average voter is negligible relative to the potential benefits they can derive from public policies. Consequently, citizens’ expectations change: they demand higher-quality services and public

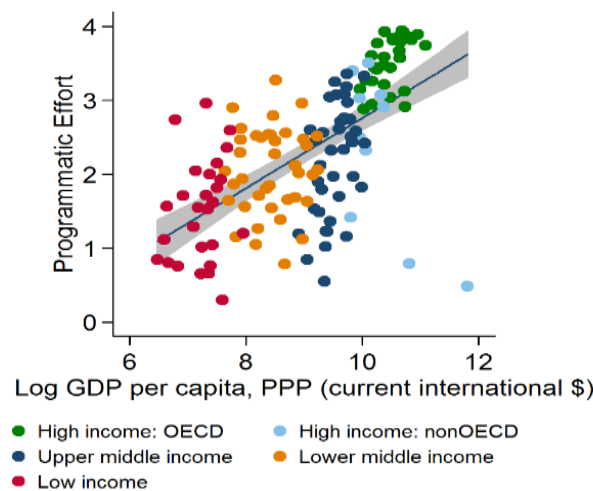
<sup>5</sup> In the real world, political parties do not fall into neat divisions of programmatic or clientelistic. Rather, they are located along a spectrum, and might display different strategies simultaneously. The focus is on the *extent* to which a specific strategy prevail over competing alternatives (Kitschelt and Wang (2014).

goods, and become less credible in their commitment to “sell” their vote to politicians. (Kitschelt and Wilkinson 2007; Stokes and others 2013).

8.23 Historical trajectories of state-building are also considered an important hard condition for the emergence of programmatic parties. Shefter (1977) presents a classic argument on the timing of democratization and bureaucratic development and its effect on party-voter linkage strategies. Using macro-historical comparisons, Shefter shows that where meritocratic recruitment to enter the civil service was set in place before mass-based political parties developed, in such countries as England, France, Germany, and Sweden. Politicians were prevented from capturing the bureaucracy for patronage purposes by a “constituency for bureaucratic autonomy”. In contrast, when the rise of mass political parties preceded the establishment of professionalized bureaucracy—as in Greece, Italy, Spain, and the United States—politicians developed the “capacity to successfully raid the bureaucracy for patronage,” leading to a dramatic increase in clientelism as political parties competed to attract mass electorates.

8.24 Macro-level structural and historical arguments alone, however, tend to be overdeterministic and can hardly explain the observed variation in programmatic efforts given a similar stage of economic development (figure 8.9); nor can they explain why, in a given country, certain political parties choose to “opt out” of clientelism and shift to programmatic strategies, while others do not (Hagopian 2007; Kitschelt 2000: 258). To explain these puzzles, one needs to consider how hard and soft conditions interact to shape the incentives of political parties and their relative bargaining power in the policy arena, leading to changes in the nature of their interaction with the voters.

**Figure 8.7 Programmatic parties tend to emerge at higher levels of development, but significant variation exists among countries at similar stages of development**



*Source:* WDR 2017 team based on World Development Indicators (2016) and V-Dem 2016.

*Note:* Income is represented by the natural log of the average per capita income in purchasing power parity terms in 2008–09. A given party’s “programmatic effort” refers to the set of “goods” that the party offers in exchange for political support. The ranks range from 0 (= clientelistic efforts) to 4 (= policy/programmatic efforts). Intermediate values reflect combinations of both strategies (V-Dem 2016: 102).

8.25 As discussed in chapter 7, when electoral competition among elites intensifies, they are more likely to adopt reforms that reduce patronage as a ‘political insurance’ mechanisms that will protect them in the event of losing power (Geddes 1994). A similar logic explains why political parties tend to diversify their “portfolio” across the national territory, and adopt a combination of clientelist and programmatic strategies to mobilize voters, depending on their relative bargaining power in the electoral arena (Kitschelt and Wilkinson 2007: 30–31). In Mexico and Argentina, for instance, municipalities that exhibited higher levels of electoral competition and had a larger middle class received the largest influx of public goods, changing politicians’ incentives to “opt out” of clientelism as a strategy to maintain political support (Magaloni, Diaz-Cayeros, and Estévez 2006; Weitz-Shapiro 2014).

8.26 The interaction between economic development (hard condition) and electoral competition (soft condition) as joint drivers of programmatic politics also explains why at low levels of development increased party competition can lead to more—not less—clientelism. This is because in lower-income countries voters are more vulnerable to vote-buying and therefore are less likely to demand programs/policies. Moreover, well-intended politicians cannot credibly commit to deliver them because of weak state capacity and the absence of institutional arrangements—such as strong checks and balances, a well-functioning parliament and independent judiciaries—that could sanctions leaders who shrink back on their promises. The experience of many low-income countries in Sub-Saharan Africa is consistent with this argument and illustrates how multiparty competition has fueled, rather than reduced, clientelism.<sup>6</sup>

8.27 Financial crises and prolonged periods of economic stagnation can also act as soft conditions that trigger the emergence of programmatic parties. They increase the opportunity costs of clientelism as a mobilization strategy to attract voters, leading politicians to rely on the party brand for their campaigns. Moreover, under rising unemployment and shrinking public services, average citizens might become more receptive to parties that advocate alternative programmatic solutions to address the crisis. In the Republic of Korea, for example, the financial crisis of 1997 reduced the resource base for clientelist practices and triggered policy reforms—such as regulations aiming to improve transparency in political party finances—that reconfigured partisan competition around programmatic lines (Wang 2012; Hellmann 2011). The outcome of these shocks, however, is not predetermined: worsening economic conditions can also trigger populist appeals that lead political outsiders to gain power on the basis of vague policy proposals. By subordinating the execution of these proposals to the will of a charismatic leader, populism undermines the emergence of programmatic parties and can lead to shrinking bargaining space, reducing opportunities for citizens to hold elites accountable.<sup>7</sup>

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<sup>6</sup> Bates 2010; Keefer and Vlaicu 2008; Kitschelt and Kselman (2013).

<sup>7</sup> While programmatic parties can have charismatic leaders, the organizational strength and autonomy of the party constrains the power of individual leaders, subordinating them to the party program. Under populism, the relationship is reversed, and the party has no internal mechanisms to sanction leaders if they fail to deliver on their programmatic agenda. This also explains why populist leaders tend to resist efforts to strengthen the party as an autonomous organization, and why such parties are often nothing more than electoral machines that disappear soon after the charismatic leader leaves office. In Peru, for instance, Alberto Fujimori won the presidential elections as “outsider” through his own party (Cambio 90). After Fujimori was removed from office in 2000, the party quickly evaporated, gaining only 3 out of 120 seats in congress and eventually being dissolved in 2013 (Mainwaring and Torcal 2005).

8.28 Finally, institutional arrangements that reflect elite-driven bargaining—such as changes in electoral laws, and decentralization reforms—can produce unintended consequences, opening up new spaces for citizens’ participation and lowering barriers to entry for grassroots movements and local civic associations that are willing to shift their strategy and directly participate in elections under a joint party committed to articulate their demands (see spotlight 7 on Decentralization). In Bolivia, for example, indigenous peoples’ movements took advantage of decentralization reforms and newly institutionalized spaces for citizens’ participation to overcome their divisions, organize collectively through autonomous political parties, and effectively bargain for collective and territorial rights in various municipalities.<sup>8</sup> These experiences created demonstration effects in other municipalities, strengthening the electoral base of indigenous parties and paving the way for their access to the presidency (Van Cott 2005; 2006).

### ***Why political parties alone are not enough to bring change***

8.29 As discussed in chapter 7, political parties can sometimes become the vehicle for elite bargaining, de facto abdicating on their function to represent and articulate the demands and preferences of ordinary citizens. When this happens, political parties tend to act as “gate-keepers,” adopting laws and regulations that grant the ruling elites special advantages and increase the barriers to entry for potential challengers. While this role might facilitate elite bargaining and promote stability, over time it can undermine vertical accountability because certain groups of citizens (and the interests they represent) might find themselves systematically excluded from the policy arena or unable to bargain on a level playing field. In South Africa, for example, the National Party enforced the apartheid regime through formal legislation from 1948 to 1994, denying basic political, social, and civil rights to the black majority on the basis of ethnic prejudice.

8.30 Political parties can also deliberately try to reduce contestability in the policy arena by adopting political financing laws and regulations that work in their favor. Because of the rising costs of politics and often in reaction to major political corruption scandals, many countries across the world have introduced public funding regulations. These aim to create a level playing field, helping new interest groups and small opposition parties compete on a more equitable basis with incumbent parties, while also reducing the influence of big corporations and private interests in shaping the parties’ agenda. As figure 8.8 illustrates, however, countries with dominant party systems are *less* likely to introduce public funding regulations, de-facto reducing the level of contestability in the system. In Africa, for example, only a minority of countries having adopted and effectively enforcing public funding laws, contrary to global trends. This regional trend is often coupled with limited transparency on party financing and heavy reliance on funding from private—often illicit—sources (Pinto-Duschinsky 2002; Van Biezen and Kopecky 2007; Norris, Abel van Es, and Fennis 2015).

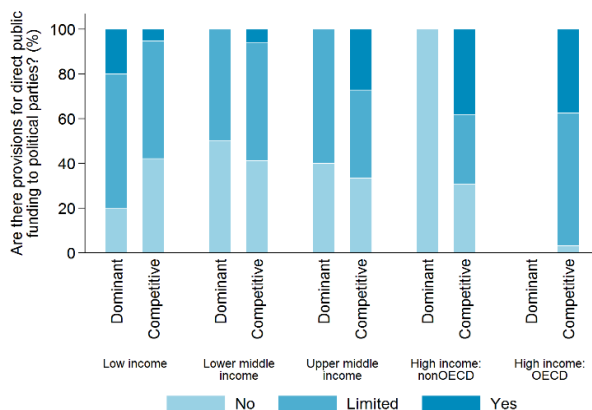
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<sup>8</sup> In other Latin American countries, however, decentralization reforms did not enable indigenous groups to form viable political parties. Van Cott 2005) argues that decentralization was a necessary but not sufficient condition, as its effects were mediated by the geographic distribution of indigenous groups. In Bolivia and Ecuador, indigenous population were a majority or a significant minority (more than 25 percent of the population) in about 79 percent and 43 percent of subnational districts, respectively. In contrast, in Peru, indigenous parties’ minorities were numerically significant in only 28 percent of subnational districts, accounting for less successful mobilization (Van Cott 2005, 218–19).

8.31 Well-established political parties can also become risk-averse and opportunistic in the way that they articulate citizens’ demands. They can decide to “sponsor” societal preferences only when their expected returns (in terms of electoral gains) is positive and large, while ignoring demands that are salient only to a small section of the electorate or appear too risky because they deviate from established social norms. As a result, the policy arena can shrink considerably and become biased against disadvantaged citizens such as women, indigenous people, and ethnic and sexual minorities.

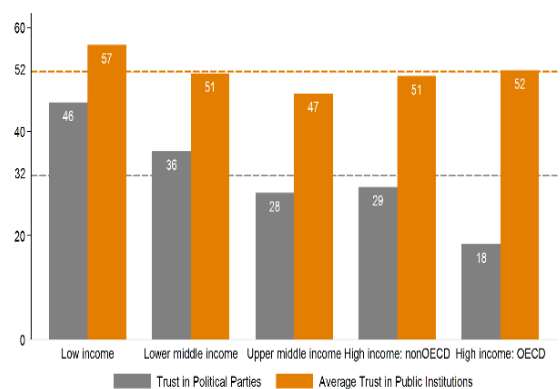
8.32 All together, these tendencies contribute to making political parties part of the problem, rather than the solution, and the main target of citizens’ discontent. Political parties are the least trusted political institution worldwide, and trust is lowest in high-income countries, public opinion surveys suggest (figure 8.9). While significant variation exists between and within regions, these perceptions highlight an important crisis of representation for traditional representative institutions, leading citizens to look for alternative mechanisms to organize collectively and bring their demands into the policy arena. The decline of party activism and membership in OECD countries is consistent with this argument (Whiteley 2011). Through social movements, civic associations, and spaces of deliberation, citizens can enhance contestability and—thereby put additional pressures on existing political parties and change their incentives, making them more likely to adapt and respond to new societal demands. The section that follows analyzes under what conditions citizens are more likely to use these mechanisms effectively and achieve change.

**Figure 8.8 Dominant party systems are less likely to introduce legal provisions for public funding to political parties, suggesting efforts to narrow the policy bargaining space**



Source: WDR 2017 team based on IDEA Political Finance Database (2016) and the Database of Political Institutions (Cruz, Keefer, and Scartascini 2015). Countries are classified based on the presence of absence of legal provisions for direct public funding to political parties. Income groups reflect the latest categorization by the World Bank.

**Figure 8.9 Political parties are the least trusted political institution; trust in parties also decreases as societies develop, suggesting growing demands and expectations from citizens**



Source: WDR 2017 team based Afrobarometer (Round 6, 2014-2015); Arab Barometer (Wave 2, 2010-11); Asian Barometer (Wave 3, 2012-14); Eurobarometer (2015); LAPOP (2014).

Note: “Average Trust in Public Institutions” is the average of trust in the government, the parliament, the judiciary, the police, and the army. Trust is calculated as the sum of all positive answers. Dotted lines indicate global averages.

## Bringing change through social organizations

### *Understanding the operating environment: Recent trends*

8.33 On April 16, 2016, the International Commission against Impunity in Guatemala (CICIG) released the results of an investigation into an illegal network of bribes established by customs official authorities in exchange for underreporting the value of imported goods, leading to massive tax evasions. Twenty-one suspects were arrested, including the former and the current head of the revenue agency. A few days later, thousands of people gathered in Plaza de la Constitución at Guatemala City to condemn elites' predatory behavior and demand the end of corruption and impunity for politicians, in the largest protest event since the end of the civil war. As the investigation continued, citizen-led protests continued to put pressures on public authorities, raising the costs for national prosecutors not to pursue the criminal cases disclosed by the CICIG (who does not have the power to rule on the cases it investigates), once the scandal escalated to the highest offices.

8.34 The social protests in Guatemala are not unique. Across the world, thousands of citizens have taken to the streets to question the legitimacy of fiscal austerity policies, condemn corruption scandals, and protest for governments' failures to address growing inequalities within societies, among other issues (Ortiz and others 2013; Carothers and Youngs 2016).<sup>9</sup> These trends suggest that ordinary citizens are becoming increasingly able and willing to peacefully mobilize to hold government accountable and voice their discontent when their confidence in public institutions is undermined, and they perceive that formal mechanisms of representation—such as elections and political parties—have weakened their capacity to articulate their interests and channel their demands.<sup>10</sup>

8.35 By coordinating action among citizens around specific issues, social movements can bring to prominence demands and interests<sup>11</sup> (Heller 2013). In doing so, social movements can potentially affect the key dimensions of change in three main ways. First, they can *change the incentives of elites* by increasing the political cost of opposing specific policies. Second, they can *reshape the preferences of actors* through the creation of new collective identities and integration of new interests in the policy arena. Third, they can *enhance contestability* by aligning with actors that can effectively challenge existing elites and limit their bargaining power. These “change” dimensions are often mutually supportive and overlapping because the ability to achieve one of them can increase the chances to fulfill other roles. By acting on these dimensions, social

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<sup>9</sup> The spread of civil society groups and citizens' activism, however, does not necessarily imply their effectiveness in bringing about change. For example, only about 37 percent of the reported protests that occurred from 2006 to 2013 were successful in producing demonstrable achievements and prompting authorities to respond with policy changes and reforms (Ortiz and others 2013).

<sup>10</sup> In other words, rather than simply “exiting” the political process—for example, by abstaining to vote, or even migrating (Hirschman 1970; Clausen, Kraay, and Nyiri 2009)—citizens seek to “voice” their opinions and directly influence the policy bargaining arena.

<sup>11</sup> Social movements are defined by scholars in different ways. This Report uses a common definition among political scientists and sociologists: “*Social movements* [are] a sustained series of interactions between powerholders and persons successfully claiming to speak on behalf of a constituency lacking formal representation, in the course of which those persons make publicly visible demands for changes in the distribution or exercise of power and back those demands with public demonstrations of support” (Tilly 1984: 306).

movements can contribute to broaden the policy debates and push for new laws and policies that rebalance access to (and distribution of) power among groups within societies, including gender equality laws, indigenous territorial rights, and transparency and right to information laws. As mentioned above, social organization can also lead to undesirable social outcomes, opposing reform, creating violence and reinforcing rent-seeking for specific clientelistic groups. In what follows, the chapter emphasizes cases of social organization for positive change.<sup>12</sup>

8.36 Social movements do not appear in a vacuum; rather they are embedded in a broader institutional and socioeconomic environment that shapes the strategies and choices available to political actors. Sociologists usually refer to the notion of “political opportunity” to highlight the role that contextual conditions play to explain why social movements emerge, the mobilization strategies they adopt, and the outcomes they achieve (Tarrow 1998). Over the last 40 years, the institutional environment has become increasingly more permissive for civic activism and social movements: the spread of democratic norms and practices has widened the civic space, with an increasing number of countries enacting laws and regulations aiming to enable and support the formation and functioning of autonomous civic society organizations. Likewise, governments’ interventions aiming to control or censor the media have decreased globally (figure 8.11), allowing independent media actors to bring new issues into the national debate, publicizing social movements’ claims, and magnifying their demands (see spotlight 8). The diffusion of new information and communication technologies has further enabled citizens’ collective action, facilitating access to information, lowering transaction costs for the creation and development of associational networks, and providing effective coordination tools for disadvantaged groups spread across the globe (Bennett and Segerberg 2012). As a result of these processes, social movements are now increasingly organized across national boundaries (figure 8.11), and are becoming an important component “of an emerging (...) global civil society” (Goodwin and Jasper 2015:157).

8.37 Evidence from the past decade, however, suggests that the global trend might be changing toward a shrinking civic space (figure 8.10). Many governments are changing the institutional environment in which citizens engage, setting up multiple legal barriers to restrict the functioning of media and civic society organizations, and reducing their autonomy from the state. These initiatives might include, in the case of media, politically motivated awarding of broadcast frequencies, withdrawal of financial support, or complex registration requirements that raise barriers to entry into a government-controlled media market. In the case of NGOs, government might resort to legal measures to restrict public and private financing, or pass stricter laws that restrain associational rights (Carothers and Brechenmacher 2014). While these initiatives are sometimes motivated by legitimate concerns for public order and national security, they can be used by elites as a strategy to narrow the policy space and limit the channels available to citizens to engage and influence the policy arena.

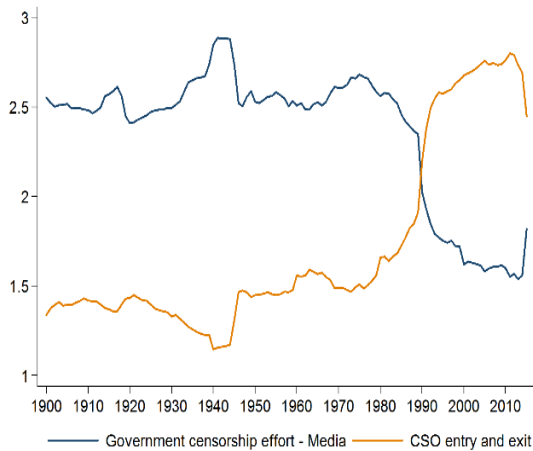
8.38 While these changes in the enabling environment might restrict the space for civic activism, historical and contemporary experiences show that the dynamics of social organizations are not entirely predetermined by the external environment in which they operate. Sometimes favorable conditions do not translate into social mobilization. In other cases, social movements have been

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<sup>12</sup> Khemani and others (2016) label it as “healthy citizen engagement”

successful against the odds and despite operating within a narrow bargaining space.<sup>13</sup> Contextual factors and strategic choices constantly interact to explain the ability of social movements to promote change in incentives, preferences, and the contestability in the policy arena.

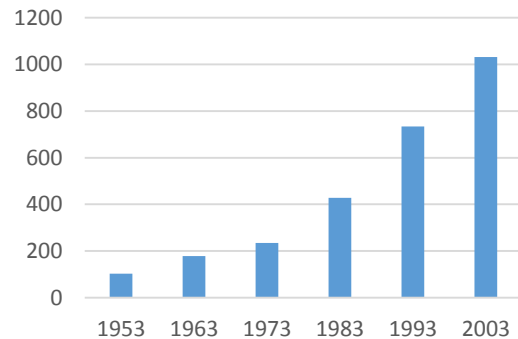
**Figure 8.10 After decades of progress, civic space is shrinking globally, driven by higher governments’ restrictions on media and CSO entry**



Source: WDR 2017 team based on V-Dem (2016).

Note: The scale was reversed for the media censorship variable (low score indicates less censorship). The average is based on a sample of 167 countries, with smaller coverage in 2013–15. CSO = civil society organization.

**Figure 8.11 Taking advantage of the digital revolution, social movements are increasingly organized across national boundaries**



Source: WDR 2017 team based on Smith 2008. The bars measure the number of Transnational Social Movement Organizations (TSMOs), defined as organizations that combine activists from multiple countries around common social change goals.

**Changing incentives: How social organization can effectively build coalitions for change**

8.39 As chapter 7 shows, elites are not monolithic. Groups that are close to the decision making process—which are called elites in this Report—actually have different preferences and interests. Such differences in objectives among the elites can open up potential opportunities for social organization to support change. As Fukuyama (2014), Fox (2015), and other scholars have emphasized, important changes in history come as a result of a coalition between reforming elite members and social organization that supports such change and makes it difficult for other elites to oppose. Economic crises and other external shocks can also trigger change by reducing the veto power of certain actors or signaling the intention of certain groups to defect from the ruling coalition. In the Philippines, for examples, business elites that originally supported Ferdinand Marcos’ coup in 1972 started to defect under pressures of economic decline. When a major event—the assassination of the main opposition leader in 1983—triggered a wave of protests, citizens’ grassroots associations exploited that juncture to forge an anti-Marcos reform coalition—the so

<sup>13</sup> Defining the impact or “success” of social movements continues to be a subject of debate among scholars. On the one hand, social movements are not homogenous organizations, and not all members might perceive a given change as an indicator of success. On the other hand, social movements often generate impact in different areas of human affairs (political, cultural, and social), as well as consequences for individuals and societies at large. These are difficult to disentangle and capture empirically, making causal inferences problematic (Giugni 1999; 2007; Amenta and others 2010).



called ‘People Power’ movement, comprising members of the private sector, representatives of the opposition, religious leaders, and civic organizations. The mobilization culminated in peaceful demonstrations that brought millions of citizens to the streets, eventually forcing Marcos to resign in 1986, paving the way for the restoration of democratic institutions (Blitz 2000).

8.40 When there is no elite actor willing to join a coalition for change, social organization usually requires sustained efforts over a longer period of time, as conditions need to be created for members of the elite to find reasons to join in their own interest. In India, for instance, the Right to Information Act (RTIA) was passed in 2005 after a prolonged struggle lasting 10 years (box 8.1). The initial positive results in Rajasthan were instrumental in boosting the belief that the status quo could be changed at affordable costs, creating a momentum for a nationwide movement. This in turn changed elite incentives, setting the stage for policy change. In other cases, factors like ideology, leadership, and provision of selective incentives can also sustain commitment amid lack of success. Labor unions, for example, sometimes provide social services to members as a way to sustain participation, especially in the aftermath of failed bargains.

**Box 8.1 Social movement and bottom-up pressures for policy reforms: The case of rights to information legislation in India**

Since independence, the Indian government has been operating under the colonial Official Secrets Act (OSA) of 1923. Officially conceived as legal instrument to prevent disclosure of information that can affect security and national sovereignty, in practice the OSA has empowered authorities to withhold information from citizens at their discretion. This has created a culture of secrecy that came to characterize administrative and political practices, seriously undermining the accountability of state institutions. Despite several attempts at reform by technical working groups and parliamentary commissions, the OSA has never been repealed (Mander and Joshi 1999). In the 1990s, a rural-based social movement emerged in Rajasthan, demanding access to information on behalf of wage workers and small farmers. The rural poor were often cheated and not paid their full wages, as they could not challenge the paymasters because they were denied access to attendance registers. The movement eventually spread nationwide, leading to the formation of the National Campaign for People’s Rights to Information (NCPRI) in 1996. Members of the NCPRI built strategic alliances with other societal groups, including journalists, lawyers, and human rights activists, creating a strong constituency for reform that moved demands for transparency to the forefront of the political agenda, and eventually succeeded in pushing adoption of the Rights to Information Act in 2005 (Bari, Chand, and Singh 2015).

***Changing preferences: How social organization can effectively bring new interests in the policy arena***

8.41 As discussed in chapter 7, elite-bargains can have unintended consequences. Sometimes, they can create the conditions for social movements to emerge and bring new interests in the policy arena. In Tunisia, for example, the progress on gender equality during the early period after independence was largely the byproduct of elite bargains—namely, the joint incentives of political and business elites to get skilled labor for the growing manufacturing sector—rather than the outcome of feminist mobilization. However, these top-down policy choices created the enabling environment in which women’s organizations emerged and was strengthened over time. In 2011, the Jasmine revolution provided women’s organizations with a window of opportunity to leverage their organizational strength and successfully lobby for a mandatory gender quota for the elections of the Constituent Assembly, boosting women’s political representation in the National Constituent Assembly to 26 percent. This initial success in turn allowed women organizations to

change elite preferences—shaping the agenda of political parties—leading to the integration of gender provisions in the new constitution (Domingo and O’Neil 2016).<sup>14</sup>

8.42 Likewise, institutional reforms that are primarily driven by elite incentives can nevertheless pave the ways for (unexpected) social mobilization. In Bolivia, for example, the ruling party, confident of having strong electoral base at the local level, introduced local elections and decentralized resources as a strategy to retain power (O’Neill 2003). The 1995 Law of Local Participation provided legal recognition to the territorial rights of peasant and indigenous communities, and institutionalized traditional deliberative processes, allowing over 15,000 grassroots territorial organizations to participate in local planning. This permissive environment in turn lowered barriers to collective actions for previously marginalized groups, opening up opportunities for indigenous movements to participate in local elections and bring new interest in the policy arena (Kohl and Farthing 2006: 125–36).

8.43 Major political events such as wars and post-conflict constitutional design processes can also alter the balance of power within societies, playing the role of coordination devices to enable collective action among marginalized groups to mobilize and influence the policy arena (box 8.2). In Afghanistan, for instance, sustained efforts by domestic women’s organizations—in collaboration with international donors and NGOs—played a key role in changing preferences of members of parliament and state officials within the bureaucracy, influencing the drafting process of a controversial law on the Elimination of Violence Against Women, which introduced criminalization of gender violence for the first time in the Afghan history (Larson 2016).<sup>15</sup>

**Box 8.2 Women’s mobilization and the promotion of gender-based policies in post-conflict settings: The case of Sub-Saharan African countries**

Across the world, women’s political representation is on average higher in post-conflict countries than in countries that have not experienced conflict (figure B8.3.1).<sup>a</sup> This trend is particularly evident in the Middle East and in Sub-Saharan Africa, where women’s presence in parliament is almost double the level of countries with no conflict. Tripp (2015) provides a possible explanation for these patterns, with a focus on Sub-Saharan Africa, where post-conflict countries have been more successful in promoting gender equality laws across multiple policy areas. Rather than looking at a single driver, the study highlights the interaction among three drivers. The first is the disruption in gender relations that is specific to conflict-prone countries, with women taking over many of the men’s traditional tasks, leading to shifts in gender norm (see chapter 4). The second is the rise of domestic women’s movements, facilitated by the inclusive and competitive nature of the post-conflict environment. The third is the influence of international processes and actors involved in the promotion of gender laws and international norms on gender inclusion (further discussed in chapter 9).

The contrasting experience of Rwanda and Angola reflect the interplay and relative strength of these three factors. In Rwanda, women played a critical role within the Rwanda Patriotic Front (RPF), holding executive positions within the movement while in exile. Women activists have been a powerful agent of transformation in the post-conflict period, advocating for greater responsibilities in light of the leadership roles played by women in the armed struggle. Their influence within the RPF is proven by the fact that “during the transitional period, before quotas were established, the RPF consistently appointed women to nearly 50 percent of the seats that it controlled in parliament” (Powley 2005: 5). Moreover, women’s involvement in the constitution-making processes and—later on—in parliament provided them with the organizational strength and legitimacy to advocate for the passage of

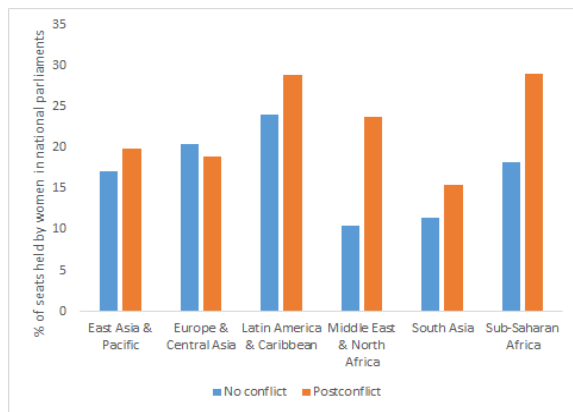
<sup>14</sup> In one specific instance, they also successfully fulfilled a veto-player role and resisted attempts by the Islamic party to undermine women’s family rights, eventually pushing the elites to withdraw regressive clauses from the final legislation, despite the party had the majority in the parliament.

<sup>15</sup> Despite ongoing implementation challenges, the law has become a critical reference point for women’s activists who increasingly use it for litigation purposes, contributing to strengthen gender equality (Larson 2016: 23).

many gender equality and anti-discrimination laws, including the 1999 inheritance law, the 2004 National Land Policy, the 2005 Organic Land Law (Powley 2005), and the 2009 legislation against gender-based violence. This influence also explains why—once the new 2003 constitution introduced a 30 percent women quota in the legislatures—Rwanda far exceeded the target, becoming a frontrunner of gender equality and women’s political participation in the world, with 64 percent of total seats occupied by women, followed by Bolivia (53 percent) and Cuba (49 percent).<sup>b</sup>

In contrast with Rwanda, Angola’s progress in promoting gender policies has been much slower, despite the adoption of gender quotas. This can be explained by the lack of a strong and autonomous women’s movement, a less prominent presence of international donors and development agencies—Angola’s heavy dependence on oil has helped insulate the country from the international pressures and gender norms—and, most importantly, the lack of an enabling environment (including the lack of a peace negotiation process) due to the substantial continuity in the political elites in power at the end of the conflict. This in turn undermined inter-elites competition and closed up opportunities for new groups and interests to emerge in the policy-bargaining arena.

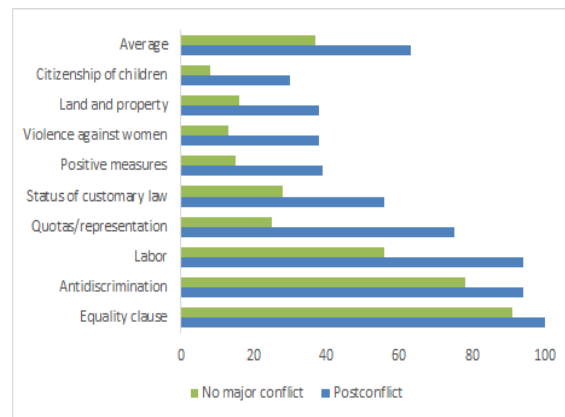
**Figure B8.3.1 The rate of women political participation is up to three times larger countries emerging from conflict**



Source: WDR 2017 team based on UCDP/PRI0 2015; WDI 2016.

Note: The figure indicates the proportion of seats held by women in national parliaments. Post-conflict countries are those that had at least one year of conflict after 1985 with more than 1,000 deaths. Countries with ongoing conflict as of 2014 and high-income OECD countries were excluded.

**Figure B8.3.2 In Africa, post-conflict countries have been more likely to integrate women’s rights in their constitutions**



Source: Tripp 2015: 1275.

Note: The figure shows the percentage of African countries with constitutional provisions relating to women’s rights.

a. This box largely relies and builds upon Tripp 2015.

b. Hunt 2014. For the world classification, see <http://www.ipu.org/wmn-e/classif.htm>.

**Changing contestability: How social organization can effectively use the law to claim rights**

1.43.1 As discussed in chapter 3, law plays different roles: it orders behavior, legitimating social hierarchies and power relationships in society; it can also be used by citizens to contest power and make legal claims to challenge the status quo and push the boundaries of citizenships rights (McCann 2004). It is not a coincidence that the most transformative cases of social movements of the 20<sup>th</sup> century—including labor, women’s rights, and civil rights, and, more recently, indigenous and environmental movements—have all explicitly adopted the language of law and the discourse of rights as *legal* entitlements as “a shared normative base that have facilitate collective action” (Heller 2013: 4).

8.44 Legal institutions of horizontal accountability such as national courts and ombudsmen offices can also be a strategic asset for organized groups of citizens. By ‘activating’ these institutions, social movements can raise awareness about collective entitlements and citizenships rights, forging the collective identities of disadvantaged citizens and raising the salience of individual grievances (Peruzzotti and Smulovitz 2006; Fox 2015). Moreover, the ability to achieve legal victories in court can boost confidence among social actors, strengthening the commitment to organize by effectively using legal instruments in their favor. Mass media campaigns are often used as a complementary strategy to publicize court victories and put the new at the forefront of the national agenda (see spotlight 8 on Media). As the history of US civil rights movements suggests, legal mobilizations have often generated a “contagion effect,” transforming local victories into nationwide struggles for rights (McCann 1994). Similar dynamics are also spreading in developing countries: in Botswana, for example, women’s groups have successfully challenged discriminatory customary laws and pushed for the implementation of gender equality principles enshrined in the constitution by adopting litigation strategies that culminated in a series of victories in far-reaching cases before national courts. (Hasan and Tanzer 2013).

8.45 Citizens can also mobilize through what O’Brien (1996) calls “rightful resistance”: rightful resisters mobilize to request the application of existing laws, such as policies and regulations approved by the central government but often denied by local authorities. In so doing, these groups find supporters and allies among those sectors that have a common interest in the implementation of specific laws and policies. In rural China, for example, local communities refused to pay unlawful taxes levied by local authorities, referring to national regulations that explicitly prohibit local fees to exceed certain limits. In some cases, this mobilization was instrumental for the central government to intervene and ban fees that had been illegally levied by local governments (O’Brien 1996; O’Brien and Lianjiang 2006: 99–102).

8.46 The effectiveness of legal strategies, however, rests on one important assumption: the presence of well-functioning and independent judiciary and a strong network of legal aid experts that can support the claims of social organizations and resist pressures to deny them. Unfortunately, the independency of judiciary is often undermined in many countries, leading some scholars to criticize the faith placed in courts as mechanisms of social change as nothing more than ‘hollow hope’ (Rosenberg 1991). Other studies, however, contend that the spread of international courts and legal bodies associated with international human rights laws provide social movements with additional toolkits to overcome the limitations of state courts and change the incentives of elites, pushing for compliance with laws and regulations ratified by national governments (Keck and Sikkink 1998). The role of these international instances is explored in chapter 9.

### ***Why social organization is not enough to bring change***

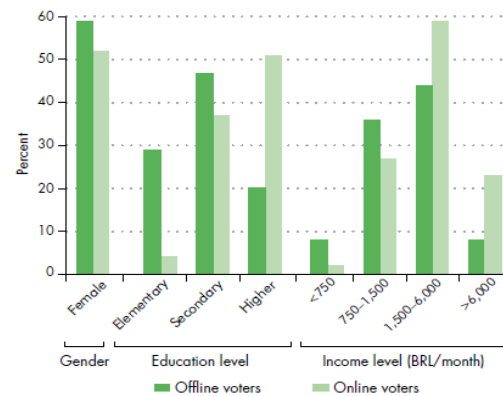
8.47 Social movements might be successful in giving voice to powerless groups and putting pressures on public authorities, but often fail to consider the tradeoff associated with the proliferation of competing interests in the policy arena. In many developing countries, state capacity is weak and political parties are often unable to perform their function to filter these demands and subordinate them to higher public priorities. In these circumstances, public institutions might be quickly overloaded with multiple pressures, undermining the coherence and effectiveness of public policies. This can generate frustrations and discontent among citizens that,

if not properly addressed, can eventually lead to violence, conflict, and political decay (Huntington 1968). Chapter 4 explores in depth violence as a manifestation of governance failure.

8.48 Moreover, social organization is not necessarily motivated by a vision of more equal and just society. On the contrary, they can also be used by reactionary and extremist groups for exclusionary purposes. As Heller (2013) contends, “There is nothing about associational life that is inherently democratizing. Associations can be formed to pursue narrow interests, and many associations are clearly uncivil, devised to deny other groups their associational rights (e.g., anti-Muslim groups in India, and the Klu Klux Klan in the United States).”

8.49 Finally, as mentioned above, social movements might be captured by narrow interest groups whose preferences might be over-represented, reinforcing existing inequalities rather than overcoming them. As Mansuri and Rao (2013)—following Devarajan and Kanbur (2012)—contend, participatory approaches to development rarely consider the possibility of “civil society failures,” understood as the risk that “communities, however constituted, may also face significant problems of coordination, asymmetric information, and inequality, which may limit their ability to respond to and resolve market and government failures.” This explains why efforts to “export” participatory budget initiatives sometimes do not work (Baiocchi, Heller, and Kunrath Silva 2011). Such failures are not necessarily ameliorated by the availability of new digital technologies (Gaventa and Barrett 2012). On the contrary, as discussed in WDR 2016, ICT instruments might actually reinforce socioeconomic inequalities in citizens’ engagement. In Brazil, for example, the use of internet voting on municipal budget proposal reveal stark demographic differences between online and offline voters—online being more likely to be male, university educated, and richer (figure 8.12).

**Figure 8.12 Citizen engagement in participatory budgeting via online voting can reinforce existing inequalities**



Source: WDR 2017 team, based on Spada and others 2015. R\$ = Brazilian real.

### The role of public deliberation

8.50 In these contexts, spaces and processes that allow group-based deliberation and weighting of alternative preferences can be more effective to level the playing field and leverage marginalized groups’ efforts to re-balance power relationships in their favor.

#### Understanding citizen’s agency as a collective action problem: Entry points for change

8.51 This chapter has analyzed the role that ordinary citizens play in driving processes of societal transformation and institutional change. Surveying historical and contemporary experiences, it argues that citizens’ face collective action problems that prevent them to effectively bargain and hold government to account. To strengthen their influence in the policy arena, citizens need to engage through multiple mechanisms designed to solve collective action problems including voting, political parties, social movements, civic associations and other less-

conventional spaces for policy deliberation. Since all these expressions of collective action are imperfect, it is their strategic combination that maximizes the chances to promote change and make governments more responsive to citizens' needs.

8.52 An important pattern emerging from the chapter is that citizens-led change is possible, but it is often a difficult and long-term process fraught with uncertainties. In India, grassroots organizations spent 10 years to scale-up local mobilization efforts, translate rural activism into a multi-stakeholder coalition for reform, and finally be able to shift incentives of state authorities toward the adoption and implementation RTIA legislation. In Uruguay, labor associations and sections of the working class started to challenge the clientelist apparatus of the state since early 1970s, but it took them three more decades to strengthen their organizational structures and expand their support base among urban sector to promote change.

8.53 The analysis of the chapter highlights multiple drivers whose interaction can contribute to lower barriers to collective action and facilitate citizens' mobilization through the mechanisms identified above: *first*, institutions that enhance 'contestability' in the policy arena—such as media regulations, political finance regulations, constitutional provisions that establish mechanism to protect citizens rights, etc.—can create the 'enabling environment' for citizens' agency by facilitating cooperation and promoting more inclusive and equitable bargaining spaces. Often the outcome of elite bargains, these institutions can nevertheless open up opportunities for previously marginalized groups to mobilize and bargain for their collective interests. *Second*, external shocks—i.e. corruption scandals, economic crises—can act as important triggers that help citizens overcome otherwise unfavorable circumstances and create opportunities for change. *Third*, coalition-building strategies matter for results: chances to promote institutional change and policy reforms are maximized when the incentives of reformers 'from above' (elites) and mobilization 'from below' (citizens) converge and mutually reinforce each other against defenders of the status quo (Fox 2015). This points at the important role that agency and leadership plays in seizing windows of opportunities for action.

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## **Spotlight 8 Media**

S8.1 Under the presidency of Alberto Fujimori in Peru, ruling elites systematically bribed politicians, judges, and news media companies to weaken accountability and coopt opposition. The architect of the system, Fujimori's security chief Vladimiro Montesinos, kept a detailed record—both on paper and on video—of all payments made. Montesinos was unable to secure support of one TV channel, which rejected bribes and continued to publicize independent analysis and investigations on the regime's performance (McMillan and Zoido 2004). It was this TV channel that made public the first “*Vladivideos*” in 2000, uncovering the magnitude of the corruption and rent-seeking behavior of elites. The popular outrage generated by the disclosure of the videos helped opposition forces mobilize, leading to the disintegration of the regime and ouster of Fujimori a few months later.

S8.2 This case highlights the central role that the media can play as an agent of accountability. By publicizing information that is reliable and salient for citizens, the media can make the policy arena more contestable, change the incentives of elites by increasing costs of certain behavior or policy decisions, and reshape preferences (Khemani and others 2016). Precisely because of their role, however, media can be captured by powerful interests and undermine—rather than support—possible entry points for change.

### **Changing contestability: The political economy of media capture and competition**

S8.3 Controlling media is one instrument through which elites bargain. Elites can capture the media to shape coverage and content, reducing contestability. Bribery is one strategy, and as shown in Peru, it can be especially valuable. Bribing the media was 10 times more expensive than bribing legislators and judges in the Fujimori regime. The television channel with the largest viewership received \$US1.5 million monthly (McMillan and Zoido 2004). Another strategy governments can use is to adopt regulations that favor a specific media outlet or buy advertising space in exchange for political support. For instance, in Argentina, the amount of coverage of corruption scandals significantly decreased for newspapers that received government-related advertising from 1998 to 2007 (Di Tella and Francheschelli 2011). Private interests can also capture media market: as of 2016, about 6 percent of all billionaires are involved in some media business, reaching peaks of more than 20 percent in countries like Mexico, Poland and Venezuela<sup>1</sup>. Other research shows that media capture by narrow interest groups is more likely when media ownership is more concentrated and income inequalities are higher (Corneo 2006; Petrova 2008).

S8.4 These findings suggest that more competition and entry into the media market is fundamental as a way to increase the contestability in the policy-making arena. Ensuring the media's independence from government ownership works toward the same effect. However, ownership of media and press freedom are also the by-product of elite bargains and power relations, creating an equilibrium that is difficult to change. One important factor driving the growth of independent media is the advertising market. Independent media are more likely to emerge in places with higher advertising revenues, a study of U.S. newspapers in the 1800s shows (Petrova 2011). When advertising revenues increase, media outlets have alternative revenue sources and thereby less willing to distort news coverage to protect the interests of subsidizing

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<sup>1</sup> WDR2017 team based on Forbes List of Billionaires.

groups, especially if such distortion undermines their ability to secure advertising revenues. Beyond this advertising's effect, elite bargains can open up opportunities for more competitive media markets and lead to unexpected changes in contestability. In Malaysia, for example, ruling elites invested in internet infrastructure as a way to attract foreign investment. This led to a “democratizing” effect in the media market, with independent bloggers publicizing news on government performance. This has had an important effect on voting behavior: in districts with higher internet access, the loss of political support for the ruling party has been more pronounced (Miner 2012). Similar effects have been found in Russia, where the access to a privately owned and independent television channel (NTS) was associated with higher propensity to vote for the opposition (Enikolopov and others 2009).

**S8.5** Media content is often decided by elites. The effect of media bias as an instrument to reduce contestability, reinforce prior beliefs, and increase polarization among social groups is well documented in the literature (Strömberg 2015, 2016). Elites can also use media as a coordinating device for propaganda purposes and—in extreme cases—for repression. For example, 10 percent of the reported killings during the genocide in Rwanda have been attributed to radio broadcasting, which facilitated militia targeting of the Tutsi population (Yanagizawa-Drott 2012).

S8.6 New social media can counteract elite control of the media market, under certain circumstances. The anti-G20 movements following the world economic crisis in 2008 (Bennett and Segerberg 2011), the Occupy Wall Street movement, the Arab Spring, and the massive protests that erupted in Brazil surrounding the 2014 World Cup (Lemieux and others 2015) all demonstrate the instrumental role played by the internet and new social media in facilitating citizens' collective action. The same events, however, also highlight the limitations of social media. They can be effective in generating sudden spikes of protests and coordinate uprising, but cannot alone yield sustained representation of interests and promote social change (Ackland and Tanaka 2015). To follow the terminology of the 2016 *World Development Report* (WDR) on digital dividends, “analog” complements are needed to maximize the potential of social media as drivers of change. Political and social organizations can act as such complements.

### **Changing incentives: The watchdog role of media**

S8.7 Media can also play a role as “public sentinels” (Norris 2013), generating and publicizing information about government performance, shaping incentives of politicians to deliver, and making governments more responsive to voters, thereby improving the quality of public policies. By making information public, media companies can strengthen the bargaining power of citizens, increasing the costs for public officials to engage in rent-seeking behavior (see chapter 8). Media can facilitate the efforts of civic associations to mobilize citizens around an anticorruption agenda and help citizens monitor the quality of government services, acting as important agents of “social accountability” (Peruzzotti and Smulowitz 2006). In Uganda, for example, elite capture undermined public service provision, with local schools receiving only 24 percent of central government grants they were entitled to, on average. After a media campaign publicized the amount the schools were supposed to receive, the average funding increased to 80 percent, improving school enrollment and learning outcomes. The effects were larger in schools that were closer to a newspaper outlet (Reinikka and Svensson 2005).



S8.8 Access to media makes government more responsive to citizen needs. For instance, a comparison of Indian states from 1958 to 1992 finds that government spending was more responsive to local needs in areas where newspaper circulation was higher (Besley and Burgess 2002). However, this type of relationship can also generate biases against citizens without access to media, especially poor living in rural areas (Strömberg 2015).

### **Reshaping preferences: The agenda-setting role of media**

S8.9 As discussed in WDR 2015 on mind, society, and behavior, media can play an important role in reshaping preferences and social norms within societies.<sup>2</sup> Media “both entertain and educate, in order to increase audience members’ knowledge about an educational issue, create favorable attitudes, shift social norms, and change overt behavior” (Singhal and Rogers 2004, 5). A growing body of studies based on randomized control trials and quasi-experimental design provides empirical support to this claim, pointing at the transformative potential of “educational entertainment” (or “edutainment”). For example, in Brazil, watching a soap opera with female characters with few or no children has been associated with significant drops in fertility rates, changing preferences for family size (La Ferrara, Chong and Duryea 2012). In India, access to television improved gender norms, son preference, and decreased fertility (Jensen and Oster 2009). In Tanzania, exposure to a radio program was associated with a significant increase in condom use and reduction in the number of sexual partners (Vaughan and others 2000). In Rwanda, exposure to radio programs changed citizens’ attitudes toward authorities, promoting more pro-social behavior and more active participation in conflict resolution (Paluck and Green 2009).

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<sup>2</sup> This section largely relies and builds upon WDR 2015. A background paper for that Report, “The Impact of Entertainment Education,” provides a recent review of the literature, analysis of selected cases, and evidence on results.

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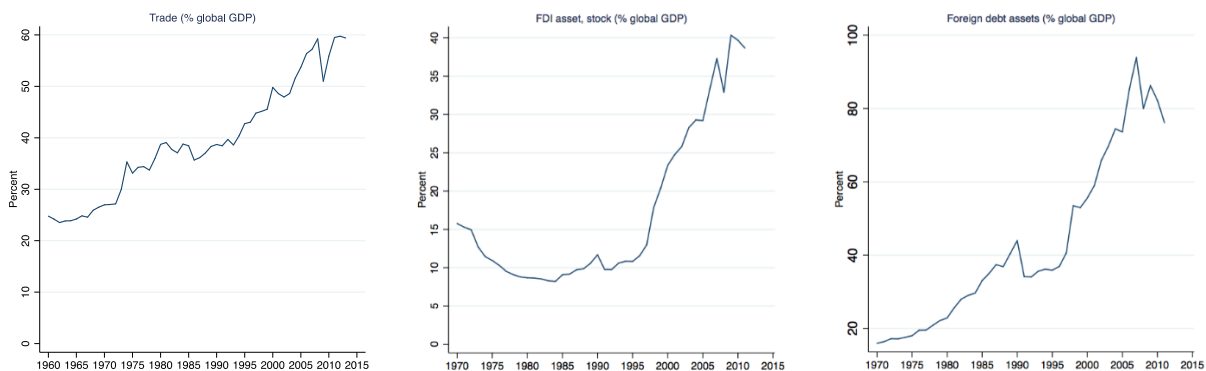


## Chapter 9 International influence

### Governance in an interconnected world

9.1 The dynamics of governance do not occur solely within the boundaries of nation-states. Countries today face an interconnected, globalized world characterized by a high velocity and a high magnitude of “flows” in terms of capital (portfolio flows and direct investment), trade (goods and services), ideas (technology and norms), and people. The share of global trade to global GDP more than doubled, from 25 percent to over 60 percent from 1960 to 2011. The share of foreign direct investment (FDI) in global GDP increased from less than 10 percent to over 40 percent from 1992 to 2010. Meanwhile, the share of foreign debt to global GDP grew from only 11 percent in 1970 to 90 percent in 2010 (figure 9.1). These increased flows over the past four decades have had profound effects on domestic growth, equity, and security outcomes—both directly and indirectly through their effects on governance dynamics. This world is very different from the one in which today’s developed countries emerged: cross-border flows were low; they received no aid; they were not subject to a proliferation of transnational treaties, norms and regulatory mechanisms. For developing countries, the era of globalization and ‘global governance’ presents both opportunities and challenges.

**Figure 9.1 Global flows of aid, trade, debt, and FDI have increased in recent years**



*Source:* WDR 2017 team based on World Bank World Development Indicators (ODA and trade) and the updated and extended version of dataset constructed by Lane and Milesi-Ferretti 2007 (FDI and foreign debt assets).

*Note:* FDI = foreign direct investment; ODA = official development assistance.

9.2 Increased flows are one dimension of globalization, a multifaceted phenomenon that potentially can greatly benefit countries in search of sustained and inclusive development. The rapid diffusion of technology and greater access to capital and world markets have enabled annual growth rates of over 7 percent for a subset of developing countries, a previously unfathomable rate of growth (Spence 2011). Such rapid growth and technology transfer helped lift over one billion people out of poverty from 1981 to 2012. International actors and international instruments for investment, trade, and cooperation can also help generate coalitions for positive change. And increased flows of development assistance have helped countries break out of poverty and conflict traps.

9.3 Globalization also has costs, and can present great challenges. By making it possible to send money and resources abroad, transnational flows increase the capacity for domestic actors to “opt out” of local bargains (see spotlight 9 on international illicit financial flows). These flows have also led to a marked rise in inequality, both within and across borders, and to a greater vulnerability to global economic trends and crises, as experienced through the 1997 Asian Financial Crisis and 2008 Global Financial Crisis. Global interactions can undermine domestic social and economic development by exerting power in ways that prevent the adoption of policies fit for context, or by reinforcing preexisting conditions which sustain outcomes that are socially undesirable. In the case of international actors and organizations seeking to help countries develop through aid and technical assistance, these unsuccessful interventions can be labeled *development assistance failures*. Development assistance failures are *not* unavoidable or intractable. Like market failures and government failures, they can be addressed.

9.4 Maximizing the potential positive impact of international instruments to achieve security, growth, and equity requires an understanding of the domestic policy arena, and, in particular, how these flows impact the contestability in the policy arena, shape the incentives of domestic actors, and influence their preferences to change outcomes. Failure to do so can nullify the effect of interventions and or have other unintended negative consequences in the domestic sphere.

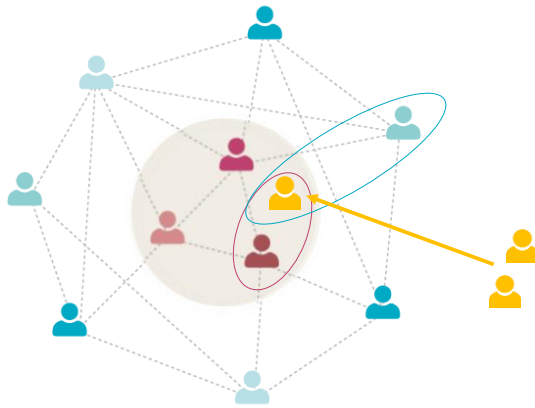
***Today’s interconnected world alters the domestic policy arena***

9.5 International actors can shape the domestic policy making and implementation process by supporting, co-producing with, or substituting for national actors. This can serve to enhance the ability of domestic actors to commit, coordinate, and cooperate to advance development outcomes, but can also serve to disrupt these functions by confusing expectations, competing with social norms, and undermining citizen-state accountability.

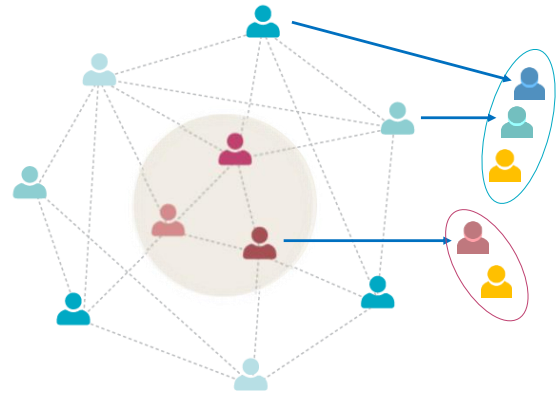
9.6 The policy bargaining framework discussed in this Report provides a lens for looking at the influence of international actors and factors. At times, international actors enter directly into the policy arena (figure 9.2, panel a). In these cases, multinational corporations, development agencies, or transnational nongovernmental organizations (NGOs) can gain a seat at the domestic bargaining table as they pursue specific goals or support domestic efforts that are aligned with their interests. However, in most cases, international actors and mechanisms affect the policy arena by shaping it indirectly. They can change the contestability of the policy arena by creating alternative spaces in which actors can bargain (figure 9.2, panel b). They can change the incentives of domestic actors by changing the payoff structure that they face for making particular decisions (by enabling collective action around a particular framing of an issue or providing direct resources to particular groups, for example) (figure 9.2, panel c). Or they can shift preferences by directly influencing the ideas and beliefs held by domestic actors (figure 9.2, panel d).

**Figure 9.2 International actors can affect the domestic policy arena by changing the dynamics of contestation, shifting actor incentives, or shaping actor norms**

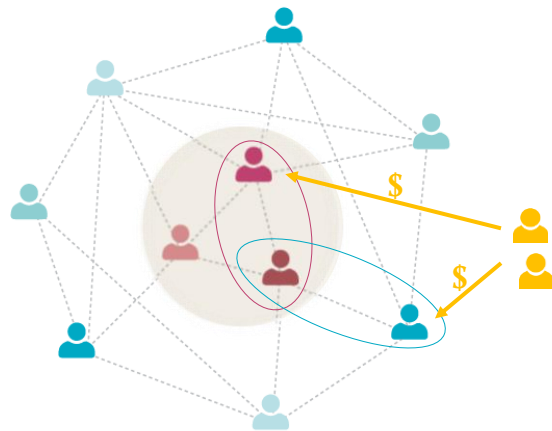
*a. International actors can themselves enter the policy arena*



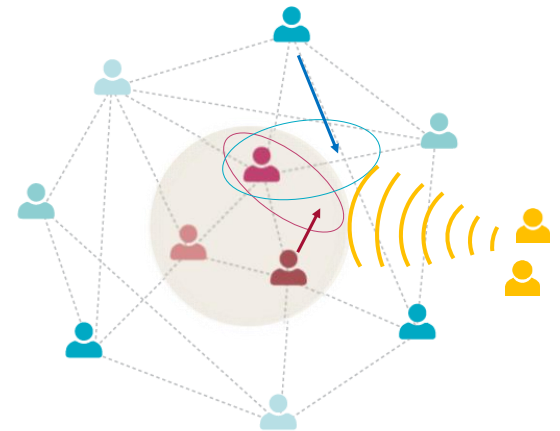
*b. International actors can provide alternative sites for contestation*



*c. International actors can empower or shape the incentives of citizens and/or elites by providing resources*



*d. International actors can shift the preferences of citizens and/or elites*



Source: WDR 2017 team.

9.7 International actors can shape the arena in which policy making and contestation occur: for example, by providing—or closing off—alternative forums for actors to promote their interests, such as international organizations and regional and international courts. For instance, courts and arbitration mechanisms allow stakeholders to protect their rights beyond domestic institutions. Appealing to courts in Australia enabled Papua New Guineans affected by the toxic waste of a mining company to negotiate new agreements reallocating the benefits and costs of the mine (Kirsch 2006). In Myanmar, residents reached a settlement for compensation for human rights abuses during construction of an oil pipeline by Unocal after filing suit in a United States court. Using an investor-state dispute settlement (ISDS) provision, U.S.-based waste treatment company

S.D. Myers successfully sued the Canadian government in an external arbitration tribunal for banning the export of toxic PCB waste, as the ban harmed S.D. Myers' business, even though Canada had pledged to ban exports of PCB waste as a signatory of the Basel Convention (which the U.S. had not signed).

9.8 Transnational flows and mechanisms can change the payoff structure and incentives of domestic actors by providing inducements or threats. For instance, conditions attached to foreign aid (conditionality) makes assistance dependent on specific behavior by domestic actors. Similarly, the desire to attract foreign investment can incentivize positive changes in domestic governance. For instance, the pursuit of foreign investment in Vietnam and China spurred institutional improvements for economic management at the provincial level, with greater flows leading to greater institutional reforms (Dang 2013; Long and others 2015). International trade agreements may help change the incentives of domestic actors and serve as a commitment device. A government may sign a trade agreement to tie its hands in the face of domestic vested interests that might induce it to implement suboptimal policies, such as high tariffs (Maggi and Rodriguez-Clare 1998, 2007).

9.9 International actors and transnational interactions also help shape the preferences of actors in the domestic policy bargaining arena. Improvements in technology, by facilitating greater global connectivity, have helped spread international ideas and norms. In addition, transnational networks of technical experts can play an important role in changing preferences and internalizing new norms through the diffusion of evidence and authoritative expertise.<sup>1</sup> In China, for example, international interactions of experts with the National Environmental Protection Agency (NEPA) introduced new perspectives, peer standards, data, and research findings that NEPA drew on to shape the debate over accession to the Montreal Protocol, shifting the perspectives of various other political actors and successfully bargaining against more domestically grounded agencies, including the State Meteorological Administration (Economy 2001). Beyond finance and other forms of leverage, development actors can be most influential through the dissemination of expertise and evidence that can significantly change domestic policy dialogue.

9.10 This chapter provides a lens for looking at how international actors can influence domestic governance dynamics through two primary instruments: the introduction and diffusion of transnational rules, norms and regulations; and overseas development assistance (aid). In discussing both instruments, the chapter focuses on the mechanisms through which these instruments act on the contestability of the policy arena and the incentives and preferences of actors in the arena.

### **Transnational rules and regulations: Enhanced cooperation and focal points for change**

9.11 As the velocity of flows across borders increases so too do the instruments and mechanisms that are used to manage these flows (figure 9.3). Since the late twentieth century, there has been an ever increasing number of international and transnational efforts to govern activities, relationships, and behavior that transcend national frontiers (Finklestein 1995). This is due, in part, to the nature of today's global challenges—such as climate, finance, and cross-border crime—

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<sup>1</sup> Haas (1992) describes an epistemic community as “a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy relevant knowledge within that domain or issue-area.”

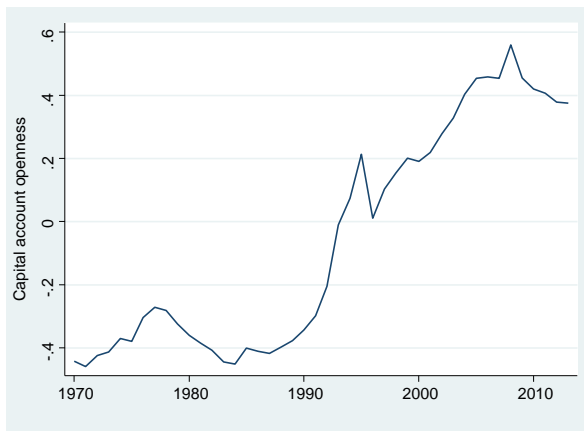


which require solutions that go beyond the traditional state model of regulation. Unlike traditional international relations, these transnational efforts involve a broad array of actors, including nation states, multilateral organizations, private actors, and advocacy groups, covering a wide range of issues, including business transactions, labor, crime, information management, intellectual property, procurement, utility regulation, human rights, food and safety standards, and environmental sustainability (Hale and Held 2011).

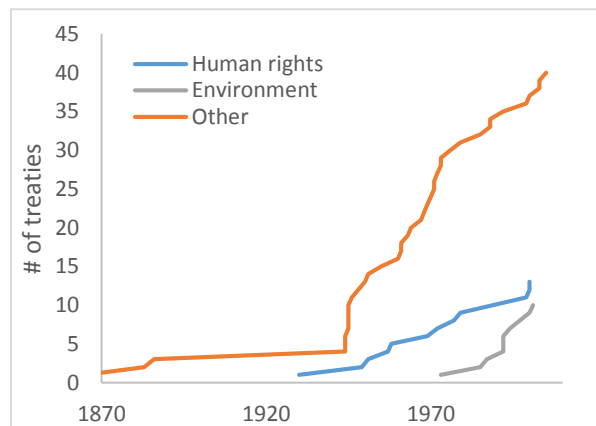
9.12 Much of this proliferation of regulation has been in pursuit of further deregulation, as exemplified by the increasingly liberalized *de jure* openness of capital accounts (figure 9.3, panel a). Other regulations and treaties are intended to enhance coordination on issues of global import. Today, for instance, there are over 1,000 multilateral and more than 1,300 bilateral environmental agreements (Green 2014).

**Figure 9.3 Regulations and legal agreements have proliferated across borders**

a. Average (*de jure*) capital account openness across countries



b. Number of United Nations treaties with more than 170 signatories



Source: WDR 2017 team based on updated database from Chinn and Ito 2006.

9.13 The formation and diffusion of this overlapping web of transnational rules mirrors this Report's framework on a transnational level. The nature and content of each regime is a product of contest among multiple actors with varying incentives, preferences, and relative power. They are institutionalized in some form of instrument, on a spectrum from authoritative/binding legal instruments to nonbinding declarations of norms and voluntary standards and regulatory regimes.<sup>2</sup> These instruments perform the functions of commitment, coordination, or cooperation through various mechanisms, from coercion to socialization (table 9.1). As various examples in this chapter illustrate, they might directly target state governments, as do European Union fiscal and monetary rules, or labor and tax standards aiming to avoid a race to the bottom. They might bypass state governments to directly regulate private actors, as do voluntary industry regimes such as the

<sup>2</sup> Transnational rules are similar to what are called "international regimes" in the international relations and international political economy literatures. See, for example, Ruggie 1975, and Krasner 1983.

Roundtable on Sustainable Palm Oil. Or they might reach directly to citizens by legitimating local grievance through international rights and norms (Braithwaite and Drahos 2000; Shaffer 2013).

**Table 9.1 Transnational actors, instruments, and mechanisms for influencing domestic governance through incentives, preferences and contestability**

ACTORS	INSTRUMENTS	MECHANISMS
International governmental organizations <ul style="list-style-type: none"> <li>• United Nations (multiple agencies)</li> <li>• International Financial Institutions</li> <li>• World Trade Organization</li> <li>• International courts and tribunals</li> </ul>	Legal and rule-based instruments <ul style="list-style-type: none"> <li>• International and regional treaties and conventions</li> <li>• International and regional standards, principles, guidelines</li> <li>• Bi-lateral treaties</li> <li>• Voluntary standard and norm regimes</li> <li>• Contracts</li> <li>• International courts and arbitration mechanisms</li> </ul>	Incentives <ul style="list-style-type: none"> <li>• Coercion (economic, military, political)</li> <li>• Rewards</li> <li>• Reciprocity</li> </ul>
Regional organizations <ul style="list-style-type: none"> <li>• European Union</li> <li>• African Union</li> <li>• ASEAN</li> <li>• OECD</li> </ul>	Expert knowledge and evidence	Preferences <ul style="list-style-type: none"> <li>• Knowledge and capacity transfer</li> <li>• Persuasion</li> <li>• Socialization</li> <li>• Demonstration</li> </ul>
International non-governmental organizations <ul style="list-style-type: none"> <li>• Multinational corporations</li> <li>• Professional associations</li> <li>• Advocacy organizations</li> <li>• Epistemic communities</li> </ul>	Public and private capital flows	Contestability <ul style="list-style-type: none"> <li>• Coalition building</li> <li>• Substitution for domestic arena</li> <li>• Empowerment</li> </ul>
Domestic actors <ul style="list-style-type: none"> <li>• Government officials</li> <li>• Political actors</li> <li>• Private sector actors</li> <li>• Local civil society groups</li> <li>• Grassroots organizations</li> </ul>	Migration and professional exchanges	
	Security operations	

Sources: WDR 2017 team, drawing on Braithwaite and Drahos 2000; Finklestein 1995; Hale and Held 2011; Shaffer 2013.

9.14 This chapter looks at three types of transnational rules. First, it looks at those rules which seek to achieve a global good through enhanced *cooperation*. To achieve international cooperation, it is essential to align the interests of the elite decision makers through both ‘carrots’ (inducements) and ‘sticks’ (sanctions). This is discussed in the context of global coordination to prevent free-riding and races to the bottom to attract capital and trade.<sup>3</sup> Second, it looks at rules that help induce domestic reform through incentives—trade and regional integration—helping to generate credible *commitment* of domestic actors. Here, the discussion focuses on EU integration and GATT/WTO accession. Third, it looks at those rules which serve as focal points for domestic actors to improve *coordination* and overcome collective action challenges. The adoption of transnational rules can

<sup>3</sup> A race to the bottom is an uncooperative process of policy making in which a country is constrained by the policies made by other countries.

become focal points that change ideas and help lead to the diffusion of international norms by enhancing the bargaining power of supporters through transnational networks. This is discussed in the context of human rights and transparency norms.

### ***Preventing free-riding and races to the bottom***

9.15 In the same way that firms in a perfectly competitive market lower prices in order to attract consumers' demand, whenever goods, services, and capital are freely exchanged and move internationally, countries have an incentive to adopt competitive strategies to gain market shares or attract investment.

9.16 Such efforts to attract investment can provide positive incentives for improvements in domestic governance (see next section); however, at other times, strategies to attract greater investment and gain a greater share of global trade lead to suboptimal domestic policies. Such strategies involve lowering tax rates on capital to attract foreign investment, lowering sales taxes to encourage foreign consumption, lowering sales prices to increase export of goods and services, but also decreasing welfare benefits to make labor cheaper or reducing benefits to repel immigration. These are examples of *races to the bottom*. Whereas competition among firms allows social welfare to be maximized, these races to the bottom push countries toward inefficient equilibria that tend to reinforce initial inequalities in welfare and power within and among countries.

9.17 In an open economy—provided that income is taxed at the source—capital will flow from high-tax to low-tax countries until competition brings tax rates to zero everywhere (Razin and Sadka 1991). Similarly, taxes on commodities cannot survive if consumers can easily shop across borders. Along the same lines, to attract productive investments, countries may decrease taxes on corporate income for foreign companies. Competition among countries on these forms of taxation has the effect of emptying the domestic tax base and considerably decreasing revenue, and also tends to shift taxation onto less mobile factors, such as labor. In turn, lower revenue means that countries need to shrink spending, with major detrimental effects on the well-being of the poorest and least powerful in society. Moreover, competition among developing countries to boost exports may result in decreasing labor and environmental standards (Chau and Kanbur 2005).

9.18 This may be particularly problematic given that increased global integration itself increases economic vulnerability. When economies are exposed to external risk, it may be optimal for the government to serve a risk-reducing role. However, when governments face low revenues, they may turn to government consumption—increased public employment and in-kind transfers—to offset risk. These measures may be inefficient from a societal perspective, but are politically necessary or expedient. Indeed, in those developing countries with greater trade openness in the 1960s, government consumption grew more in the three decades that followed (Rodrik 1998).

9.19 Once competition pushes countries to a low equilibrium, they have no incentive to change policy. Any attempt of one country to raise taxes on good and services, capital, or corporate income would result in a loss of sales or investments. Any intervention that could enhance employees' welfare or the sustainability of production would also raise costs and hence reduce output and exports. Because of the sensitivity of global capital to domestic adjustments and perceptions of investment risk, policy makers seeking global investment may become largely accountable to

external actors, rather than to domestic constituents. For instance, policy makers seeking to increase domestic debt levels to finance an expanded education budget may be prevented from doing so by the fear that international ratings agencies will downgrade their sovereign bond rating and lead to capital flight.

9.20 Global coordination is needed to prevent races to the bottom, underprovision of global public goods, and negative cross-border externalities. International factors can strengthen the commitment capacity of states through agreements on specific issues—such as investment or environmental standards, labor standards, or tax coordination. If all countries coordinate and adopt the same policy, such as international labor standards (Basu and others 2003), they can move to a welfare-enhancing equilibrium. For instance, in parallel with the creation of a common market, the European Union set up a Code of Conduct to prevent countries from engaging in harmful tax competition and to harmonize value added taxes on goods and services, and, less successfully, corporate taxes and capital income taxes.

9.21 Such agreements can strengthen the commitment of countries to specific minimum standards that prevent the occurrence or perpetuation of an undesirable equilibrium. However, states are self-interested actors, and transnational rules do not override their self-interest; rather, the rules themselves reflect the self-interest of states (Keohane 1984). In the case of races to the bottom, incentives to defect from an international agreement are very high when credible sanctions for defection are not present. Preventing defection requires a recognition that international negotiation involves negotiations both with other nations and with various domestic actors: that is, it is a “two-level game” that also entails a domestic bargaining process. Ideally, sanctions can be targeted, so that the actors who benefit from defection are the same actors who suffer from sanctions. However, achieving this one-to-one correspondence requires information about and understanding of the domestic policy arena. Ultimately, the preferences and relative power of relevant domestic actors determine that credibility of commitment and the effectiveness of international sanctions.

***Transnational rules to induce credible commitment for domestic reform: the role of trade agreements***

9.22 Efforts to attract investment and expand trade can provide positive incentives for improvements in domestic governance; international agreements on economic integration can provide credible commitments that domestic actors will follow through on economic reforms. The success of the European Union (EU) integration process, for example, demonstrates the power of inducements. Prospective member countries had to change domestic rules to abide by 80,000 pages of regulations in the *acquis communautaire*. For those countries, the potential economic benefits of joining the EU outweighed any loss of domestic autonomy in specific areas, and the benefits of accession were used by elites to overcome domestic resistance to the required reforms. EU membership contributed to the consolidation of democratic institutions in former dictatorships in the European periphery, such as Greece, Portugal, and Spain in the 1980s and central and eastern European countries in the former communist bloc in the 1990s and 2000s.

9.23 Trade agreements have been particularly effective, leading to significant domestic reforms. The possibility of accession to the General Agreement on Tariffs and Trade/World Trade Organization (GATT/WTO) has induced considerable domestic reforms in nations that seek to

develop through global trade. WTO accession has had the strongest growth-promoting effects in countries that undertook deeper commitments as part of their accession negotiations, including China and Vietnam. Moreover, this pro-growth effect of accession was strongest in countries with the weakest domestic governance (Tang and Wei 2009).

9.24 In China, the process of WTO accession at the turn of the millennium led to a major restructuring of the economy towards more market- and rules-based mechanisms, with accession acting as a “wrecking ball” for the closed command economy (Woo 2001; Jin 2002). China’s leadership leveraged foreign competition and external commitment to accelerate domestic reforms, including reductions in tariff and nontariff barriers, greater market access for foreign firms, and greater intellectual property protection. By many measures, China’s commitments to liberalize trade in services have been the most radical of any country acceding to the WTO (Mattoo 2004). The accession helped China’s leadership overcome domestic opposition to reforms, and also signal to the emerging private sector that reforms were credible. The reforms enhanced the commercial legal environment and forced SOEs and state-owned banks to restructure and compete on a market basis, facilitating a more modern financial system, a growing private sector, and rapid economic growth (Lardy 2002).

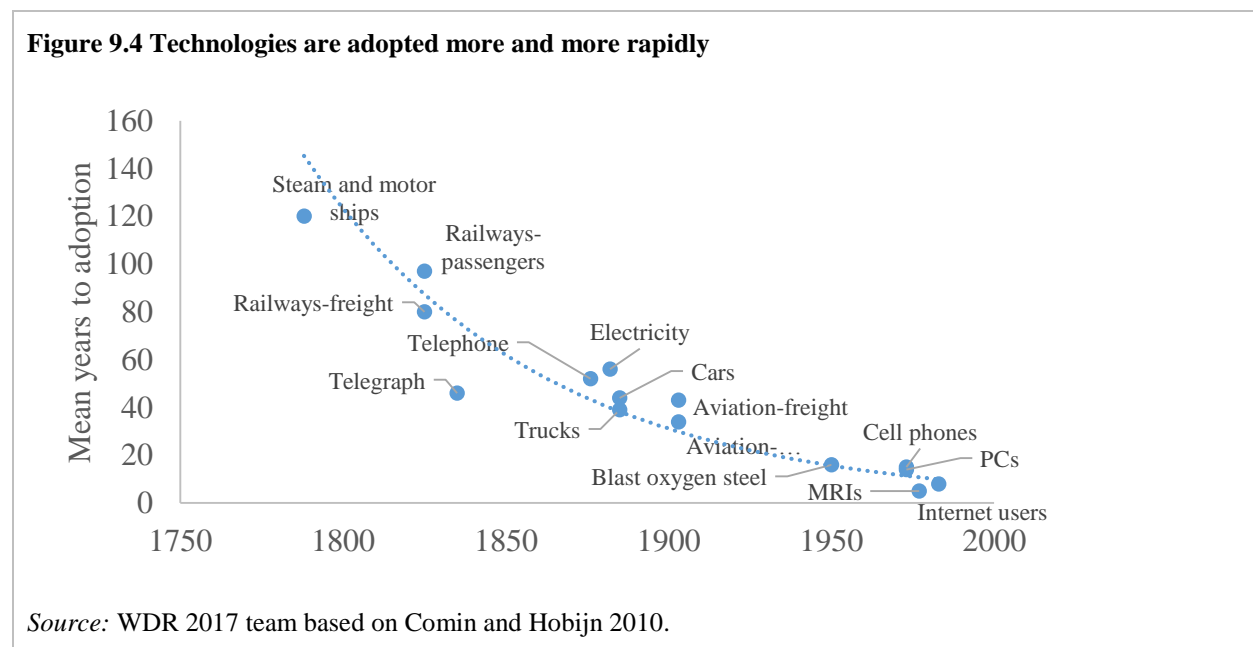
9.25 Or consider the emergence of the Multi Fibre Arrangement (MFA) beginning in 1973 under the General Agreement on Tariffs and Trade (GATT). Under U.S. pressure to protect its domestic clothing industry, the MFA set quotas for textile exports from developing countries, but excluded some of the world’s least developed countries from the quota system. This gave “quota rents” to countries such as Bangladesh, Cambodia, and Tunisia, which could produce more and set prices higher than competitors. In Bangladesh, this positive shock induced high-level support from President Zia, whose support facilitated institutional innovations, including back-to-back letters of credit and the bonded warehouse, which enabled a transformation of the Bangladeshi economy and an evolution of the elite bargain that determined governance dynamics and political reform (Khan 2013).

9.26 Trade agreements can help achieve commitment to domestic reforms by empowering new domestic actors. For instance, workers at a Nike factory in Mexico succeeded in unionizing by leveraging corporate codes of conduct and transnational advocacy networks that developed following the North American Free Trade Agreement to put pressure on management and government to comply with labor regulations (Rodriguez-Garavito 2005). In Cambodia, a surge in garment exports to the U.S. following the MFA led to a bilateral trade agreement in 1999 that used export quotas as a mechanism for improving domestic labor standards in Cambodia, resulting in greater bargaining power for Cambodia’s workers. Specifically, the U.S. agreed to increase garment quotas by 14 percent annually if working conditions complied with international standards, and an ILO project was established to independently monitor worker conditions in Cambodian garment factories. This enhanced commitment through external monitoring and economic incentives led to significant improvements in freedom of association in the few years following the agreement: while only 12 percent of Cambodian garment workers were unionized in 2000, by 2005 nearly 50 percent were (Adler and Woolcock 2009).

### ***Transnational rules as focal points for coordination of domestic actors***

9.27 As Amartya Sen reminds us, “when a modern mathematician in Boston invokes an algorithm to solve a difficult computational problem, she may not be aware that she is helping to commemorate the Arab mathematician Mohammad Ibn Musa-al-Khwarizmi, who flourished in the first half of the ninth century (The word algorithm is derived from the name al-Khwarizmi.)” Indeed, al-Khwarizmi is one of many non-European scientists whose works influenced the European Renaissance, the Enlightenment and the Industrial Revolution (Sen 2004).

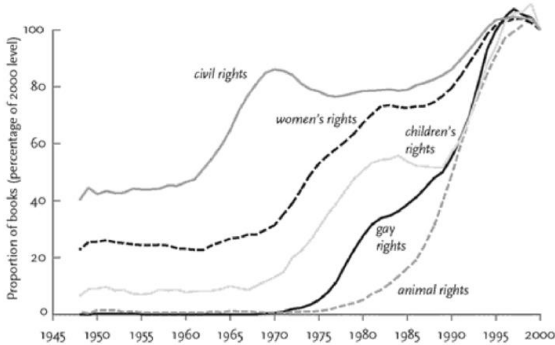
9.28 The world is so embedded in a network of mutual influence in terms of ideas and technology that it becomes difficult to even recognize how much our everyday life has depended on such interconnections through the centuries. Today, improved technology and interconnectivity further increase the sensitivity of international flows to economic and political developments. Evidence of just how fast this process is occurring comes from CHAT (Cross-country Historical Adoption of Technology), a database containing information on the diffusion of over 100 technologies in over 150 countries since 1800. Lags in cross-country adoption of technologies have consistently shrunk over time: for every decade later a technology is invented, it is adopted on average 4.3 years faster (Comin and Hobijn 2010) (figure 9.4).



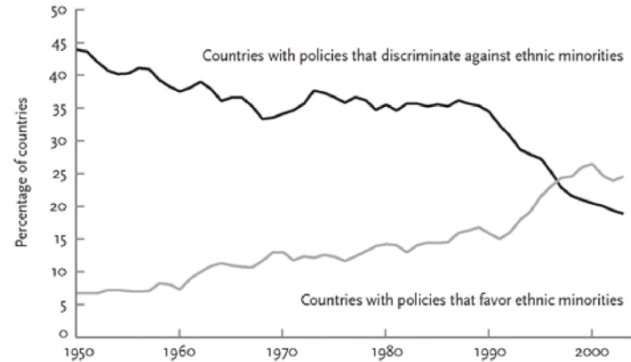
9.29 Along with technology, global ideas and values are spreading increasingly rapidly across countries. The convergence of international ideas has had many positive effects. In the past century, there has been a “Rights Revolution” by which norms for the protection of minority rights have spread globally, changing government policies (Pinker 2011) (figure 9.5). Global treaties and agreements have facilitated the spread of these norms. This section explores how transnational ideas and norms diffuse and the mechanisms through which they affect domestic governance arrangements by enhancing the contestability in the policy arena, changing the incentives of actors, and eventually reshaping preferences in society through “demonstration effects.”

**Figure 9.5 The “Rights Revolution” has led to a global spread of rights-related norms, facilitated and supported by global treaties and agreements**

a. Use of “rights” terms in English-language books, 1948-2000



b. More countries have policies helping ethnic minorities than discriminating against them

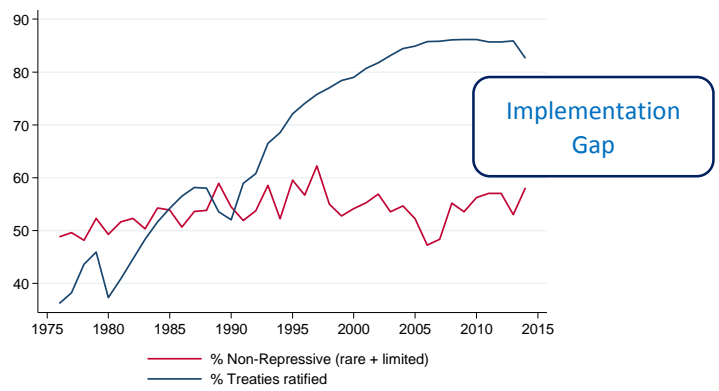


Source: Pinker 2011.

*International human rights as a focal point for change*

9.30 Since the passage of the Universal Declaration of Human Rights in 1948, human rights have been increasingly specified and embedded in international treaties, institutions, and organizations, and country adoption and participation has been widespread. However, global trends show that international treaties are not always effective in changing state behavior and practices. There is a persistent implementation gap between the *de jure* pledge to protect human rights—measured by states’ ratification of major international human rights treaties and conventions—and actual compliance with the provisions of the treaties to which states have committed (figure 9.6).

**Figure 9.6 Human rights treaties are spreading, but de-facto changes in state performance is lagging behind**



Source: WDR 2017 team, based on Hafner-Burton and Tsutsui 2005. “Percent treaties ratified” measures the percentage out of six core human rights treaties the average state has ratified in a given year. “Percent nonrepressive” measures the percentage of states that reported very rare or limited violations of personal integrity rights in a given year, based on data from the Political Terror Scale ([www.politicalterror scale.org](http://www.politicalterror scale.org)).

9.31 Some scholars argue that human rights laws are nothing more than “window dressing” or empty promises unable to constrain power or change the behavior of domestic actors (Posner 2014). Many countries continue to systematically violate the rights they have committed to protect. A growing body of statistical analysis provides support for these claims, pointing at the limited impact of international human rights treaties on state practices. Still, there are important instances in which they make a difference.<sup>4</sup>

9.32 Explaining why state compliance with legal provisions under human rights treaties and conventions varies so much from country to country requires unpacking the interaction between international norms and the domestic bargaining process. Once signed, international treaties “empower individuals, groups, or parts of the state with different rights preferences that were not empowered to the same extent in the absence of the treaties” (Simmons 2009: 125). By referring to international norms, ordinary citizens and disadvantaged groups that are otherwise weak can strengthen the legitimacy of their claims and successfully challenge prevailing norms, putting pressures on governments to transform state institutions and reform public policies. Elite resistance often increases the incentives for domestic actors to build transnational alliances to support their claims. Often referred to as the “boomerang effect,” this dynamic process increases the costs for state actors to resist change and eventually leads to compliance (Keck and Sikkink 1999). The experience of human rights struggles in Latin America countries during military dictatorships illustrates this point, as well as the mobilization against the apartheid government in South Africa. Indeed, the most transformative cases of social movements of the twentieth century—including labor rights, women’s rights, and civil rights, and, more recently, indigenous and environmental movements—have all explicitly adopted the language and instruments of international rights (Heller 2013).

*The case of gender quotas: changing the policy arena to change preferences*

9.33 Over the past 25 years, different forms of gender quotas for representation in national legislatures—including legislated quotas, reserved seats, and voluntary party quotas—have spread to more than 100 countries around the world (figure 9.7).<sup>5</sup> These new provisions have helped double the percentage of women in the lower house of national legislatures from approximately 10 percent in 1995 to 22 percent in 2015 (Norris and Dahlerup 2015). Quotas for women in local government positions, as in India, are also increasingly common.<sup>6</sup> Domestic social movements and left-leaning political parties were especially influential in the case of early adopters, mainly European countries that introduced voluntary party quotas in the 1980s (Ramirez, Soysal, and Shanahan 1997). In contrast, international nongovernmental organizations and multilateral organizations have become increasingly influential for late adopters among developing countries,

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<sup>4</sup> See Landman (2005); Hafner-Burton and Tsutsui (2005); Risse, Ropp and Sikkink (2013); Simmons (2009).

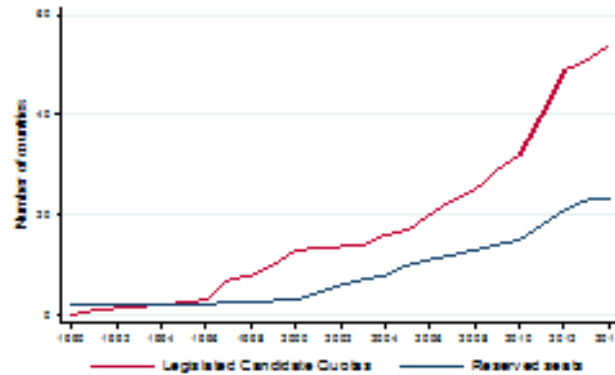
<sup>5</sup> Legislated gender quotas and reserved seats are typically introduced through changes in electoral laws or the constitution, while voluntary party quotas are adopted by individual parties committing to a specific share of women among their candidates.

<sup>6</sup> About 40 percent of the world’s countries have some form of gender quota, according to the 2016 Women, Business and the Law database. In particular, 73 countries have quotas at the national level, and 65 countries have quotas at the local government level (World Bank 2015). Some countries have quotas at both the national and local levels; others have one but not both. For example, India adopted a quota at the local level but not at the national level.



especially in the case of post-conflict countries largely dependent on international assistance (Krook 2006; Celis, Krook, and Meier 2011).

**Figure 9.7 Gender quota laws have spread worldwide since 1990**



Source: WDR 2017 team based on Polity IV data, Norris and Dahlerup 2015, and gender quota project <http://www.quotaproject.org>.

Note: The figure only includes quotas introduced at the nation level. Moreover, it does not include voluntary party quotas (adopted in 32 countries) as the adoption year varies across parties in a given country.

9.34 These processes of international norm diffusion interact with domestic factors to strengthen the bargaining power of women’s organizations and improve their capacity to influence constitutional reforms and lobby for the adoption of gender-sensitive policies. Many countries, however, still face important challenges in closing their implementation gap and achieving the target level of political participation for women as defined in the quota laws. The gap is larger in the case of legislative quotas. While this might be in part reflect overly ambitious targets, the short time since the adoption of the quota, and the weakness of mechanisms to sanction noncompliance, evidence suggests that social norms also play a role. Time may be needed to change them. In Spain, for example, a recent study shows that political parties nominate female candidates in seats where they had little chance to be elected, to reduce risk of losing decision-making power within the party (Esteve-Volard and Bagues 2012). Major shocks—such as conflict—can speed up this process of changing norms and create new windows of opportunity for disadvantaged groups. In other cases, a process of “policy learning” occurs; initially ineffective quotas laws have been revised to improve their effect on de facto political representation for women (Norris and Dalerup 2015).

### Impact of foreign aid on governance

9.35 Since the end of the Second World War, foreign aid has been one of the most prominent policy tools used by rich countries to induce security, growth, and equity outcomes in poor countries.<sup>7</sup> Primarily intended to fill capital shortfalls, official development assistance (ODA) has become a means to affect a range of developmental, humanitarian, strategic, and commercial purposes. In addition to finance, aid includes the transfer of knowledge, expertise, and ideas

<sup>7</sup> Foreign aid refers to official development assistance as defined by the Organisation for Economic Co-operation and Development (OECD).

intended to influence norms, capacity, and power (box 9.1). Between 1960 and 2013, OECD countries that are members of the Development Assistance Committee (DAC) provided some US\$3.5 trillion (in constant 2009 U.S. dollars) in aid. Non-OECD economies are an increasingly important source of aid: in 2014, the flow of aid to developing countries from both DAC and non-DAC contributors amounted to over US\$161 billion (map 9.1). While aid has ebbed and flowed over time, its significant increase over the past two decades coincides with the establishment of the Millennium Development Goals, as well as with the surge in flows toward conflict-affected countries in the aftermath of the Cold War.<sup>8</sup> Still, few donors have met the ODA target of 0.7 percent of gross national income (GNI) first agreed in 1970.

### **Box 9.1 Aid as a delivery mechanism for transnational rules and ideas**

Development actors, especially the international financial institutions, have been among the most influential generators of transnational rules, norms, and ideas, using aid as a diffusion mechanism. Just as economic orthodoxy has evolved over time—from the emphasis on the role of the state in planning and investment in the 1960s and 1970s, to the macroeconomic discipline and market liberalization of the Washington Consensus in the 1980s, to poverty alleviation and market institutions in the 1990s, to achievement of the Millennium Development Goals and improvement of governance institutions in the 2000s—so too have aid modalities evolved in search of more effective means of translating these norms into development outcomes.

Structural adjustment lending policies in the 1980s marked the high point of *ex ante conditionality*: that is, aid transfers made only upon the recipient's adoption of preset conditions. This has been universally regarded as a failure due to the ineffectiveness of these conditional loans to act as a commitment device. In theory, the threat of nondisbursement, or reward of disbursement, was meant to act as an incentive to government actors to overcome participation constraints, either from opposing objectives or because of domestic political economy factors. While *ex ante conditionality* could sometimes strengthen the hand of reformist governments who needed to swing domestic opinion behind these changes, it proved ineffective in changing incentives and preferences of opposing elites (Collier and others 1997). This was due in large part to the lack of a credible threat and the time consistency problem: more often than not donors submitted to pressures to disburse despite the failure of recipients to meet the prescribed conditions (Kanbur 2000; Killick 1997). More fundamentally, the content of the prescribed rules were often politically unfeasible, disabling the systems of patronage needed to hold coalitions together (Mbembe 2001). In short, norm diffusion through coercion was incapable of changing the much stronger dynamics of the domestic bargaining arena (Temple 2010).

In the 1990s, *ex ante conditionality* was largely replaced by aid modalities that encompass principles of partnership and ownership, on the theory that aid will be more effective in good policy environments (World Bank 1998; Dollar and Burnside 2000). Many donors adopted a form of *ex post conditionality*, under which aid in the form of budget support (mostly unconditional funds) was directed to countries that themselves adopted good economic and governance policies. While aid still served as an incentive, its primary role was to amplify reform efforts and maximize poverty reduction by selecting places most likely to achieve results. A further feature has been the emphasis on social participation in the development of policies, as introduced in the Poverty Reduction Strategy Paper (PRSP) process of the World Bank, as a means of enhancing the contestability of the policy arena. This has also been subject to criticism, most notably around the imperfect science of measuring institutional performance for purposes of aid allocation, and the questionable concept of “ownership,” given the power imbalance both between donors and recipients and between government elites and other domestic constituencies (Wilhelm and Krause 2008). At worst, this can give rise to enhanced legitimacy for governments that grow through the motions of “ownership,” while in fact cutting off space for local contestation and innovation. This has caused some to question the extent to which this method improves on the flaws of donor-prescribed conditionality (van de Walle 2005; Craig and Porter 2003; Andrews and others 2013).

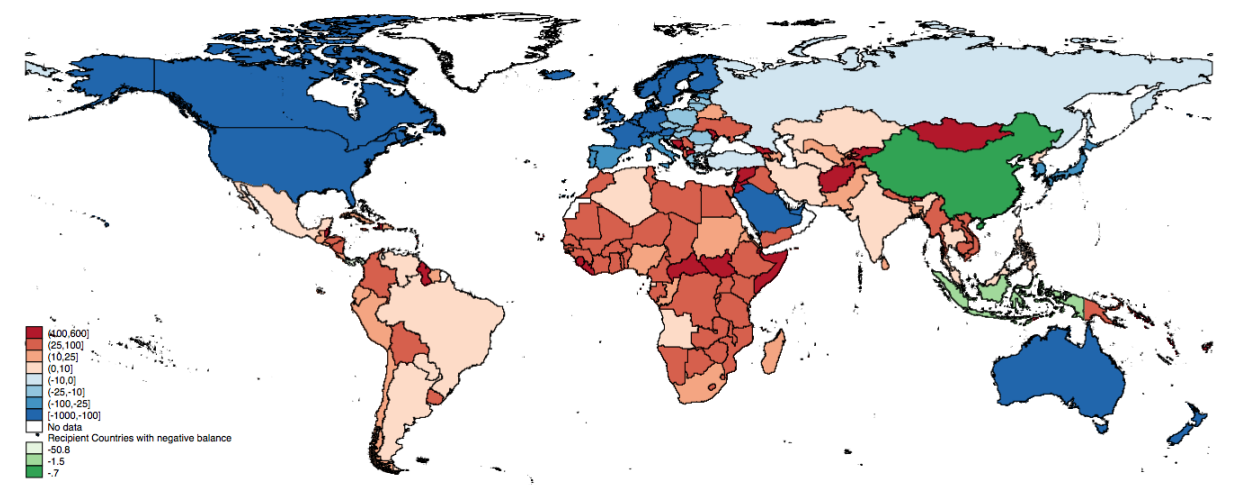
The most recent generation of aid instruments seeks to overcome the difficulty of influencing the bargaining arena to yield “good” policies by focusing instead on outcomes. Donors have introduced a range of results-based

<sup>8</sup> This increase in foreign aid has accompanied the steep rise in peacekeeping operations in the 1990s, and the post 9/11 interventions in Iraq and Afghanistan.

approaches, such as the World Bank's Performance for Results instrument (PforR), which disburses upon achievement of results according to agreed performance indicators. This *outcome-based conditionality* is particularly suited to social sector outcomes such as those set out in the Millennium Development Goals. In theory, by setting clearly defined objectives, indicators, and verification protocols for programs initiated by the government, this method seeks to enhance government accountability to its own goals (Temple 2010). Another noteworthy development is the advent of the New Deal for Engagement in Fragile States, which established a mutual compact between OECD (Organization of Economic Cooperation and Development) donors and a group of fragile states known as the g7+ to support country-led strategies based on a set of overarching peacebuilding and statebuilding goals.

*Sources:* Andrews, Pritchett and Woolcock 2013; Dollar and Burnside 2000; Collier and others 1997; Craig and Porter 2003; Kanbur 2000; Killick 1997; Temple 2010; Van de Walle 2005; Wilhelm and Krause 2008.

**Map 9.1 In 2014 aid flows amounted to over US\$161 billion from donor countries (blue) to recipient countries (red and green)**



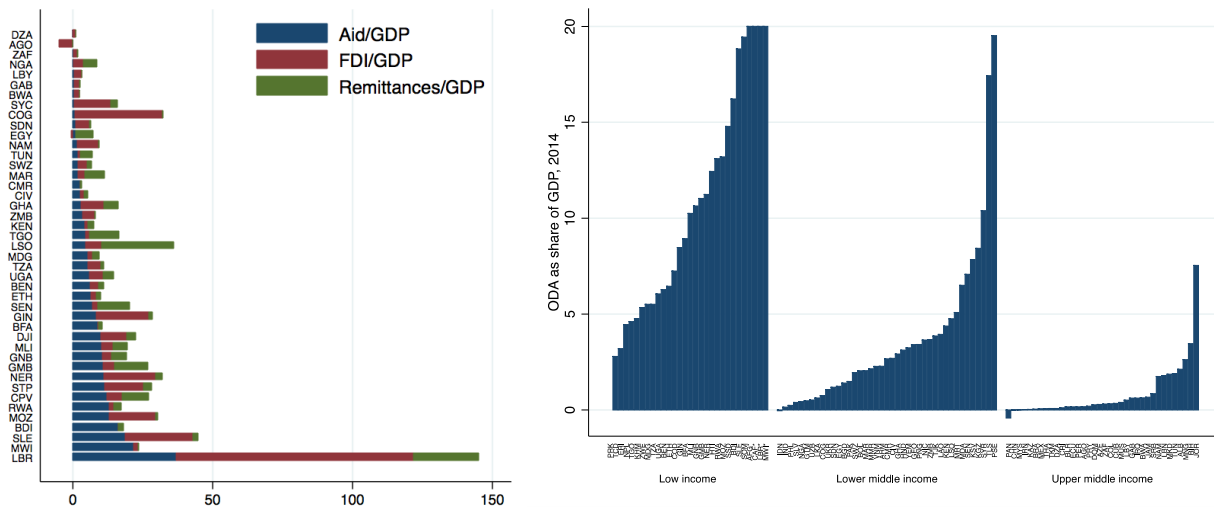
*Note:* Data are on a per capita basis, as of 2014. Shades of red denote recipient countries. Shades of blue denote donor countries. The darker the country, the higher the amount of aid received or transferred. Green countries (China, Indonesia and Panama) are recipient countries where payment of debt to donors is higher than aid received.

9.36 While the volume of aid is increasing, its share is decreasing relative to flows of private capital and other sources of finance into developing countries. In middle income countries, aid makes up a median of only 1.9 percent of GDP, compared to 9.6 percent in low income countries. Foreign direct investment—reflecting new and increased exploitation of natural resources—and remittances have overtaken aid as a percentage of GDP in 21 out of 43 African countries with available data (figure 9.8a). Nevertheless, aid represents more than 10 percent of GDP for half of all low income countries, and over 30 percent of total revenues for approximately 40 countries (figure 9.8b).

**Figure 9.8 Aid is a large share of GDP and revenue in many developing countries**

a. Aid, FDI and remittances as a percent of GDP in Africa

b. Aid flows as a share of GDP are on average much higher in poorer countries

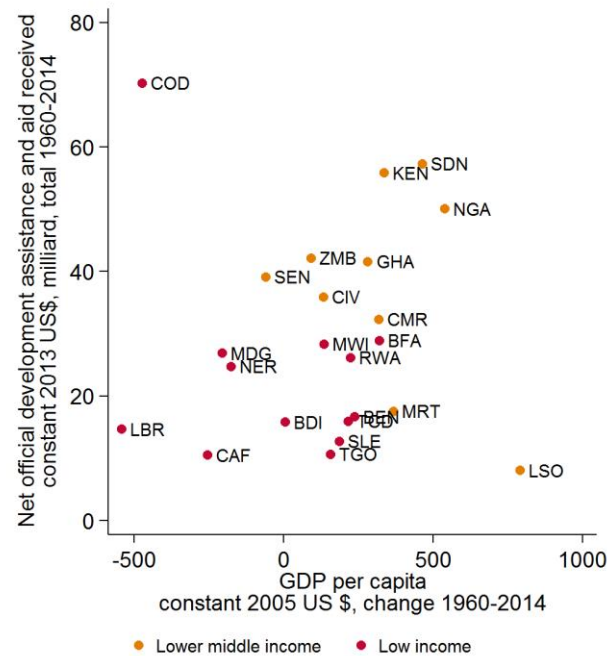


Source: WDR2017 team based on data from OECD (for ODA); World Bank Africa Development Indicators (for FDI/GDP); World Bank World Development Indicators (for GDP and remittances/GDP); and International Monetary Fund, *World Economic Outlook*, (for general government revenues).

Note: FDI and remittances refers to the latest available data point; ODA data are as of 2014. FDI = foreign direct investment; ODA = official development assistance.

9.37 While the term “aid” has normative connotations, aid itself may not always have a positive impact on development. A look at the impact of more than five decades of development aid on growth, equity, and security outcomes shows great variation across regions and countries. Some countries, such as the Central African Republic, the Democratic Republic of Congo, Liberia, and Madagascar, are poorer in 2014 than they were in 1960, while others have stagnated or have improved only marginally (figure 9.9). Other underlying factors account for this variation.

9.38 As this Report explores, structural imbalances in power affect the decision making processes which determine the allocation of resources. This may be particularly salient in the case of foreign aid inflows. More powerful groups, especially incumbent ruling elites, are better positioned to channel foreign aid flows to their benefit or to that of their constituencies, whether in government or outside, and consequently accumulate more power. In this way, aid, like other resources, can reinforce existing power structures, and does not necessarily lead to more inclusive growth, more equity, and more security for all. As introduced previously, “development assistance failures”—defined as a well-intentioned intervention that becomes ineffective because it reinforces an equilibrium that sustains the outcome that the intervention attempted to change—can arise from interventions that are blind to the existing power balance. From the perspective of the framework presented in this Report, one of the reasons behind these failures may be related to an “incumbent bias,” where—by design—some of these instruments tend to strengthen the bargaining position of the actors in government.

**Figure 9.9 There is great variation in the amount of aid received and improvement in GDP per capita**

Source: WDR 2017 team.

### *Understanding the impact of aggregate aid flows on governance*

9.39 The literature on aid effectiveness is voluminous but tends to be inconclusive, particularly regarding the impact of ODA on the quality of governance. Alongside disputed efforts to empirically measure the relationship between aid and various indicators of governance (such as those relating to institutional effectiveness, equity and accountability, and political representation and participation) is the growing consensus that what matters is how ODA interacts with prevailing power relations.

9.40 Two decades ago, an influential study concluded that the link between aid and growth is much stronger in countries with sound institutions, leading to calls for donors to target assistance to those states that could demonstrate good governance (Burnside and Dollar 2000; World Bank 1998).<sup>9</sup> But what effect can aid have on governance? This question has been the subject of considerable debate among leading scholars, spawning an array of attempts to empirically measure whether aid in the aggregate promotes or undermines the quality of institutions in recipient countries. Some of the pessimists, including Deaton (2013) and Easterly (2006), claim that large amounts of aid can deepen negative pathologies in countries with poor governance.<sup>10</sup> Conversely, the optimists argue that aid can help overcome resistance to good policies and support the

<sup>9</sup> The findings of this study have been called into question by Easterly, Levine and Roodman 2003.

<sup>10</sup> This leads to the unsettling view that: “When the ‘conditions for development’ are present, aid is not required. When local conditions are hostile to development, aid is not useful, and it will do harm if it perpetuates those conditions” (Deaton 2013). See also Easterly (2006).

development of political institutions, including democracy.<sup>11</sup> Unfortunately, the evidence belies clear answers, in large part due to inherent methodological flaws, including the fact that aid aggregations lump together different sources (bilateral and multilateral); different modalities (budget support, project finance, technical assistance); different desired outcomes (development, democracy, humanitarian relief), and different local contexts. The answer is that aid is neither inherently good, nor inherently bad for governance. What matters is how aid interacts with prevailing power relations.

9.41 While empirically inconclusive, the literature converges on a set of analytical arguments that shed light on the conditions under which aid can have a positive or negative impact on governance. The first concerns donor incentives. Studies of aid in the aggregate include large amounts of bilateral aid, which has historically been used to project a dynamic mix of the donor's strategic, commercial, and programmatic priorities. Significant correlations have been documented between the allocation of aid and a range of donor interests, including former colonial ties, voting record in the United Nations, business opportunities, and supply-side factors such as food surplus (Alesina and Dollar 2000; Qian 2015). In inherently unstable or institutionally fragile environments, the lack of a single objective, and the broadening to multiple purposes often projected through ODA—stability, security, humanitarian assistance, state-building—frequently have contradictory and—most often—unintended effects (Paris and Sisk 2007). When aid is granted without taking the development objective of the recipient country as the priority, it could be more likely to lead to a development assistance failure, reinforcing local power dynamics.

9.42 The second set of arguments focuses on the aggregate impact of aid flows on the quality of governance in the recipient country. Several econometric studies have found a negative correlation between high levels of aid the accountability of political institutions.<sup>12</sup> A line of argument focuses on the high potential for aid funds to be misused by those in power, whether through outright embezzlement (perhaps best illustrated by the case of Mobutu Sese Seko, former dictator of Zaire, known to have appropriated \$US12 billion in aid money) or by diverting aid money—or government funds freed up by the injection of aid money—to nondevelopmental aims that reinforce extractive, patrimonial, and exclusionary power structures (Ahmed 2012; Deaton 2013). This potential can increase where aid is unconditional, and where political elites do not face organized opposition (Acemoglu and others 2004).<sup>13</sup> Some have argued that large amounts of aid may encourage political instability and coup attempts, as individuals and groups vie for the opportunity to control these assets (Grossman 1992).

9.43 Underlying these pathologies is the claim that aid can undermine the relationship between the state and its citizens by making the state less responsive to their demands. The more that states rely on revenues from the international community, the fewer incentives that they have to build the public institutions necessary to mobilize domestic revenues through taxation. And the less that states rely on their domestic tax base, the more state-citizen accountability erodes (Moore 2004). The empirical evidence linking aid flows to decreased taxation is mixed (box 9.2). Aid has thus been likened to a natural resource curse: a windfall of unearned income that enables irresponsible

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<sup>11</sup> See, for example, Goldsmith 2001; Dunning 2004; Wright 2009; Dietrich and Wright 2013.

<sup>12</sup> Among the cross-country studies that find a negative correlation between aid and governance quality are: Brautigam and Knack 2004; Rajan and Subramanian 2007; Moss and others 2008; Djankov, Montalvo, and Reynal-Querol 2008; Bueno de Mesquita and Smith 2009; Busse and Gröning 2009.

<sup>13</sup> But see Tavares 2003.

government spending and behavior, unconstrained by the kind of state-citizen social contract thought to lie at the heart of modern democracies.<sup>14</sup>

**Box 9.2 The impact of aid on domestic resource mobilization: what does the evidence say?**

There is a growing consensus that increasing domestic resource mobilization can enhance accountability, particularly if such efforts are explicitly linked to the provision of public goods. If ruling elites need to depend on broad-based taxation, they are more likely to include citizens and others elites in policy bargains. The need for revenue to finance wars led European states to bargain among subject populations for greater taxation (Tilly 1990). And once taxed, citizens may demand a greater say in state affairs: as 18th century American colonists fumed at being taxed by Britain without representatives in Parliament, “taxation without representation is tyranny.” More recently, taxpaying has been shown to increase political interest in sub-Saharan Africa (Broms 2014).

But does foreign aid undermine domestic resource mobilization—and hence accountability to citizens? Studies testing that hypothesis initially showed a negative correlation between the two (most notably Gupta and others 2004). More recently, these studies have been refuted by the adoption of different datasets (Morrissey and Torrance 2015) or different econometric techniques. For instance, Clist and Morrissey (2011) invalidate the contemporaneous negative correlation found in Gupta and others (2004) by introducing a lagged effect of aid and taxation, concluding that the relationship is negligible. Although the behavioral effect of aid flows undermining accountability has been tested and isolated in experimental settings (Martin 2014; Paler 2013), in reality the relationship is more complex and seems to depend on three factors: the type of aid (for instance, whether it is grant or debt; budget support or project-specific); the contemporaneous effects of conditional policies associated with the aid; and, more importantly, the governance setting specific to each country.

Moreover, even were aid to reduce incentives for domestic resource mobilization, the removal of aid may result in societally sub-optimal taxation policies to raise revenues, leaving the poor worse off. The effects of domestic resource mobilization depends on how domestic funds are mobilized. Many available taxes may not have the capacity to enhance accountability, e.g., resource taxation, or may have distortionary effects, e.g., trade taxes. International corporate tax competition and trade liberalization have also diminished states’ capacity for domestic resource mobilization (see earlier discussion on races to the bottom). In environments with low savings rates or the potential for capital flight and tax evasion, consumption taxes are most likely to be effective, but also the most likely to be regressive. Frequently in these cases, domestic resources are mobilized in ways that may increase poverty—for example, by increasing consumption taxes—without specific mechanisms of compensation. In 9 out of 25 countries with available household survey data around 2010, fiscal policy itself increased the \$2.50 per day poverty headcount ratio: in other words, in these countries more poor people were made poorer through the taxing and spending activities of governments than benefited from those activities (Lustig 2016).

Progressive, non-distortionary taxes exist, but may require greater capacity in tax administration systems; in these cases, aid may be effective at increasing domestic resource mobilization. Many developing countries are often characterized by high levels of informal employment, small establishments, and relatively weak bureaucracies, all of which make increasing revenues difficult. In these countries aid can help increase domestic resource mobilization through technical assistance that can help governments enhance the economic efficiency of their taxation systems. This can come through the transfer of technologies, skills training, legal support, and other forms of assistance, including improving taxpayer education.

***Aid and the policy arena: Overcoming development assistance failures***

9.44 Beyond quantitative studies, a growing theoretical and qualitative literature identifies how development assistance projects and practices interact with local governance. Development assistance can produce three possible outcomes on governance: no effect, negative effect, or positive (generative) effects.

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<sup>14</sup> The “aid curse” argument is made by Collier 2003; Moss and others 2006; Djankov, Montalvo, and Reynal-Querol 2008.

9.45 The first category includes projects that—intentionally or not—miss opportunities to reshape elite incentives and preferences. Projects that deliver goods directly, and thus circumvent government systems, may succeed in the immediate effort (and indeed this can be a worthy result), but may have little to no effect on the quality of governance. Some community-driven development initiatives fall into this category, despite broader claims to reshape citizen-state relations (Casey and others 2012; King 2013). An impact evaluation of a community-driven reconstruction project in Congo found no evidence that it altered local institutions and decision-making processes beyond the immediate confines of the project (Humphreys and others 2015). These findings are consistent with evaluations of a wider range of community-driven development projects.<sup>15</sup>

9.46 Projects that aim to directly improve governance arrangements, such as public sector reform or demand-side initiatives, may end up creating negative dynamics in they reinforce preexisting power imbalances. The tendency of donors to introduce reforms based on “best practice” solutions that worked elsewhere, with an expectation that tight monitoring of top-down implementation will yield similar results, has been seen as an example of “isomorphic mimicry,” a term drawn from organizational sociology (DiMaggio and Powell 1983). These reforms focus forms— such as laws, systems and procedures—without attention to how they change the nature of the policy arena. This practice can create “capability traps” when recipient governments adopt these forms in order to ensure flows of donor financing and reap legitimacy gains, while evading more fundamental reforms to make the functioning of institutions more effective. Not only does this leave recipients with unsustainable and dysfunctional institutions; it may also cut off room for local innovation and collective action (Pritchett and others 2010; Andrews and others 2013).

9.47 But generative effects are also possible when donor engagement supports the emergence of more accountable and equitable governing arrangements that embed in the domestic context. Evidence from a community-driven reconstruction program in Liberia, for instance, suggests that introducing new institutions at the local level can have an effect on social cooperation that can persist beyond the completion of the program (Fearon and others 2009). When and how generative effects take place, however, is difficult to predict in advance, given the web of intersecting and evolving factors that determine how donor initiatives engage with local spaces—including the vagaries of internal politics, shocks of various sizes and effects, and a range of contextual factors. Many people have been thinking about how to think “politically” about aid, in order to overcome challenges to its effectiveness and potential development assistance failures (box 9.3). A burgeoning literature on ways to increase the chances of generative outcomes points to a common set of principles, which are discussed next.

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<sup>15</sup> See, for example, Wong 2012; Casey and others 2012; Mansuri and Rao 2013; King 2013. While Fearon and others (2009, 2015) find evidence that a community-driven reconstruction project in Liberia altered patterns of social cooperation beyond the project, they attribute this to increased mobilization capabilities that can be triggered by external intervention, leaving local institutional incentives and preferences unchanged. Their conclusion is that “Any new institutions that outsiders introduce will interact and compete with pre-existing structures, which are often resilient. While more democratic or gender-balanced institutions may have appeal to external actors on normative grounds, they will not necessarily trump those institutions that are already in place, especially if they are no more effective for the kinds of challenges that communities regularly confront” (Fearon and others 2015, 468).



**Box 9.3 Beyond technocratic approaches: Opening the door to considerations of politics and power in development policy**

The past ten years have seen a striking rise in discussions of politics and power in development policy circles. This new focus reflects a reaction against technocratic approaches that rely on the provision of capital and injections of technical know-how to overcome developmental challenges. It grows out of the evolution of governance programming, which encountered serious limits after emerging in the 1990s when well-intended efforts to strengthen governance institutions in poor countries encountered entrenched resistance to reform and other structural obstacles.

One result has been the progressive incorporation of political economy analysis by many development organizations and practitioners as a basic tool of program design. Debates over how much the growing use of political economy analysis is actually resulting in more effective development programs remain heated, but few organizations are now willing to argue that attempting to operate in complex, challenging, and diverse national contexts does not require at least some concerted efforts to understand the local political economy of reform—who are the winners and the losers, and who holds the balance of power in such processes.

Potentially much deeper change involves establishing new types of development programming that embody the recognition of developmental change as an inherently political process—one that consists, in the words of the late Adrian Leftwich (2004), of “conflict, cooperation and negotiation in taking decisions about how resources are to be owned, used, produced, and distributed.” Adherents of the “Doing Development Differently” manifesto emphasize the importance of focusing on local solutions advanced by local conveners in processes legitimized at all levels, while proceeding through rapid cycles of planning, action, and reflection and managing risks by making small bets. The Developmental Leadership Program stresses the importance of leadership in development, defining leadership as a political process involving authority and capacity to mobilize people and resources and to forge coalitions. The recently launched Global Partnership on Collaborative Leadership for Development seeks to put leadership and coalitions at the center of development. At the UK Department for International Development, giving serious attention to how political settlements are established and sustained in fragile states is a central element of politically smart development work. An informal coalition of practitioners organized under the rubric of “Thinking and Working Politically” aims to advance innovative efforts to move politics and power from the margins to the core of development thinking and action. This entails ensuring that attention to these issues extends well beyond their original home in governance work to all major areas of development practice, from health and education to transportation, food, and others.

A strong sense of “at last” accompanies this push to take politics in development seriously—relief that outdated, artificial walls created in the early days of development assistance are finally being dismantled. Yet changing developmental practice is hard. Many of the operational imperatives that arise from greater attention to politics and power—such as the need to increase flexibility of implementation, tolerate greater risk and ambiguity, devolve power from aid providers to aid partners, and avoid simplistic linear schemes for measuring results—run up against long-established bureaucratic structures, practices, and habits. In addition, taking politics seriously in development points directly to the need to challenge the interests of the power holders that control institutions—something that many development organizations have still not yet decided they are willing to do, especially in the current global environment of heightened sensitivity in many countries over national sovereignty. The development community is talking the talk of politics. How much it will walk the walk is not yet clear.

*Source:* Prepared for WDR 2017 by Thomas Carothers, Vice President for Studies, Carnegie Endowment for International Peace.

***Using aid to foster positive governance dynamics for development***

9.48 Over the past seventy years, great expectations have hinged on foreign aid bringing about the kind of institutional change that translates into sustainable development outcomes. Some of these expectations have been met, at specific historical junctures, resulting in resounding success stories heralded as blueprints for others yet to come (Commission on Growth and Development 2008; Sachs 2005). Others have not, resulting in much soul searching about the limitations of the

ability of foreign aid to generate positive outcomes in adverse contexts (Easterly 2002). On the sides of this raging debate, pragmatic approaches at the micro-level have taken root, which have instead asked very specific questions: what kind of aid programs have succeeded, and in what kinds of institutional environments in a given country, and why? (Banerjee and Duflo 2011). Still, answers to the broader question of the relationship between aid spending and development outcomes remain in flux.

9.49 It is time for the larger debate to move beyond the value of foreign aid per se, to the timing and conditions under which domestic actors can harness foreign aid to promote pro-development reforms. Changes in the global balance of power, and the accompanying reductions and increases in geopolitical rents and aid flows can carve enlarged bargaining spaces for domestic actors to build coalitions for pro-development reforms. Changes in the incentives and preferences of key individuals and groups in the domestic bargaining arena, by way of constrains to power and collective action, can significantly improve the chances of governance reforms translating to into more growth, equity and security.

9.50 Not understanding and taking into account how shifts in global, national power balances affect the desirability, and consequently the feasibility of a governance reform agenda can result in missed opportunities or in the failure of this agenda. In summary, timing, pacing, and synchronizing a governance reform agenda to take into account the openings and constraints presented by shifting domestic and foreign balances of power are key to the ability to foreign aid to induce and sustain pro-development governance reforms.

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## Spotlight 9 Illicit financial flows

S9.1 In early spring 2016, the leak of a set of 11.5 million confidential documents from a Panamanian law firm was breaking news worldwide. These documents, referred to as the Panama Papers, contained information on the assets held in offshore companies by wealthy individuals, including policymakers, in more than 40 countries around the world. While holding assets in a tax haven may not be illegal, the prevailing sentiment expressed in newspaper articles, and reaction from the public, has mainly been that of condemnation and criticism of a practice interpreted as powerful economic and political elites concealing taxable income from domestic fiscal authorities, with the assistance of the financial systems of many developed countries.

### What are IFFs?

S9.2 These secret accounts are a manifestation of what has come to be known as illicit financial flows (IFFs). There are varying definitions of IFFs and two leading interpretations of what makes these financial flows illicit.<sup>1</sup> The normative interpretation suggests that financial flows become illicit “not only because they hinder development, but also because they are deemed illegitimate from the perspective of an existing consensus about the social (developmental) good” (Blankenburg and Khan 2012: 32). The legal interpretation, upon which the empirical literature on IFFs is predominantly built, suggests that IFFs refer to money that is earned, transferred, or used in contravention to existing law. In some cases, this could mean money that is legally earned, but is transferred out of the country illegally to evade taxes or currency controls. There are many different sources of illegally earned IFFs, ranging from drug trafficking to embezzlement. The types of IFFs can be classified based on whether the actors involved are criminal organizations, individuals, or corporations (Jaský 2013). Table S9.1 presents a few examples.

**Table S9.1 Different actions generating Illicit Financial Flows**

		Source of earnings	
		Money legally earned	Money illegally earned
Actors involved	Criminal organizations		<ul style="list-style-type: none"> <li>• Drug trafficking</li> <li>• Human smuggling</li> </ul>
	Individuals	<ul style="list-style-type: none"> <li>• Tax evasion</li> <li>• Evasion of currency controls</li> </ul>	<ul style="list-style-type: none"> <li>• Corruption</li> <li>• Embezzlement</li> </ul>
	Corporations	<ul style="list-style-type: none"> <li>• Tax evasion</li> <li>• Profit shifting</li> </ul>	<ul style="list-style-type: none"> <li>• Violation of intellectual property rights</li> <li>• Illegal exploitation of natural resources</li> </ul>

Source: WDR2017 team.

S9.3 Although estimates of the size of IFFs are controversial (UN 2015), there is consensus among development scholars and practitioners that IFF outflows on average actually exceed official development assistance in developing countries (Herkenrath 2014).

<sup>1</sup> See Epstein (2005: 7). For a recent review of the different definitions found in the literature, see Tropina (2016).

## **Rethinking our approach to IFFs**

S9.4 IFFs deprive developing countries of resources that could be used for redistribution, to finance public goods, and to foster private investments in local businesses. In doing so, IFFs support existing inequalities and are particularly detrimental to the poor. IFFs are also deeply connected to the governance process. Corruption and embezzlement thrive in environments of low accountability to citizens, and, in turn, weaken trust in state institutions. Tax evasion—a manifestation of a lack of cooperation in society—is fuelled by a lack of commitment of the state to use resources for the delivery of public goods, and, in turn, undermines the outcome legitimacy of the state, which is based on the delivery of public services. Criminality also flourishes in environments where trust is low and where the state fails to provide the means for large population groups to effectively participate in the legitimate economy.

S9.5 The WDR 2017 framework can help to shed light on how to think about approaching reforms to combat IFFs.

### ***Think of function, not only form***

S9.6 As discussed in chapter 1, importing forms is not enough to change the facts. Kenya is often cited as a major destination for the proceeds from piracy in the Indian Ocean and a key transit point for terrorist funds to neighboring Somalia. With the aim of fighting illicit financial activities, especially money laundering and terrorism financing, Kenya established the Financial Reporting Centre (FRC) in 2012. While creating this Centre enabled the country to get off the Financial Action Task Force's (FATF) list of countries that might be sanctioned for noncompliance, little seems to have changed.<sup>2,3</sup> There is substantial evidence of high-level corruption in the government of that time, yet no cases have been brought against senior officials as a result of violations of the money laundering regulations. To make the Centre meaningful, the administration would have had to pursue many of its own senior members.

### ***Think of power, not only capacity***

S9.7 The lack of capacity of developing countries in managing complex laws and regulations is often stressed as the cause for difficulties in curbing IFFs. Some developing countries do not have any transfer pricing rules, thus ensuring that the multinational corporation operating in its jurisdiction can transfer as much of its profits elsewhere as it wishes. Multinational corporations are often the initiating actors in these matters.<sup>4</sup> Nevertheless, the basis of low capacity is often a power issue: it is in the interest of someone to keep the capacity low because it allows them to extract some rents (Leite 2012). Lack of political will has indeed been recognized as more difficult

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<sup>2</sup>The Financial Action Task Force (FATF) is an intergovernmental body established in 1989 by the ministers of its member jurisdictions to set standards and promote effective implementation of legal, regulatory, and operational measures for combating money laundering, terrorist financing, and other related threats to the integrity of the international financial system. Currently it comprises 35 member jurisdictions and 2 regional organisations (the European Commission and the Gulf Co-operation Council).

<sup>3</sup>For example, Findley, Nielson and Sharman (2014) find that Kenya is the single country in the world where it is easier to open an anonymous shell company, one of criminals' preferred devices to transfer money internationally. Moreover, FRC's website does not seem to have been updated after 2013, and it does not provide any information on its current or past activity, as none of the reports are downloadable.

<sup>4</sup>See, for example, Global Witness (2006).

to overcome than any legal, institutional, or operational issues in this context (Stephenson and others 2011).

***Think of the role of law, not only the rule of law***

S9.8 Incumbents can seemingly promote compliance with international laws and regulation to gain legitimacy, while continuing to do business as usual. One important requirement of the FATF Anti-Money Laundering (AML) regime is to facilitate requests for information and cooperation from other nations pursuing money laundering cases involving the country's nationals (Recommendations 35–40). Most nations have adopted statutes and regulations that conform to the FATF rules. However, in many developing nations, authorities have a long record of dragging out the process of cooperation so long that in fact the laws are effectively nullified: for example, on requests from countries where the illicit funds are hidden for Mutual Legal Assistance (MLA) (Chêne 2006). On the other hand, using delay to deny politically motivated requests from developing countries for MLA may be fair in systems that are essentially corrupt (Terracol 2015).

**A way forward**

S9.9 Fighting the illicit flow of capital abroad is an important development concern. The money returned in 2009 to Peru from Switzerland and belonging to the accounts of Vladimiro Montesinos, the de facto chief of intelligence and main advisor of former Peruvian President Alberto Fujimori (1990–2000), amounted to \$US93 million. In 2004, the Philippines Treasury recovered \$US683 million from the Swiss accounts of Ferdinand and Imelda Marcos, president and first lady of the Philippines (1965–86). In both cases, the money recovered would have been enough to fill at least 25 percent of the nations' poverty gaps in the same year.<sup>5</sup>

S9.10 In the aftermath of the Panama Papers revelation, the top five European economies (France, Germany, Italy, Spain, and the United Kingdom) announced actions to improve information sharing to fight tax evasion and money laundering. The United Kingdom has a particularly sensitive role in this respect as a number of its dependencies, such as the British Virgin Islands and Jersey, derive a substantial share of their GDP from providing financial secrecy services. Panama itself, according to a statement of the OECD secretary general, seems to have decided to adopt international tax reporting standards. Also, a group of 300 prominent economists around the world directed a letter to country leaders as well as international organizations, including the World Bank, urging them to take concrete measures to bring to an end fiscal havens deemed responsible for worsening global inequality by benefitting some rich individuals and multinational corporations (Oxfam 2016). Fundamental reforms that seemed fantasies just ten years ago are now being discussed as active proposals by powerful bodies such as the G7, G20, and OECD. These include country-by-country reporting of corporate profits, which facilitates detection of transfer pricing abuses and other methods of shifting profits to low-tax jurisdictions, and the creation of public lists of beneficial ownership to prevent concealment through shell corporations.

S9.11 However, the generation of each type of IFF featured in table S9.1 involves a complex network of actors, including domestic and foreign state institutions, corrupt domestic and foreign public officials, and foreign financial institutions. Failure to take into account the mutually

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<sup>5</sup> WDR2017 team estimates on the STAR (Stolen Asset Recovery Initiative) database and World Development Indicators.

sustainable relations of incentives among all the actors involved in IFFs risks generating ineffective reforms. In particular, attempts to solve the issue should not concentrate only on the countries of origin, but also on the countries receiving IFFs. Only efforts to foster interstate coordination, sustained by transparent sharing of information and monitored by national, foreign, and transnational actors (including civil society) can try to stop this problem.

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# | Appendices



## **Appendix A Governance measurements**

### ***Governance Indicators: The first wave***

1. When they first appeared in the early 1990s, aggregate indicators that measured governance represented something of a sensation.<sup>1</sup> They held the promise of finally measuring the unmeasurable and comparing the incomparable: the quality of intangible processes, like participation and voice; inherently enigmatic manifestations, like corruption; and notions deeply rooted in nuance and interpretation, like the law. The notion of governance itself was—still is—elastic and malleable; it straddled several better-established spheres like politics, economics, public administration, and the law, even blurring the lines between them. The measurement challenge was conceptual before it could be empirical.

2. The World Bank’s World Governance Indicators (WGI), launched in 1996, was part of this “first wave” of governance indicators.<sup>2</sup> Twenty years on they still dominate the field and serve as the primary resource on governance empirics for researchers, donors, governments, and the media. Their success and resilience are a testimony to their broad coverage (13 data sources and 173 countries already in 1996); their early start, which makes for long time series; as well as their transparency—underlying sources are accessible, and so are margins of errors. Their aggregation methodology, based on the Unobserved Components Method (UCM), has been criticized (Arndt and Oman 2006; Knack 2006), and defended (Kaufmann, Kraay, and Mastruzzi 2007a, 2007b).<sup>3</sup>

### ***The second wave***

3. The “second wave” of aggregate indicators, in the mid-2000s, drew on a decade of interest in and research on the field, and made some important conceptual advances: indicators like those of the nongovernmental organization Global Integrity differentiated between *de jure* (rules on paper) and *de facto* (rules in practice) aspects of governance, highlighting and measuring “implementation gaps.” They also made the distinction between governance processes (such as an inclusive rule-making process) and outcomes (such as good rules on paper). Aggregate indicators such as the World Justice Project’s Rule of Law Index, first published in 2012, focused on *de facto* measures based on a combination of expert surveys and a poll of the general population. However, short and discontinuous time series—there have been no updates since 2011—and spotty country coverage limited the appeal of “second wave” governance indicators to researchers and policy makers.

### ***A third wave?***

4. The Framework Indicators developed for the WDR 2017 simultaneously build on the strong empirical foundations and broad country and year coverage of the first wave, and on the

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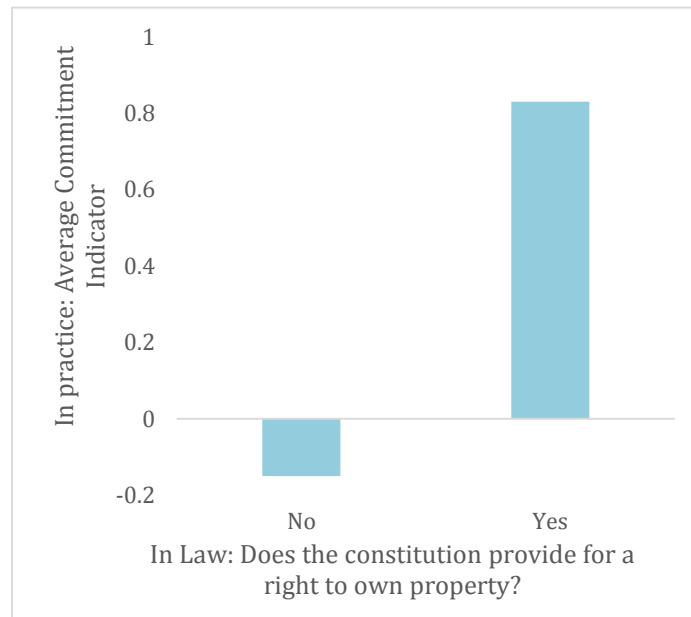
<sup>1</sup> Aggregate indicators are indicators that draw on many different sources to build one single measure.

<sup>2</sup> Transparency International’s Corruption Perceptions Index (CPI) started in 1995 with 41 countries. Its original methodology has been heavily criticized, including by one of its creators (Galtung and Sampford 2005).

<sup>3</sup> The WGI were also criticized for measuring perceptions and not objective data, but the WGI team showed that perceptions mattered for outcomes at least as much as reality, and that even objective indicators had a dimension of subjectivity, making the dichotomy a false one.

strong conceptual foundations of the second wave. They purport to illustrate the main elements of the Report’s theoretical foundations by disentangling a number of governance dimensions from one another: first, differences between governance on paper and governance in practice (for an example, see figure A.1); second, differences between governance processes and outcomes; and third, differences between form (what governance looks like, through such manifestations as democracy, elections, decentralization) and function (what governance does: inducing cooperation, strengthening credible commitment, coordinating expectations). To achieve this objective, the WDR2017 team mapped more than 300 primary indicators from the 32 primary data sources underlying the WGI and eleven other sources against the main elements of the Report’s framework in eight areas: Public Constraints on Power, State Constraints on Power, Equal Distribution of Power, Capacity, Commitment, Voluntary Compliance, Security, and Absence of Corruption (box A.1).

**Figure A.1 De facto and de jure commitment to property rights protection, 2012**



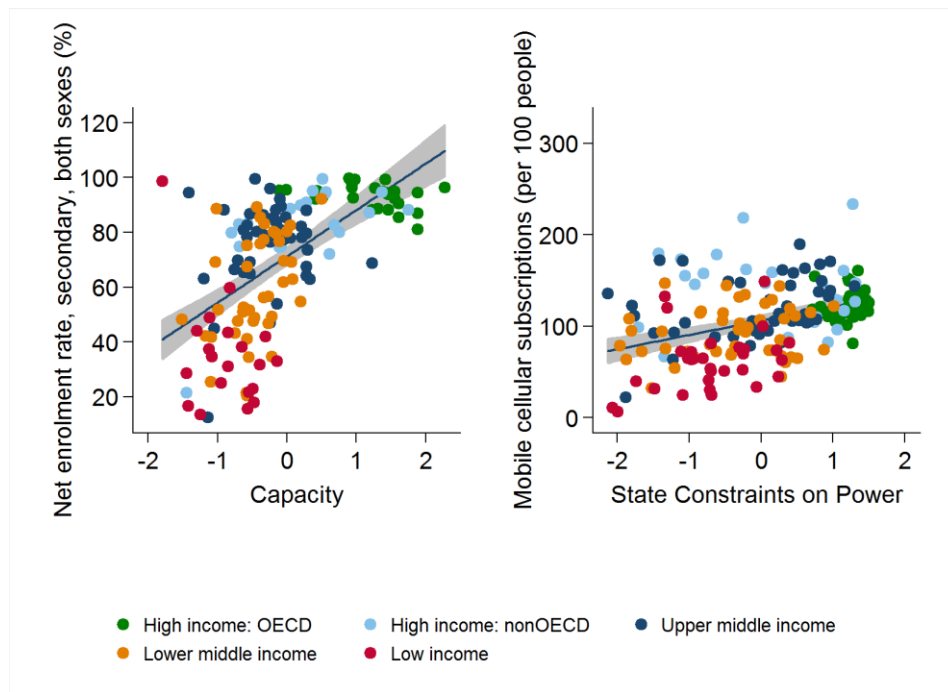
Source: WDR2017 team based on the Commitment indicator and Comparative Constitutions Project.

5. As a next step, the WDR 2017 team aggregated these primary indicators for each framework element—for example, all the primary indicators mapped to “commitment”—into one composite indicator. Doing so makes it possible to examine associations between, for example, governance “inputs” such as power and capacity, and governance “functions” such as commitment, as well as between these “functions” and development outcomes such as security (figures A.2 and A.3). In particular, this is meant to be the first set of governance indicators that seeks to explicitly look at the institutional functions of commitment and cooperation.<sup>4</sup>

<sup>4</sup> The French Development Agency’s Institutional Profiles Database and the Bertelsmann Transformation Index cover several governance variables about institutional functions, but do not explicitly identify them as such.

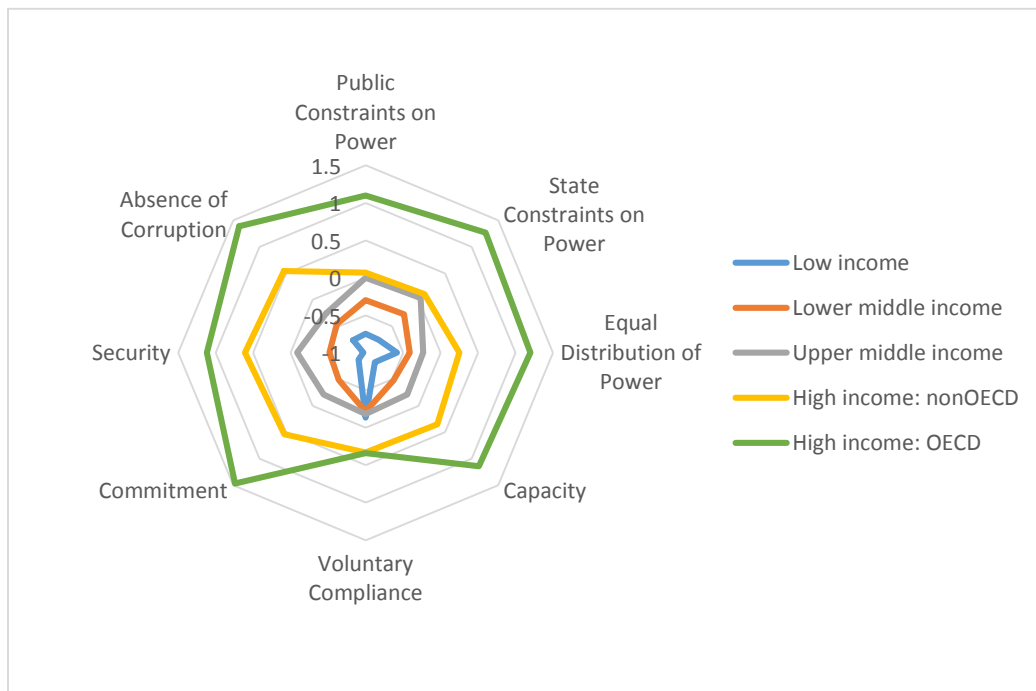


**Figure A.2 Correlation between WDR 2017 governance Framework Indicators and development outcomes**



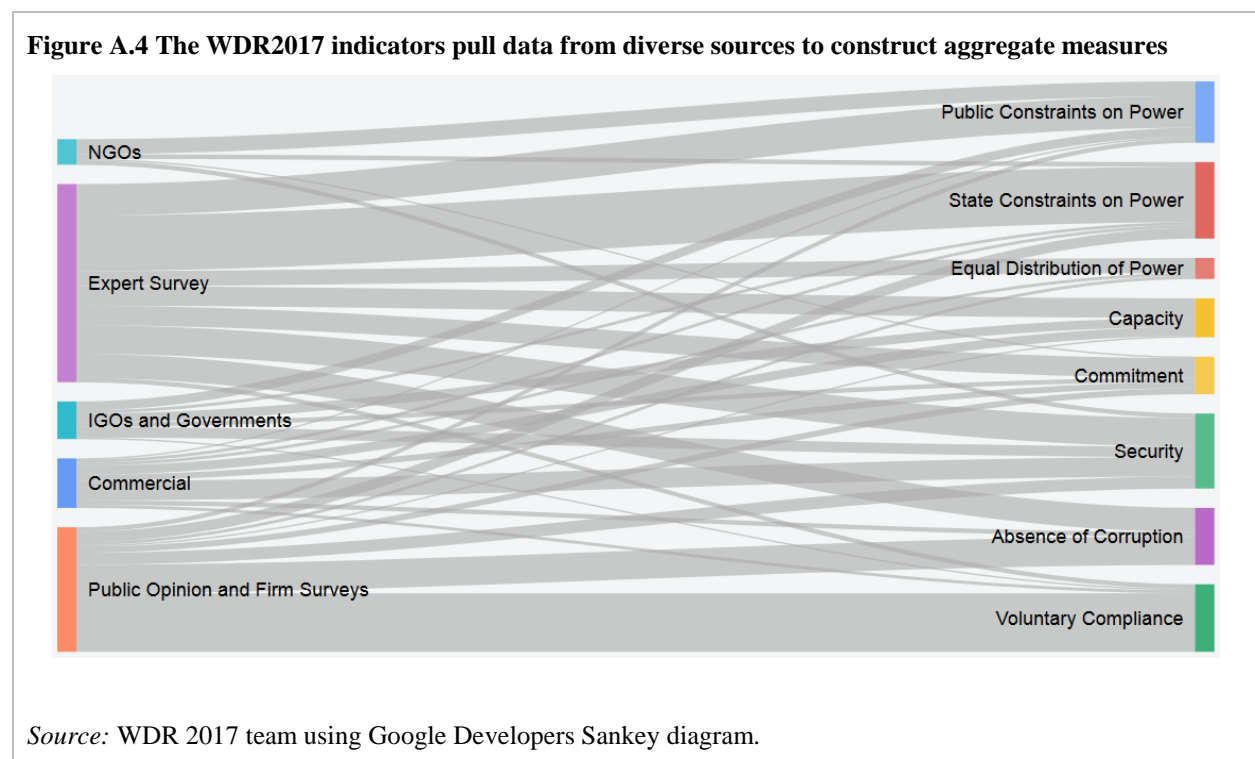
Source: WDR 2017 team.

**Figure A.3 Correlation between WDR 2017 Framework Indicators and GDP per capita**



Source: WDR 2017 team.

6. Navigating between 41 different data sources was a challenge: many variables purport to measure the same concept or different shades of it, yet datasets vary in coverage in terms of countries and years. The WDR Framework Indicators provide measures that far outstrip the underlying data in terms of coverage and combine varied sources such as expert surveys, business-oriented data, public opinion polls, factual statistics, and assessments by international organizations (figure A.4). The WDR 2017 team used the same methodology as the Unobserved Components model as developed by the authors of the World Governance Indicators. The model belongs to the family of latent variable models, or more specifically, to factor analysis. This approach allowed observed variables to be decomposed into a linear combination of the unobserved indicator plus an error term. In other words, observed data often measures the concept imperfectly, especially when it is very abstract. The goal of constructing an index is to isolate the underlying concept.



7. An insightful approach of this aggregation method is to separate data sources into representative sources (that cover a wide selection of countries) and non-representative sources (that have smaller coverage). This helps address the fact that many data sources cover only specific regions, concentrate only on developing countries, or lack information on smaller countries, or are hard to access. The representative sources are used to create the preliminary index measures. The non-representative sources are then introduced to augment the model and to recalibrate weights that are applied to variables that comprise the index. The end result is an index measure for each country that had data available for at least one underlying source, and a measure of certainty for this country's index estimate. The higher the number of underlying sources, the more precise the estimate.

### **Box A.1 The Framework Indicators of the WDR 2017**

In line with the WDR2017 framework, the following indicators were developed and used throughout the Report:

#### **Public Constraints on Power**

Measures the “bottom-up” constraints on power as mechanisms through which the public can hold those in power accountable. Assesses access to the political process via elections, development of the party system, whether freedom of speech and assembly is guaranteed and respected, and whether civil society organizations and mass media are active contributors to the political process.

#### **State Constraints on Power**

Measures the “top-down” constraints on power that are instituted within the state via separation of powers with the legislative and judiciary that scrutinize the actions of the executive, pro-active anti-corruption policy and prosecution of office abuse, established and accepted mechanism for transition of power, and transparent policy making.

#### **Equal Distribution of Power**

Measures whether political power is uniformly distributed within society across all social groups with limits on the power of special interest groups such as business lobbies, the military, and clergy.

#### **Capacity**

Measures the “stock” that government possesses to implement its policies and contains variables on the quality of the bureaucracy, the human capital of civil servants, ability to collect taxes in a timely and efficient manner, and statistical capacity to collect data relevant for policy making.

#### **Commitment**

Measures commitment as protection of property rights, contract enforcement, and lack of arbitrary expropriation without proper compensation.

#### **Voluntary Compliance**

Measures public trust in government institutions, lack of tax evasion, respect for law, and participation in voting.

#### **Security**

Is defined in a broad sense in line with the unified theory of violence to include both regular crime and violence as well as political violence, external conflicts, and terrorism.

#### **Absence of Corruption**

Measures whether the government suffers from corruption, nepotism, and improper influence.

*Source:* WDR 2017 team.

## **Variables used in aggregation**

### **Original Data Sources**

AFR	Afrobarometer
ARB	Arab Barometer
ASI	Asian Barometer
BTI	Bertelsmann Transformation Index
CIRI	Cingranelli-Richards Human Rights Database
CPIA	World Bank Country Policy and Institutional Assessments
CTD	Collecting Taxes Dataset (USAID)
DB	Doing Business
DPI	Database of Political Institutions
EIU	Economist Intelligence Unit Market Indicators and Forecasts Plus & Democracy Index
ES	Enterprise Survey
EUR	Eurobarometer
FNT	Freedom House - Nations in Transit
FRP	Freedom House - Freedom of the Press
FRW	Freedom House - Freedom in the World
FSI	Fragile States Index
GBAV	The Global Burden of Armed Violence
GCB	Transparency International Global Corruption Barometer Survey
GCS	World Economic Forum Global Competitiveness Report
GI	Global Integrity Report
GWP	Gallup World Poll
HER	Heritage Foundation Index of Economic Freedom
IDEA	Voter Turnout
ICRG	Political Risk Services International Country Risk Guide
IFD	IFAD Rural Sector Performance Assessments
IJT	iJET Country Security Risk Ratings
IPD	Institutional Profiles Database
IRP	IREEP African Electoral Index
LBO	Latinobarometro
MSI	International Research and Exchanges Board Media Sustainability Index
OBI	International Budget Project Open Budget Index
POL4	Polity IV
PRC	Political Economic Risk Consultancy Corruption in Asia Survey
PTS	Political Terror Scale
RSF	Reporters Without Borders Press Freedom Index
TPR	US State Department Trafficking in People report
VAB	Vanderbilt University Americas Barometer
VDEM	Varieties of Democracy
WCY	Institute for Management and Development World Competitiveness Yearbook
WDI	Statistical Capacity
WJP	World Justice Project Rule of Law Index
WVS	World Values Survey

**[Public Constraints on Power]**

1	AFR	Free and Fair elections
2	ARB	Last parliamentary elections: free and fair?
3	BTI	2.1 Free and fair elections: To what extent are political representatives determined by general, free and fair elections?
4	BTI	5.1 Party system: To what extent is there a stable and socially rooted party system able to articulate and aggregate societal interests?
5	CIRI	Electoral Self-Determination
6	DPI	EIEC: Executive Electoral Competitiveness
7	DPI	LIEC: Legislative Electoral Competitiveness
8	EIU	Democracy Index: Electoral process and pluralism
9	FNT	Electoral Process
10	FRW	Electoral Process
11	GI	Can all citizens exercise their right to vote?
12	IPD	Are electoral processes flawed?
13	IPD	Freedom of elections at national level
14	IRP	Africa Electoral index
15	VDEM	Electoral democracy index
16	BTI	16.4 Civil society participation: To what extent does the political leadership enable the participation of civil society in the political process?
17	BTI	2.3 Association / assembly rights: To what extent can individuals form and join independent political or civic groups?
18	BTI	5.2 Interest groups: To what extent is there a network of cooperative associations or interest groups to mediate between society and the political system?
19	FNT	Civil Society
20	FRW	Associational and Organizational Rights
21	GI	Are anti-corruption/good governance NGOs able to operate freely?
22	IFD	Dialogue between government and rural organizations
23	IPD	Freedom of assembly, demonstration
24	IPD	Freedom of association
25	WJP	1.5 Government powers are subject to non-governmental checks
26	WJP	3.3 Civic participation
27	WJP	3.4 Complaint mechanisms
28	WJP	4.7 Freedom of assembly and association is effectively guaranteed
29	BTI	2.4 Freedom of expression: To what extent can citizens, organizations and the mass media express opinions freely?
30	CIRI	Freedom of Assembly and Association
31	CIRI	Freedom of Speech
32	FNT	Independent Media
33	FRP	Freedom of the Press
34	FRW	Freedom of Expression and Belief
35	GWP	WP10251 Freedom of Media
36	IPD	Freedom of access to the foreign press (no seizures)
37	IPD	Freedom of access, navigation and publishing on Internet
38	IPD	Freedom of television access (cable, satellite, etc.)
39	MSI	Media Sustainability Index
40	RSF	Press Freedom Index
41	WJP	4.4 Freedom of opinion & expression is effectively guaranteed

**[State Constraints on Power]**

42	AFR	In your opinion, how often, in this country: Does the President ignore the courts and laws of the country?
43	ARB	To what extent is the government working to eliminate corruption in your country?
44	ASI	Do officials who commit crimes go unpunished?
45	ASI	To what extent is the legislature capable of keeping government leaders in check?
46	ASI	When government leaders break the laws, there is nothing the court can do.
47	BTI	15.3 Anti-Corruption policy
48	BTI	3.1 Separation of powers: To what extent is there a working separation of powers (checks and balances)?
49	BTI	3.2 Independent Judiciary: To what extent does an independent judiciary exist?
50	BTI	3.3 Prosecution of office abuse
51	CIRI	Independence of the Judiciary
52	CPIA	Transparency, accountability and corruption in public sector (This criterion assesses the extent to which the executive, legislators, and other high-level officials can be held accountable for their use of funds, administrative decisions, and results obtained)
53	EIU	Transfer of power rating
54	FNT	Corruption (Has the government implemented effective anticorruption initiatives? Are there significant limitations on the participation of government officials in economic life? Does the government advertise jobs and contracts? Are allegations of corruption given wide and extensive airing in the media? etc.)
55	GCS	1.06 Judicial Independence
56	GI	In practice, when necessary, the judiciary reviews laws passed by the legislature.
57	GI	In practice, when necessary, the judiciary reviews the actions of the executive.
58	GWP	WP6763 Government Fights Corruption
59	IPD	Degree of judicial independence vis-à-vis the State
60	IPD	Do the representative Institutions (e.g. parliament) operate in accordance with the formal rules in force (e.g. Constitution)?
61	POL4	Executive Constraint (institutionalized constraints on the decision-making powers of chief executives)
62	VAB	To what extent would you say the current administration combats government corruption?
63	VDEM	Election assume office - Following this national election, did winners assume office according to prescribed constitutional rules and norms?
64	VDEM	Judicial constraints on the executive index
65	VDEM	Legislative constraints on the executive index
66	WJP	1.1 Government powers are effectively limited by the legislature
67	WJP	1.2 Government powers are effectively limited by the judiciary
68	WJP	1.3 Government powers are effectively limited by independent auditing and review
69	WJP	1.4 Government officials are sanctioned for misconduct
70	WJP	1.6 Transition of power is subject to the law
71	GCS	1.12 Transparency of government policymaking
72	GI	In practice, citizens can access itemized budget allocations.
73	GI	In practice, the national budgetary process is conducted in a transparent manner in the debating stage (i.e. before final approval).
74	IPD	Are the results of local public procurement bids predictable?
75	IPD	Are the results of national public procurement bids predictable?
76	IPD	Award of public procurement contracts and public service delegation to foreign firms
77	IPD	Award of public procurement contracts and public service delegation to local firms
78	IPD	Degree of transparency in public procurement
79	IPD	Extra-budgetary funds
80	IPD	Is State economic policy (e.g. budgetary policy, fiscal policy etc.)... communicated?

81	IPD	Is State economic policy (e.g. budgetary policy, fiscal policy etc.)... publicly debated?
82	IPD	Is the report produced by the IMF under Article IV published?
83	IPD	Reliability of basic economic and financial statistics (e.g. national accounts, price indices, foreign trade, currency and credit, etc.).
84	IPD	Reliability of State-owned banks' accounts
85	IPD	Reliability of State-owned firms' accounts
86	IPD	Reliability of the State accounts (completeness, audit, budget review law etc.)
87	IPD	Reliability of the State budget (completeness, credibility, performance etc.)
88	OBI	Open Budget Index
89	VDEM	8.2 Reasoned justification
90	WCY	Transparency of government policy is satisfactory
91	WJP	3.1 Publicized laws and government data
92	WJP	3.2 Right to information

**[Equal Distribution of Power]**

93	BTI	2.2 Effective power to govern: To what extent do democratically elected political representatives have the effective power to govern, or to what extent are there veto powers and political enclaves?
94	EIU	Lobbying by special interest groups
95	GI	In practice, the military and security forces remain neutral during elections.
96	ICRG	Military in politics
97	IPD	Can political authorities make independent decisions vis-à-vis the various lobby and interest groups? Influence of economic stakeholders (Do major national economic stakeholders (interest groups, lobby groups etc.) influence 1 economic legislation?; tax policy? Do major foreign economic stakeholders (excluding international organisations) effectively influence public policies?) Influential organisations in political life (1. Alongside the legal institutions, do certain organisations (e.g. religious, ethnic, political, economic and media organisations etc.) have an influence on the political running of the country nationally? 2. Degree of involvement of the military in politics, in law or fact)
98	IPD	
99	IPD	
100	IPD	Is the capacity of national public authorities hampered by pressure group (economic, social, regional groups etc.)?
101	IPD	Is the political and cultural influence of the middle classes increasing or decreasing?
102	LBO	Generally speaking, would you say that (country) is governed for a few powerful groups in their own interest? Or is it governed for the good of all?
103	VAB	Those who govern this country are interested in what people like you think.
104	VDEM	14.2 Power distributed by socioeconomic position
105	VDEM	14.3 Power distributed by social group
106	VDEM	14.4 Power distributed by gender

**[Capacity]**

107	BTI	1.4 Basic administration: To what extent do basic administrative structures exist?
108	BTI	14.1 Prioritization: To what extent does the government set and maintain strategic priorities?
109	BTI	14.2 Implementation: How effective is the government in implementing its own policies?
110	BTI	14.3 Policy learning: How innovative and flexible is the government?
111	BTI	15.1 Efficient use of assets: To what extent does the government make efficient use of available human, financial and organizational resources?
112	BTI	15.2 Policy coordination: To what extent can the government coordinate conflicting objectives into a coherent policy?
113	BTI	16.3 Cleavage/conflict management (To what extent is the political leadership able to moderate cleavage-based conflict?)
114	CPIA	Efficiency of revenue mobilization

115	CPIA	Quality of budgetary and financial management
116	CPIA	Quality of public administration
117	CTD	Tax Administration Costs
118	DB	Paying Taxes: Time (hours per year)
119	EIU	Effectiveness of system in policy implementation
120	EIU	Institutional effectiveness rating
121	EIU	Quality of bureaucracy
122	ES	[reg5] Percent of firms identifying tax administration as major constraint
123	GCS	1.08 Wastefulness of government spending
124	GI	In practice, the agency, series of agencies, or equivalent mechanism overseeing state-owned companies has a professional, full-time staff.
125	GI	In practice, the customs and excise agency has a professional, full-time staff.
126	GI	In practice, the tax collection agency has a professional, full-time staff.
127	ICRG	Bureaucratic quality
128	IPD	Practical ability of the administration to limit tax evasion
129	WCY	Adaptability of government policy to changes in the economy is high
130	WCY	Government decisions are effectively implemented
131	WDI	Statistical Capacity
132	WJP	6.1 Government regulations are effectively enforced

**[Commitment]**

133	DB	Enforcing Contracts: Cost (% of claim)
134	DB	Enforcing Contracts: Time (days)
135	IPD	Degree of observance of contractual terms between national private stakeholders
136	IPD	Generally speaking, does the State exercise arbitrary pressure on private property (red tape etc.)?
137	IPD	In the past 3 years, has the State withdrawn from contracts without paying the corresponding compensation... vis-à-vis foreign stakeholders?
138	EIU	Expropriation risk
139	ICRG	Investment profile: Contract Viability/Expropriation, Profits Repatriation, Payment Delays
140	IPD	Does the State pay compensation equal to the loss suffered in cases of expropriation (by law or fact) when the expropriation concerns... land ownership?
141	IPD	Does the State pay compensation equal to the loss suffered in cases of expropriation (by law or fact) when the expropriation concerns... production means?
142	WJP	6.5 The Government does not expropriate without adequate compensation
143	BTI	9.1 Property Rights: To what extent do government authorities ensure well-defined rights to private property and regulate the acquisition, benefits, use and sale of property.
144	CPIA	Property rights and rule based governance
145	EIU	Degree of property rights protection
146	EIU	Intellectual property protection
147	GCS	1.01 Property Rights
148	GCS	1.02 Intellectual property protection
149	GWP	WP763 Private Property Respected
150	GWP	WP798 Asset/Property Safe
151	HER	Property Rights
152	IPD	Efficiency of the legal means to protect property rights in the event of conflict between private stakeholders?
153	IPD	In the past 3 years, has the State withdrawn from contracts without paying the corresponding compensation... vis-à-vis national stakeholders?
154	IPD	Respect for intellectual property rights relating to... trade secrets and industrial patents
155	LBO	Guarantees: Protection of private property



156 VAB Government Respects Private Property  
157 VDEM 10.21 Property rights

**[Voluntary Compliance]**

158 AFR People must obey the law  
159 ARB Citizens must support the government's decisions even if they disagree with them  
160 ASI A citizen should always remain loyal only to his country, no matter how imperfect it is or what wrong it has done.  
161 WJP 5.3 People do not resort to violence to redress personal grievances  
162 WVS Democracy: People obey their rulers  
163 AFR People must pay taxes  
164 ES [infor1] Percent of firms competing against unregistered or informal firms  
165 ES [infor2] % of firms identifying practices of competitors in the informal sector as a major constraint  
166 ES [infor3] Percent of firms expressing that a typical firm reports less than 100% of sales for tax purposes  
167 ES [infor4] Percent of firms formally registered when started operations in the country  
168 IPD Importance of tax evasion in the formal sector  
169 LBO Justifiable: avoid paying taxes  
170 WCY Tax evasion is not a threat to your economy  
171 WVS Justifiable: cheating on taxes  
172 AFR How much do you trust the courts of law?  
173 AFR How much do you trust the parliament?  
174 AFR Trust in police  
175 ARB Do you trust public security (the police)?  
176 ARB Do you trust the government (the cabinet)?  
177 ARB Do you trust the judiciary (the courts)?  
178 ASI Trust in Parliament  
179 ASI Trust in the Courts  
180 ASI Trust in the national government  
181 ASI Trust in the police  
182 EUR Trust in Government  
183 EUR Trust in Parliament  
184 EUR Trust in Police  
185 EUR Trust in the Legal System  
186 GCS 1.04 Public Trust in Politicians  
187 GWP WP112 Confidence in Local Police  
188 GWP WP138 Confidence in Judicial System  
189 GWP WP139 Confidence in National Government  
190 ICRG Popular support  
191 LBO Trust in Government  
192 LBO Trust in Judiciary  
193 LBO Trust in Parliament  
194 LBO Trust in Police  
195 VAB Trust in Judicial System  
196 VAB Trust in National Police  
197 VAB Trust in the National Legislature  
198 WVS Confidence in Government  
199 WVS Confidence in Justice System/Courts  
200 WVS Confidence in Parliament  
201 WVS Confidence in Police

202	IDEA	Voter turnout in Parliamentary elections
		<b>[Security]</b>
203	AFR	Had something stolen from your house?
204	AFR	Have been physically attacked?
205	AFR	How often feared crime in your own home?
206	EIU	Impact of crime
207	ES	[crime8] Percent of firms identifying crime, theft and disorder as a major constraint
208	GCS	1.14 Business Cost of Crime and Violence
209	GCS	1.15 Organized Crime
210	GWP	WP117 Money/Property Stolen
211	GWP	WP118 Assaulted in Past Year
212	IPD	Degree of security of goods and persons
213	IPD	Intensity of violent activities... by criminal organisations (drug trafficking, arms trafficking, prostitution etc.)
214	LBO	Have you been a victim of crime?
215	TPR	Trafficking in People
216	VAB	Have you been a victim of crime?
217	WCY	Personal security and private property rights are adequately protected
218	WJP	5.1 Crime is effectively controlled
219	BTI	13.3 Conflict intensity: How serious are social, ethnic and religious conflicts?
220	BTI	3.4 Civil rights: To what extent are civil rights guaranteed and protected, and to what extent can citizens seek redress for violations of these rights?
221	CIRI	Disappearance
222	CIRI	Extrajudicial Killing
223	CIRI	Political Imprisonment
224	CIRI	Torture
225	EIU	International disputes and tensions
226	EIU	Political stability rating
227	EIU	Risk of armed conflict
228	EIU	Risk of social unrest
229	EIU	Terrorism threat
230	FSI	Refugees and Internally Displaced Persons
231	FSI	Security Apparatus - Measurements include internal conflict, riots/protests, military coups, rebel activity, and the emergence of state-sponsored or state-supported private militias that terrorize political opponents or civilians seen to be sympathetic to the opposition.
232	GBAV	The Global Burden of Armed Violence - Violent Deaths
233	GCS	1.13 Business costs of terrorism
234	GI	Are journalists safe when investigating corruption? In practice, in the past year, no journalists investigating corruption have been imprisoned/physically harmed/killed
235	ICRG	Ethnic tensions
236	ICRG	External conflict
237	ICRG	Internal conflict
238	ICRG	Religious Tensions
239	IJT	Security Risk Rating
240	IPD	Intensity of internal conflicts of an ethnic, religious or regional nature
241	IPD	Intensity of social conflicts (excluding conflicts relating to land)
242	IPD	Intensity of violent activities... by underground political organisations
243	IPD	Violence over access to natural resources (oil, mining resources, etc.)
244	IPD	Violent social conflicts

245	PTS	Political Terror Scale - Amnesty International
246	PTS	Political Terror Scale - US State Department
247	VDEM	10.4 Freedom from torture
248	VDEM	10.5 Freedom from political killings
249	VDEM	12.8 CSO anti-system movements
250	WCY	The risk of political instability is very low
251	WJP	4.2 The right to life and security of the person is effectively guaranteed
252	WJP	5.2 Civil conflict is effectively limited

**[Absence of Corruption]**

253	AFR	How many border/tax officials do you think are involved in corruption?
254	AFR	How many elected leaders (parliamentarians) do you think are involved in corruption?
255	AFR	How many government officials do you think are involved in corruption?
256	AFR	How many judges and magistrates do you think are involved in corruption?
257	ARB	Do you think that there is corruption within the state's institutions and agencies?
258	EIU	Level of corruption
259	ES	[corr11] Percent of firms identifying corruption as a major constraint
260	ES	[corr3] Value of gift expected to secure government contract (% of contract)
261	ES	[corr4] Percent of firms expected to give gifts to public officials (to get things done)
262	ES	[graft3] Bribery incidence (% of firms experiencing at least one bribe payment request)
263	GCB	Frequency of corruption among public institutions: Legal system/Judiciary
264	GCB	Frequency of corruption among public institutions: Media
265	GCB	Frequency of corruption among public institutions: Parliament/Legislature
266	GCB	Frequency of corruption among public institutions: Political parties
267	GCB	Frequency of corruption among public institutions: Public officials
268	GCB	Frequency of household bribery - paid a bribe to one of the 8/9 services
269	GCS	1.03 Diversion of Public Funds
270	GCS	1.05 Irregular payments and bribes
271	GCS	1.07 Favoritism in Decisions of Government Officials
272	GWP	WP146 Corruption in Government
273	ICRG	Corruption
274	IPD	Level of "petty" corruption between citizens and the administrations
275	IPD	Level of corruption between administrations and foreign businesses
276	IPD	Level of corruption between administrations and local businesses
277	LBO	Have you or your relatives witnessed an act of corruption?
278	PRC	To what extent does corruption exist in a way that detracts from the business environment for foreign companies?
279	VAB	Frequency of corruption among government officials
280	VDEM	2.30 Political corruption
281	WCY	Bribing and corruption do not exist
282	WJP	2.1 Government officials in the executive branch do not use public office for private gain
283	WJP	2.2 Government officials in the judicial branch do not use public office for private gain
284	WJP	2.3 Government officials in the police and the military do not use public office for private gain
285	WJP	2.4 Government officials in the legislative branch do not use public office for private gain
286	WJP	6.2 Government regulations are applied and enforced without improper influence
287	WJP	7.3 Civil justice is free of corruption
288	WJP	7.4 Civil justice is free of improper government influence
289	WJP	8.5 Criminal system is free of corruption
290	WJP	8.6 Criminal system is free of improper government influence

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## Appendix B Experimental design for the “governance game”

1. This appendix describes the experimental design for a lab experiment to test the impact of a variety of governance policies on the behavior of policy makers (in particular) and development outcomes (in general). According to the framework of the *World Development Report 2017*, *development outcomes* are defined in terms of citizen welfare (income and equity). *Governance* is defined as the institutions that solve collective action problems through power, commitment, and accountability mechanisms.
2. Recognizing the fact that the impacts of governance policies on the behavior of policy makers and citizens are difficult to identify, disentangle, and measure, the laboratory approach is used to test the impact of institutions on development outcomes. The following game (hereafter referred to as the “governance” game) is designed to capture key elements of collective action problems faced by societies. The governance game contains modifications on existing games (specifically, the public goods games and trust games) in the economics literature used to address social dilemmas.
3. The baseline governance game corresponds to a society with weak institutions. A series of treatments explicitly strengthen institutions and is used to estimate the impact on policy maker behavior, and citizen income, equity, and welfare.
4. The baseline governance game is conducted in the following way: Fixed groups of four subjects are created for the session. One subject is randomly assigned to the “policy maker” role, while the other three are assigned to the “citizen” role (instructions are neutrally framed, however, with subjects referred to as “type X” or “type Y”). Policy makers are retained in their role for the duration of the game. In each round, subjects are endowed with an equal endowment of 20 tokens. Subjects are informed that they can use their endowments to contribute to a group account. All tokens contributed to the group account are doubled. Once citizens have made their contribution decisions, the policy maker will distribute the tokens among all four subjects in the group (including himself or herself). The distribution rule (expressed in terms of the percentage of the group account assigned to each player) is revealed to all subjects in the group. In addition, beliefs of citizens regarding other citizens’ contributions and policy maker behavior are recorded. Beliefs are collected in each round while policy makers are making decisions. This game is repeated for 20 rounds, and subjects are informed that the game will continue for 20 rounds. Once the governance game is complete, subjects take a short exit survey, are paid for all decisions (redeem all tokens earned for cash at the specified exchange rate), and the experiment ends.
5. The experiment has an additional feature worth mentioning: subjects earn their endowments for use in this game by working on a coding task beforehand (Erkal, Gangadharan, and Nikiforakis 2011; Charness, Masclet, and Villeval 2014; Gangadharan, Nikiforakis, and Villeval 2015). This is implemented to inculcate subjects’ ownership of the initial endowment.
6. The game measures cooperation and generates outcomes relevant to the Report: policy maker behavior and citizen welfare. Furthermore, by using a real effort task, the game captures essential elements of the relationship between government and citizens through income taxation. Note that due to weak institutions managing the behavior of the policy maker, the equilibrium of this game (through backward induction) is for the policy maker to keep all contributions made to

the group account, and (anticipating this) for citizens to never contribute to the group account. Since this is a finitely repeated game, the equilibrium holds for each round in the game. Individual incentives yield the minimum level of social welfare, constituting a social dilemma.

### Treatments

7. The treatments introduce a series of institutions designed to strengthen governance, and are expected to impact policy maker behavior, cooperation, income, equity, and welfare.

8. *Treatment 1: Random replacement of the policy maker.* Recall that in the baseline governance game, the policy maker is randomly assigned at the beginning of the game and retains this role for all 20 rounds. In this treatment, the policy maker is replaced by a randomly selected subject from the same group every four rounds (each group member has an equal chance of being selected, meaning that the same subject may become policy maker multiple times). This treatment corresponds to *faux*-democratic elections where citizens have no voice and policy makers cannot be held accountable, but are replaceable.

9. *Treatment 2: Citizen punishment of the policy maker.* This treatment is identical to the baseline, with the additional step of citizens spending resources to “punish” the policy maker. Once the policy maker distributes the group account, citizens observe the distribution rule, and can then spend tokens (i.e. exert effort) to punish the policy maker. Punishment constitutes a coordination problem for the citizens: citizens bear the full cost of punishing the policy maker, but the lowest cost is enacted as a decision for all citizens (corresponding to a “weakest link” punishment mechanism). The implemented level of punishment is multiplied and the policy maker’s earnings are reduced by this amount. This treatment corresponds to a weak form of voice and accountability that is common in developing countries (such as protests).

10. *Treatment 3: Vote of no confidence.* This treatment is identical to the baseline, with the exception that every four rounds, citizens can vote to retain or replace the policy maker through a simple majority voting mechanism. Retaining the policy maker means that the policy maker continues in his/her role for an additional four rounds. Replacing the policy maker means that another policy maker is randomly selected from the group. This treatment corresponds to a strong form of voice and accountability where citizens have indirect control over policy maker behavior through a voting mechanism.

11. *Treatment 4: Credible commitment.* This treatment is identical to the baseline, with the exception that policy makers credibly commit to a policy (distribution rule) before citizens make their contribution decisions. This means that policy makers announce a distribution rule, which is then implemented with certainty. This treatment corresponds to credible commitment on the part of the policy makers toward their citizens.

12. In sum, the experimental design creates a lab form of the governance problem, which is then used as a wind tunnel to test specific institutions. Outcome variables include citizen and policy maker surplus (the measures of welfare).

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