

[DRAFT: NOT FOR QUOTATION OR CIRCULATION]



Governance and the Law Overview

Green Cover Draft

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World Development Report 2017: Governance and the Law

Overview

0.1 In the last 20 years, enormous progress has been made around the world in terms of socioeconomic indicators. The rapid diffusion of technology and greater access to capital and world markets have enabled economic growth rates that were previously unfathomable and have helped lift over one billion people out of poverty. Yet at the same time, increased flows have also led to rising inequality, both within and across borders, and to greater vulnerability to global economic trends and cycles. Although the global spread of capital, technology, ideas, and people has helped many countries and people progress, other places and populations have been seemingly left behind and are still confronted by violence, slow growth, and limited opportunities for advancement.

0.2 As ideas and resources spread increasingly rapidly across countries, policy solutions to promote further progress abound. However, policies that should be effective in generating positive development outcomes are often not adopted or are poorly implemented or end up backfiring over time. While the development community has focused a great deal of attention on learning *what* policies and interventions are needed to generate better outcomes, it has spent much less attention on learning *why* those approaches succeed so well in some contexts, but fail to generate the same results in others.

Improving governance to meet today's development challenges

0.3 Ultimately, 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 process by which state and nonstate actors interact to design and implement policies, what this Report calls governance (box 0.1). Consider some recent cases that have attracted global attention.

Box 0.1 What is governance?

For the purpose of this Report, *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.^a This Report defines *power* as the ability of groups and individuals to make others act in their interest and to bring about specific outcomes.^b

Depending on the context, actors may establish a *government*, as a set of formal state *institutions* (as used in the literature to denote 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.

a. Dahl 1957; Lukes 2004.

b. The general definition of governance used in the Report is consistent with the World Bank's corporate definition, which emphasizes formal institutions and the role of state actors.

0.4 *State building in Somalia and Somaliland.* Somalia is one of the world's most fragile countries. It has been racked by violence for more than two decades. Insurgent attacks and regional conflicts have prevented the emergence of a centralized state with monopoly over the legitimate use of force. Warring factions, many with their own regional sources of power, have been unable to reach a credible deal that determines the make-up and responsibilities of the central state. In contrast, in Somalia's autonomous region of Somaliland, an area with similar tribal and clan tensions, 20 years of stability and economic development have followed a 1993 clan conference that brought together leaders from both modern and traditional sectors, successfully institutionalizing these clans and elders into formal governing bodies.

0.5 *Confronting corruption and the resource curse in Nigeria.* Just a year after a decade-long bounty of windfall revenues from high oil prices, Nigeria was requesting budget support from its development partners. Instead of saving to invest in the future, Nigeria's government has squandered its oil wealth. According to a former president of the central bank, billions of dollars have been lost to corruption by the National Petroleum Company. Nigeria's institutional context did not provide the capacity to safeguard natural resource revenues to reduce fiscal volatility and promote a macroeconomic environment conducive to long term investment. Corruption has become a built-in feature of government interactions, rather than a discrete problem to be eradicated. Several countries have demonstrated that the "resource curse"—the paradox that countries with abundant natural resources have slower growth and worse development outcomes than countries without resources—can be avoided through effective economic and fiscal policies. These policies, however, were not credibly adopted in Nigeria.

0.6 *China's growth performance and growth challenges.* For four decades, as China has increasingly integrated with the global economy, it has grown at double-digit rates and lifted more than 700 million people out of poverty. This successful track record of economic growth is well known. Yet, according to frequently 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 the adaptive policy decisions and state capacity that enabled economic success were facilitated by deep changes to 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. Meanwhile, China today faces a growth slowdown. Maintaining rapid growth requires the political incentives 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 little incentives to join coalitions for further reforms. Going forward will involve addressing these governance challenges.

0.7 *Slums and exclusion in India's cities.* Urban development that stems from coordinated planning and investment by coalitions of developers, bureaucrats, citizens, and politicians can lead to cities that are centers of growth, innovation, and productivity. Planners can help ensure that infrastructure meets the demands of investors who seek to maximize land rents; businesses that need connectivity to consumers, employees, and other firms; and citizens who want access to services and jobs. But many cities fail to deliver on these promises. In India, massive urban slums—about 49,000 at the latest count, with tens of millions of inhabitants—represent failures to align public investments and zoning with the needs of a diverse set of urban constituents. Poorly designed cities with misallocated investments have limited connectivity between housing,

affordable transportation, and utilities, driving workers into informal settlements, often in peripheral areas. While many developers and politicians have exploited the system to generate rents for themselves, this uncoordinated urban development has prevented cities from achieving their growth potential, and has resulted in large slums where most citizens are deprived of basic services.

0.8 *Demanding better services in Brazil.* In 2013, the world watched when protests erupted in Brazil's streets, with citizens complaining about the quality of public services—transport, education, and health—as the FIFA World Cup soccer tournament approached. Brazil had gone through twelve years of inclusive and sustained growth, which had lifted more than 30 million people out of poverty and strengthened the 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 has historically been weak and fragmented. Low-quality public services were provided to the poor, while the upper-middle classes relied upon private services and were thus unwilling to contribute to the fiscal system. The creation of an expanded middle class and the reduction of poverty paradoxically heightened the perceptions of unfairness as the new middle class expected more than low-quality public services for its contributions.

0.9 *“Brexit” and the rise of populist parties.* In June 2016, voters in the United Kingdom elected to leave the European Union (EU). The British pound immediately fell in value, and fear set in over the potential medium- and long-term economic consequences and costs of this decision. Across the European continent, far-right populist parties campaigning against further European integration have enjoyed unprecedented electoral success, and in 2016, hold power in Finland, Hungary, Latvia, Lithuania, Norway, and Switzerland. In these countries, despite high incomes (Western Europe) and rapid economic growth over the past two decades (Eastern Europe), populist “anti-Europe” messages have resonated as citizens have felt increasingly disenfranchised and excluded from European decision making, while a perception of free-riding by specific groups was growing without much objective assessment. With the perceived ineffectiveness of “voice” in European decision-making bodies, they have opted for “exit,” most clearly in the case of Britain's vote to leave the EU.

0.10 What do these examples have in common? This Report assumes that all countries share a set of developmental objectives: minimizing the threat of violence (*security*), promoting prosperity (*growth*), and ensuring that prosperity is shared (*equity*), while also protecting the sustainability of the development process for future generations (box 0.2). But policies do not always translate into these development outcomes in expected ways. As the previous examples illustrate, contradictions occur in the real world. Somalia is as close as it gets to a failed state, while Somaliland seems to be doing well. China grew rapidly, even though its institutions apparently did not (and may need to do so now). India grew, but cannot control the propagation of slums. Nigeria has an abundance of resources, but is persistently poor. Brazil experienced inclusive growth, but is now facing widespread protests from the middle class. Britain had low unemployment, but voted to quit the EU. The common thread across these contradictions appear to be governance malfunctions: ineffective policies persist, effective policies are not chosen, and unorthodox institutional arrangements generate positive outcomes. So, what drives policy effectiveness?

Box 0.2 Governance for what? Achieving the goals of security, growth, and equity

Many aspects of governance 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”.^a 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”.^b These positive relationships are what economists call complementarities. This Report acknowledges the intrinsic value of various dimensions of governance, and the notion of development as positive freedom, 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 because 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 in order to enable more effective policies.

a. Sen 1999.

b Sen 1999.

Drivers of effectiveness: Commitment, coordination and cooperation

0.11 Often, when policies and technical solutions fail to achieve intended outcomes, blame falls on institutional failure, and the solution usually proposed is to “improve” institutions. But many types of institutional arrangements and trajectories can enable development, as examples around the world demonstrate—while many other supposed “best practices” fail. In some cases, rapid progress comes about suddenly, seemingly unexpected. Given this diversity of paths and perils, it becomes essential to uncover the underlying drivers of policy effectiveness. How can policies increase the likelihood of this kind of switch? This Report draws attention to *commitment*, *coordination*, and *cooperation* as the three core functions of institutions that are needed to ensure that rules and resources yield desired outcomes.¹

Form versus function: Underlying determinants of policy effectiveness

0.12 *Commitment.* Commitment enables actors to rely on the credibility of policies so as to calibrate their behavior accordingly. Consistency over time in terms of policies is not easy to achieve. Circumstances change, policy objectives may extend beyond the political cycle, and resources may fail to match, changing the incentives to implement previously chosen policies. In line with the economic theory of incomplete contracts, policies require commitment devices in order to ensure their credibility.

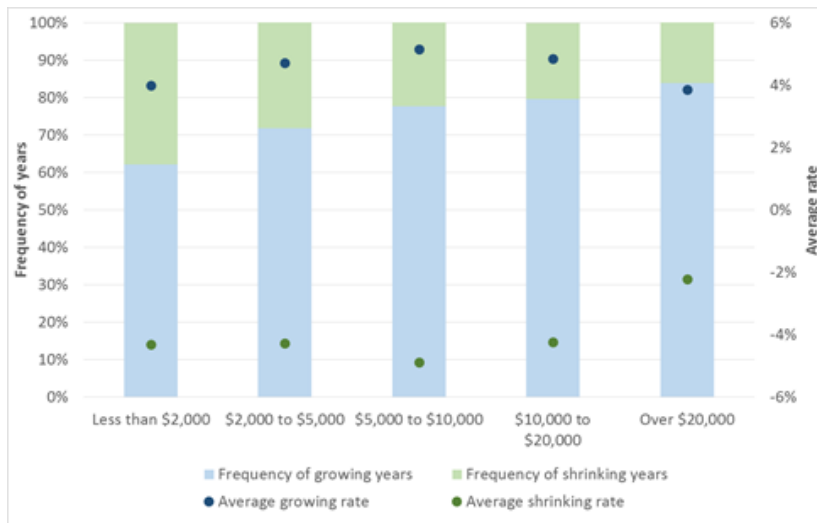
¹ The chapters of this Report will focus on the specific question of policy effectiveness. The framework, however, can be used to address broader questions about social dynamics.

0.13 For instance, security—a foundation for sustained development—is premised most basically on commitment. Are conflicting parties able to reach credible agreements to renounce violence and endow the state with the monopoly on the legitimate use of violence? In Somaliland, for example, commitment has been achieved by establishing institutional arrangements that provide sufficient incentives for all key groups to work within the rules. The commitment is credible because all parties stand to lose if any party reneges on the institutional arrangements. In Somalia, by contrast, despite several internationally sponsored efforts at state-building, polarized groups continue to believe that they are better off retaining their own power or forming shifting alliances with others than conferring the monopoly of violence on a central state. This is mainly because the nature of the agreements and proposed institutional arrangements have failed to serve as effective commitment devices. When commitment to deals is not credible, contending sides walk away from the bargaining table 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.

0.14 Credible commitment to pro-growth policies and property rights is also essential to ensure macroeconomic stability and to enable growth. Recent evidence shows that most long-term growth comes not from episodes of rapid growth—as commonly believed—but from countries not shrinking as a result of economic crisis or violent conflict (figure 0.1). Growth requires an environment in which firms and individuals feel secure in investing their resources in productive activities. This commitment may be provided in diverse ways. China’s growth success depended on a credible pledge to local governments, private enterprises, and rural farmers that they would be able to keep their profits—credible commitment was thus provided, even if it did not enshrine formal private property rights. In contrast, in Nigeria, the institutional context did not provide the commitment capacity to safeguard revenues from natural resource extraction to support long-term development. In the Nigerian context of rent-distribution, implementing “best practice” fiscal rules that worked in other country contexts did not constitute a credible commitment because government officials were overcome by short-term interests. State governors, for instance, uncertain about whether resources would still be there in the future, had incentives to spend them straight away.

Figure 0.1 Long-term growth is less about how fast you grow than about not tripping along the way

High-income countries are better off not because they grow faster when they grow, but because they shrink less frequently and at a slower rate than low-income countries.



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

Note: Real GDP per capita (constant prices: chain series). Countries first sorted into income categories based on their income in 2000, measured in 2005 dollars. Average annual growth rates are the simple arithmetic average for all the years and all the countries in the income category, without weighting. The sample underlying the figure includes 141 countries, which have data available from at least 1970 onward.

0.15 *Coordination.* Credible commitment alone, however, is not sufficient. Coordination is also needed. Investment and innovation require that firms and individuals believe that others will also invest. Institutions can help solve market failures by coordinating investment decisions and coordinating the expectations of market participants. The insight that a failure to coordinate investment activity can lead to underdevelopment is decades old.² Consider the case where large-scale factories are more efficient, but investing in them is not profitable for individual firms unless investment is made simultaneously in a group. This could be because the market size is too small to justify large-scale investments, unless all the industries expand together, providing markets for one another. There are two possible outcomes, or “equilibriums,” 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 problems of coordination can occur in many contexts, ranging from finance and adoption of technology to innovation and industrial clusters to urban planning.³ In India, the lack of coordination between urban planners, real estate developers, and local politicians has prevented an efficient design of urban areas, hindering many cities from performing their roles in enhancing growth.

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

³ 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.

0.16 *Cooperation.* Finally, policy effectiveness to achieve equitable development requires cooperation, particularly citizens’ willingness to contribute to public goods and not free-ride on others. The extent to which societies can ensure opportunities for all individuals relies on their ability to provide high-quality services, such as health, education, or connectivity, and to ensure access to economic opportunities, especially access to markets that allow individuals to use the assets acquired. Collecting the taxes needed to fund investments in public goods requires individuals’ willingness to comply and cooperate. Credible and consistent enforcement of laws are also needed to expand opportunities and level the playing field.

0.17 Sometimes, societies face a breakdown of cooperation. For example, Brazil, where citizens organized to demand higher quality of public services, faced a problem common to many countries: namely, the fragmentation of a social contract. In these cases, the low quality of service provision leads the upper middle classes to demand private services, which in turn weakens their willingness to cooperate fiscally and contribute to the provision of public goods, in a perverse cycle. At other times, actors potentially affected by policies may be excluded from their design, undermining their incentive to cooperate, and weakening compliance. An induced perception that the European Union engaged in technocratic and exclusionary decision making, and that there was free-riding by some countries, which were benefiting disproportionately from the agreement, led to the United Kingdom vote for “Brexit”—and to the rise of populist parties in Europe that challenged further integration.

0.18 *Commitment, coordination, and cooperation* are therefore essential institutional functions for making policies effective and thereby achieving development outcomes (table 0.1).⁴ Yet, they are only effectively fulfilled under certain conditions. This Report proposes an analytical framework to advance our understanding of how governance can help achieve these functions to promote development outcomes.

Table 0.1 Three institutional functions—commitment, coordination, and cooperation—are essential to the effectiveness of policies

Function	Some examples of why these functions matter
Commitment	<ul style="list-style-type: none"> • Decision makers may want to spend windfall revenues now instead of saving them for others to spend in the future. • Politicians may resist continuing policies that have worked in the past and prefer to propose others that are associated with their political group. • Public service providers may push to renegotiate the terms of their contracts in their benefit, when they know the political cost of suspending service is high.
Coordination	<ul style="list-style-type: none"> • Investment and innovation are induced when individuals believe the others will also invest. • Financial stability relies on beliefs about credibility of policies; failures involve, for example, bank runs, where everyone believes the rest will rush to withdraw deposits.

⁴ Including at the subnational level. Preventing crime, for instance, can be explained from the functional perspective as part of what local governments provide for the public, as shown in Part 2 of this Report.

	<ul style="list-style-type: none"> • Laws serve as a focal point for individuals to behave in certain ways, such as the convention to drive on the right side of the road.
Cooperation	<ul style="list-style-type: none"> • People have incentives to free-ride or behave opportunistically, for example, not paying taxes while enjoying the public services other (tax-paying) individuals are contributing to fund. • Some actors potentially affected by policies may be excluded from their design, which weakens compliance and leads to fragmentation.

Source: WDR 2017 team.

When political will is not enough: Power, bargaining, and the policy arena

0.19 This Report argues that institutions perform three key functions to enhance policy effectiveness for development: enabling credible *commitment*, enhancing *cooperation*, and inducing *coordination*. But why are policies so often ineffective in doing so? A typical response among policy practitioners is that the right policies exist, ready to be implemented, and that what is missing is the existence of political will in the national arena. This Report argues that decision makers—the elites⁵—may have the right objectives and yet may still be unable to implement the right policies because doing so would challenge the existing equilibrium—and the current balance of power. Thus, the balance of power in society may condition what kind of commitment, coordination, and cooperation results come about.

0.20 Ultimately, policy effectiveness depends not only on what policies are chosen, but also on *how* they are chosen and implemented. Policy making and policy implementation both involve bargaining between different actors. The setting where (policy) decisions are made can be termed the *policy arena*: the space where different groups and actors interact and bargain over aspects concerning the public space, and where resulting agreements eventually also lead to changes in the formal rules (law). It is the setting where governance manifests itself. Policy arenas exist at the local, national, international, and supranational levels. They can be formal (parliaments, courts, intergovernmental organizations, government agencies); traditional, and informal (backroom deals, Old Boys networks).

0.21 Who bargains in this policy arena, and how successfully they bargain, is determined by the relative *power* of actors, by their ability to influence others through control over resources, threat of violence, ideational persuasion (de facto power), as well as by and through existing rules themselves (de jure power). Power is expressed in the policy arena by the ability of groups and individuals to make others act in their interest and to bring about specific outcomes. It is a fundamental enabler—or constraint—to policy effectiveness (see box 0.3).

0.22 The distribution of power is a key element in the way in which the policy arena functions. During policy bargaining processes, the unequal distribution of power—*power asymmetry*—can influence policy effectiveness. Power asymmetry is not necessarily harmful, and can actually be a means to achieve effectiveness—for example, through delegated authority. In contrast, the negative manifestations of power asymmetries are reflected in capture, clientelism, and exclusion.

⁵ What distinguishes elites from citizens in this Report is their ability to directly influence the design and implementation of a certain policy. Elites, in this way, are defined in a positive (as opposed to a normative) sense. See box 0.6 for further detail.

How power asymmetries matter for security, growth and equity

Box 0.3 The idea of power and the power of ideas

“The ideas of economists and political philosophers,” John M. Keynes noted in *The General Theory of Employment, Interest and Money*, “both when they are right and when they are wrong, are more powerful than they are commonly understood. Indeed, the world is ruled by little else.” The notion of how ideas can influence historical paths in fundamental ways has long been studied by social scientists, not only from the perspective of ideology and culture but also from the view of “cultural entrepreneurship.”^a It is important, however, to distinguish two specific ways—not exhaustive but fundamental—in which ideas influence policy making and effectiveness: ideas as knowledge, and ideas as a means to shape preferences and beliefs.

From the perspective of ideas as knowledge, the policy discussion has been influenced in the past few decades by the principles of “capacity building” in the form of knowledge sharing and dissemination of “best practices.” Ideas as knowledge undoubtedly play a role in strengthening the effectiveness of policies and enhancing the capacity to deliver on specific policy commitments.

But ideas also shape preferences and beliefs. Keynes ended his discussion on ideas by saying that “practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist. . . soon or late, it is ideas, not vested interests, which are dangerous for good or evil.” Since the eighteenth century, Hume’s law established that no normative statement (such as a policy prescription) can be derived from a positive one (observation of facts) without a normative idea as an assumption. Policy prescriptions based on facts still require some normative notion: an idea, in the background. Acknowledging the importance of ideas, this Report discusses the relevance of shaping preferences as a means to understand the policy bargaining process

It was Eric Wolf who, in 1999, called attention to the importance of understanding power and ideas as complementary to understanding social dynamics.^b Indeed, following Michel Foucault, Wolf argues that the ability to shape other people’s beliefs is a means to elicit an action from another person—an action the other person would not otherwise take. The ability to make others act in one actor’s interest or to bring about a specific outcome—the definition of power in this Report—is thus closely related to the notion of ideas as beliefs.

The dichotomy between ideas (ideology and culture) and power as a primary determinant of social dynamics is thus a false one. The idea of power cannot be understood without taking seriously the power of ideas.

a. See, for example, Mokyr (2005) for a discussion on the “intellectual origins of modern economic growth.”

b. Wolf (1999). See also Barret and others (2001).

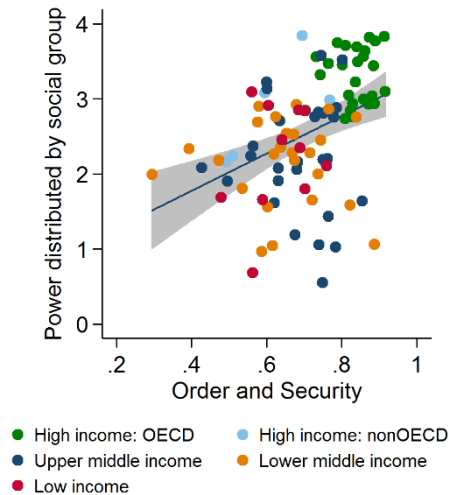
0.23 *Exclusion*. One manifestation of power asymmetries, the *exclusion* of individuals and groups from the bargaining arena, can be particularly important for security (figure O.3). When powerful actors are excluded from the policy arena, violence may become the preferred—and rational—way for certain individuals and groups to pursue their interests, such as in Somalia. It can lead to 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).

0.24 *Exclusion*, which can take the shape of lack of access to state institutions, resources, and services, often 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).⁶ Cross-country statistical analyses using the Ethnic Power Relations dataset from 1945 to 2005

⁶ 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), as does the opportunity to mobilize. On the former, see Fearon and Laitin (2003).

indicate that states that exclude large portions of the population based on ethnic background are more likely to face armed rebellions.⁷ The existence of norms that exclude certain groups, like women and minorities, from the bargaining arena where disputes are settled tend to reinforce power asymmetries and perpetuate inequitable and insecure outcomes.⁸

Figure 0.2 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 (consisting of “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).

Note: OECD = Organisation for Economic Co-operation and Development.

0.25 *Capture.* A second manifestation of power asymmetries, the ability of influential groups to “capture” policies and make them serve their narrow interest, is helpful to understand the effectiveness (or lack thereof) of policies in promoting long-term growth. In the 1990s, for example, some of Indonesia’s largest industrial groups had strong connections to then-President Suharto.⁹ Between 1995 and 1997, rumors about President Suharto's health circulated on several occasions. In every episode, the closer that industrial groups were to the president, the more their stock market returns fell (figure 0.3). The effects of capture can be quite costly for the economy. 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 through access to loans, ease of licensing requirements, energy subsidies, or import barriers. This can stifle competition and lead to resource misallocation, with a toll on innovation and productivity. 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

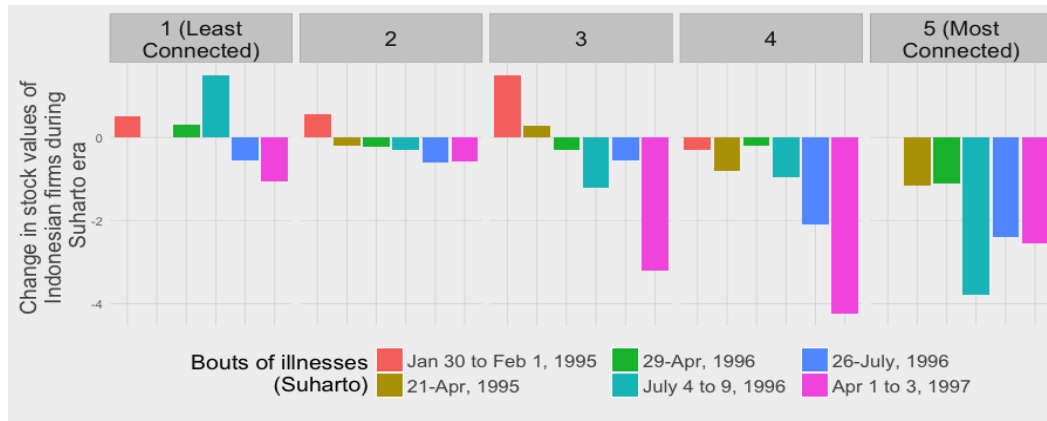
⁷ Wimmer and others 2009.

⁸ Platteau 2000.

⁹ Suharto was the second President of Indonesia; he held the office for 31 years from the ousting of the first President Sukarno in 1967 until his resignation in 1998.

that were 50 percent higher. Based on the productivity gap between firms, the annual cost of this credit misallocation could have been as high as 1.6 percent of GDP.¹⁰

Figure 0.3 The value of political connections: Indonesia during President Suharto's era



Source: Fisman (2001, figure 1).

0.26 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. 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? 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. The real problem, however, may have political roots: 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”). These actors may exert influence to capture policies to serve their own interests. Box 0.4 presents an example of the political challenges in transitioning toward a different growth strategy, related to investments in environmental sustainability.

¹⁰ Khwaja and Mian 2005.

Box 0.4 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” .^a 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 and fertilizers. In 2005, faced with food insecurity, Malawi introduced a fertilizer subsidy for smallholder maize farmers, which led to a sizeable effect on maize production. However, the intensive use of fertilizers—such as that promoted by this subsidy—can have substantial long-term costs on the environment and the economy. While more environmentally friendly alternatives exist, their adoption tends to be unfeasible in the short run. It would not be easy for small farmers to adopt greener approaches, such as microdosing—which consists of smaller but more targeted doses of fertilizer—which would also require a shift in the behavior of farmers on a relatively broad scale. Getting rid of the subsidy could therefore hurt maize farmers for some years .^b

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 a strong electoral 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 relatively abundant 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 .^c These examples illustrate how taking into account the potential resistance from short-term losers into the design of policies can improve effectiveness.

a. Hallegate and others 2012

b. Resnick, Tarp, and Thurlow 2012.

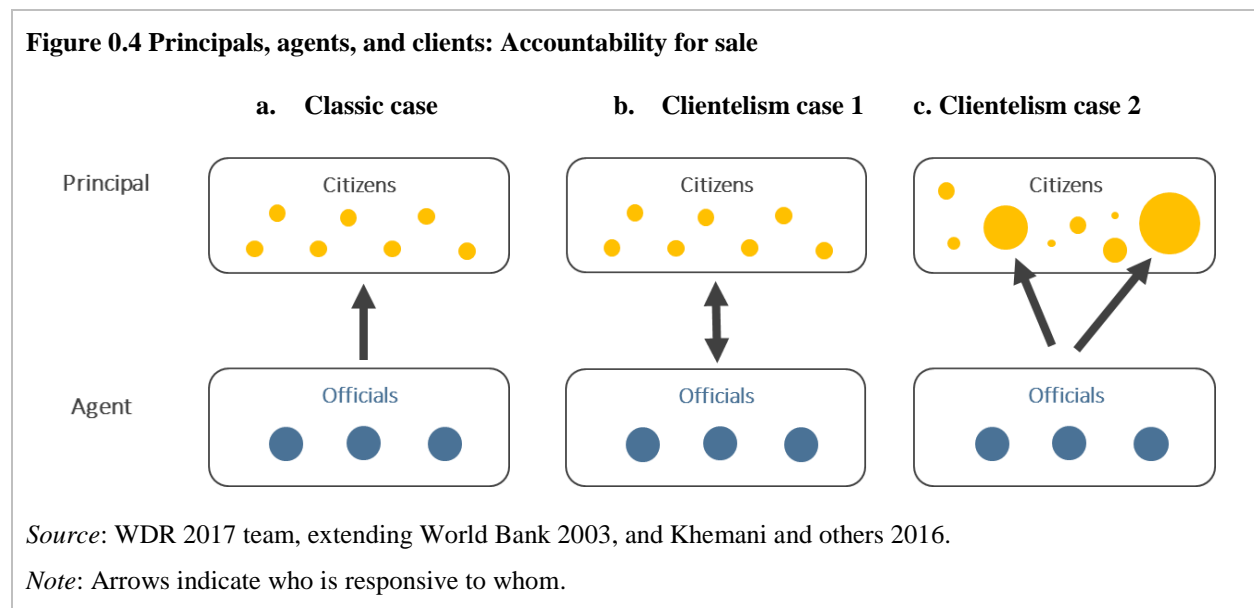
c. Resnick, Tarp, and Thurlow 2012.

0.27 *Clientelism*. A third manifestation of power asymmetries, *clientelism*—the exchange of political support for short-term benefits—is helpful to understand why policies that look to promote equity are often ineffective. Expanding opportunities and leveling the playing field may boost growth in the medium and long run, but in the short run may threaten the interests of specific groups. When such groups have direct influence on policy design or implementation—including because of existing patterns of inequality—they may attempt to undermine the adoption or implementation of redistributive policies, weakening the commitment to such policies. Clientelism can shape the adoption and implementation of policies in two main ways. First, in clientelistic settings, the relationship between public officials and voters becomes distorted. Instead of a dynamic where the official is the agent of the voter (who monitors and sanctions the agent) (figure 0.4, panel a), the interaction becomes a bargain, where the politician “buys” the vote in exchange for (usually) short-term benefits—such as transfers or subsidies .¹¹ This leads to a breakdown of

¹¹ Khemani and others 2016.

commitment to long-term programmatic objectives and becomes an obstacle in the achievement of a sustained path to equitable outcomes (figure 0.4, panel b).

0.28 Moreover, incumbent public officers often become dependent on the support of certain groups for their political survival, including the providers of public services. In this clientelistic equilibrium, politicians become responsive to those groups that wield greater influence—for instance, favoring the interests of teacher unions (over those of students) (figure 0.4, panel c). The costs of this malfunction can be high. In exchange for their political support, service providers may extract rents through the diversion of public resources, or withhold their effort in the form of absenteeism or low-quality provision, or engage in corrupt practices, hampering the delivery of services such as education, health, or infrastructure. For example, 40 percent of doctors in public health facilities were absent at any given time in a representative sample of rural areas of Madhya Pradesh in India. Doctors in public facilities in the sample spent on average 2.4 minutes with a patient and completed only 16 percent of a checklist of examination items and questions on medical history—while the same doctors performed better when they were in the private sector.¹² This form of clientelism also leads to a breakdown in commitment, where accountability becomes up for sale.



0.29 When commitment breaks down systematically, it can affect legitimacy, eroding people’s incentives to cooperate and some groups may “opt out” by demanding private services and avoiding to contribute to the provision of public goods.¹³ In clientelistic settings, states tend to have low tax revenues and provide few public goods, undermining economic activity and future taxation.

¹² Das and others, 2015

¹³ Ferreira and others 2013.

0.30 In contrast, repeated commitment builds legitimacy in terms of outcomes¹⁴. When a government repeatedly delivers on its commitments, it legitimizes itself—for instance, by reliably providing public services. Legitimacy also comes from other sources, namely a perception of fairness in the way that policies and rules are designed and implemented, i.e., *process* legitimacy. Finally, legitimacy is also relational, where sharing a set of values and norms encourages individuals to recognize authority. Outcome, process and relational legitimacy form the three types of legitimacy identified in this Report. Legitimacy matters for cooperation and coordination, as it implies voluntary compliance with an act of authority. Even if a government delivers on its commitments and is able to coerce people into complying, there might be “legitimacy deficits” if the process is perceived as unfair and people might not be willing to cooperate.

Best practice or best fit? Revisiting the notion of “first best”

0.31 The development community has largely focused its reform attempts on designing best practice solutions and building the capacity needed to implement them. Capacity is often considered a prerequisite for policy effectiveness. Capacity is certainly important, and in many cases constitutes an overriding constraint. At a given point in time, 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 if physical and administrative capacity exists, policies may still be ineffective if groups with enough bargaining power have no incentives to pursue implementation. An example is the low investments in statistical capacity in Africa that limit the ability to monitor policy effectiveness (box 0.5). In addition, existing power structures may be reinforced by prevailing norms, as socially accepted, persistent shapers of behavior.¹⁵ Such norms may reinforce or undermine policy effectiveness.

Box 0.5 The need to strengthen incentives 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.^a 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 incentives to do so.

In many countries, political incentives lead those in power to avoid investing in capacity or 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.^b Of course, this practice is not unique to Africa.

The argument is as valid for the use of existing capacity as it is for building such capacity. In Latin America, a region well-known for its capacity for data collection, there are examples where the political dynamics led to a weakening of the credibility of official statistics. For example, in Argentina, after building a reputation for high-quality data collection and independence from the political sphere, the Kirchner administration decided to replace the technical experts with political appointees who first manipulated the data to reduce the poverty estimates and then stopped measuring poverty altogether.^c

a. Devarajan 2013.

b. Beegle and others 2016

c. Noriega 2012; Roitberg and Nagasawa 2016.

¹⁴ Outcome legitimacy is related to the notion of *trust*, which is defined in this WDR as the probability that an actor assigns to other actors delivering on their commitment, conditional on their past behavior.

¹⁵ World Bank 2015.

0.32 Thus, investing in capacity may not be enough. Designing policies to improve security, growth, and equity requires understanding the balance of power among different actors. In the presence of powerful actors who can block or undermine policies, optimal policies from a strict economic standpoint (first-best policies) may not be the optimal implementable policies (second-best, but feasible). Even when feasible, implementing what seem like first-best economic policies, from a static perspective, can lead to worse outcomes for society when they negatively affect the power equilibrium. 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,¹⁶ even if representation is not perfect. In such cases, passing a law to make labor contracts more flexible may undermine union membership and lead to more inequality, which, in turn, can perpetuate the power of the wealthy.¹⁷

Levers for change: Incentives, preferences, contestability

0.33 From the perspective of power asymmetries, efforts to strengthen the ability of institutions to effectively enable commitment, coordination, and cooperation call into question many traditional practices of the development community. In order to design more effective policies, it is necessary to recognize how the distribution of power in the policy arena may affect policy design and implementation and to consider how the policy arena can be reshaped to expand the set of policies that can be implemented.

Reshaping the policy arena occurs when changes take place in who can participate in decision-making processes (the contestability of the policy arena), when *incentives* to pursue certain goals are transformed, and when there are shifts in actors' *preferences and beliefs*. For example, the enfranchisement of previously disengaged illiterate voters in Brazil (through the introduction of electronic ballots) shifted the balance of power in their favor by reducing the entry barriers for their participation, increasing contestability, ultimately leading to increased spending in healthcare. In Kenya, elections helped transform the incentives of ruling elites, reducing the scope of ethnic favoritism. Moreover, political parties, as a form of political organization, can help aggregate citizens' preferences, integrating different groups in the political process, encouraging a culture of compromise. In Tanzania, the power-sharing agreements within the Chama Cha Mapinduzi party has been instrumental in accommodating the demands of various leaders.¹⁸ Depending on the primary functional challenge (that is, whether the policy needs to enable commitment, coordination, and/or cooperation), the entry point may be different. As these functional challenges are interdependent, the entry points act as complements to one another.

0.34 As an illustration, consider 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) based on individuals' market income is 0.47 for developed countries and 0.52 for developing countries. After considering the effect of taxes and transfers, the corresponding

¹⁶ Collective action problems include those solved through *coordination* (the coordinated actions among actors based on a shared expectation about what others will do) and *cooperation* (the cooperative behavior among actors, whereby opportunistic behavior—free riding—is limited). Throughout the Report the term refers to these two different manifestations of collective action problems.

¹⁷ Acemoglu and Robinson 2013.

¹⁸ Ezrow and Frantz 2011.

coefficients drop to 0.31 and 0.50, respectively. If the effect of publicly provided services (in particular, education and health) is also included, inequality falls further: to 0.22 in developed countries and to 0.42 in developing countries.¹⁹ The quantifiable redistributive capacity of these countries can be interpreted in different ways. It can be interpreted as the relative ability of different 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; more checks and balances on power are associated with more redistribution.²⁰ Or it can be interpreted as the preferences for redistribution in a given country. WDR 2017 explores in depth how changes to contestability, incentives, and preferences can enhance policy effectiveness for security, growth, and equity.

The role of law: Closing the gap between laws on paper and laws in practice

0.35 Law is a powerful instrument to reshape the policy arena. While laws generally reflect the interests of those actors with greater bargaining power, law has also proven to be an important instrument 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. 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. Effective laws are those that are able to shape bargaining spaces that increase contestability by under-represented actors; change incentives by changing payoffs to lower the cost of compliance (or increase the cost of noncompliance); and change preferences by enhancing substantive focal points around which coordination can occur.

0.36 *Contestability.* Who is included and who is excluded from the policy arena is determined by the relative power of the competing actors, as well as by the barriers of entry to participate (that is, the *contestability* of the process). A more contestable policy arena is one in which actors or groups who have reason 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 it also emphasizes the barriers to participation. While the inclusion of more actors in the decision-making process is not necessarily a guarantee of better decisions, a more contestable policy arena tends to be associated with higher levels of legitimacy and cooperation. When procedures for selecting and implementing policies are more contestable, those policies tend to be perceived as “fair” and to induce cooperation more effectively.

0.37 Law can play a role in making the policy arena more contestable. Enhancing the contestability of the arena encompasses both *ex ante* procedures (which relate to the means by which law is made, and the extent to which it is participatory and transparent) and *ex post* ones (the extent to which it is applied consistently and fairly). If various actors believe that the process is exclusionary, or reflects only the interests of some groups, they may not comply, or they may outright oppose it. Public hearings, stakeholder consultations, social audits, and participatory

¹⁹ See Aaberge and others (2010); Lustig (2015).

²⁰ See Besley and Persson (2014).

processes are some examples of instruments that can make the arena more contestable.²¹ In this case, law serves as a tool to promote accountability, change the rules of the game, or both. This is embodied, for example, in the advocacy to adopt right to information laws.

0.38 *Incentives.* The *incentives* that actors have to comply with agreements are fundamental to enable commitment in the policy arena. Credible commitment requires consistency in the face of changing circumstances; incentives for actors to commit to agreements is thus crucial for the effectiveness of policy design and implementation. Stronger incentives to hold policy makers accountable can also strengthen voluntary compliance, as repeatedly delivering on commitment helps build trust in institutions. Law can play a role in shaping the incentives of actors to comply with agreements, for instance, by providing a credible threat of punishment or a credible commitment to obtaining the reward for compliance. Law orders behavior through rules ranging from prohibiting bribery, to establishing licensing fees and business registration, to banning child marriage, as well as by the means to enforce them. Laws induce particular behaviors of individuals and firms through coercive power, coordination power, and legitimating power.

0.39 *Preferences and interests.* The *preferences and interests* of decision-making actors matter for shaping whether or not the outcome of the bargain will enhance welfare, and whether or not the system is responsive to the interests of those who have less influence. Law can effectively reshape preferences and coordinate expectations about how others will behave, serving as a focal point. As the different preferences and beliefs of actors shape their policy goals, an important condition for policy effectiveness relates to the coordination of actors' expectations. In this way, law can serve the role of a sign post—an expression—to guide people as to how to act when they have several options, or, in economic terms, in the presence of multiple equilibria.²² The law provides a clear reference in the midst of diverging views. People comply with the law because doing so facilitates social and economic activities.

0.40 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 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.” The ideal of the rule of law comes about as a result of a home-grown (endogenous) process of contestation that shapes societies' adherence to principles of rule of law over time—sometimes a very long time. Box 0.6 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.

²¹ The evidence for how some of these mechanisms lead to better outcomes however, is mixed, as further discussed in chapter 8.

²² Basu 2015; McAdams 2015.

Box 0.6 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. Some 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.^a What this theory does not 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 at the end of the nineteenth century. 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.

a. See North, Wallis, and Weingast (2009).

Reshaping the policy arena: Entry points for reform

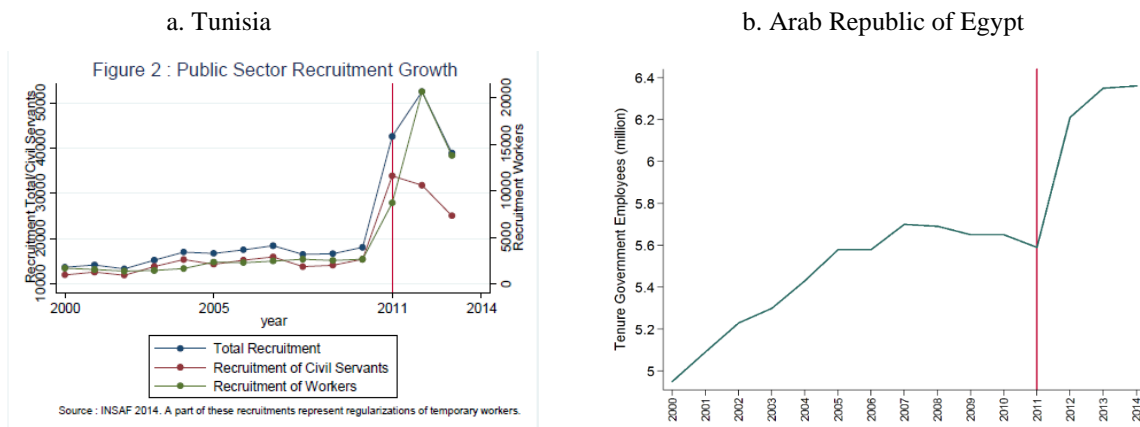
0.41 How can strengthening the role of law to change contestability, incentives, and preferences enhance policy effectiveness for security, growth, and equity? Take the case of security. Whether formally or informally, institutions of governance can solve commitment and cooperation problems in ways that create incentives not to use violence. Four main governance mechanisms matter for improving security outcomes: power sharing, resource redistribution, dispute

settlement, and sanctions. Power sharing and resource redistribution are highlighted in the illustrations below.

0.42 *Power sharing and resource redistribution can reduce exclusion and the incentives to engage in violence.* Just as exclusion may lead to violence, 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. 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 one another and to inspire inclusion among their followers; and by offering alternative avenues for contesting power.

0.43 Mechanisms that redistribute resources can also reduce violence by reordering power and changing incentives. Redistributive arrangements include budget allocation, social transfers, and victim compensation schemes. Some government interventions to reduce urban crime in Latin America follow a common pattern of increasing security by reducing poverty and inequality. Employment in the public sector is also a potential instrument that can bring about stability by ensuring the loyalty of key constituencies. Witness the dramatic increase in the numbers and salaries of public employees following the Arab uprisings in 2011 (figure 0.5). While this kind of 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 0.5 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).

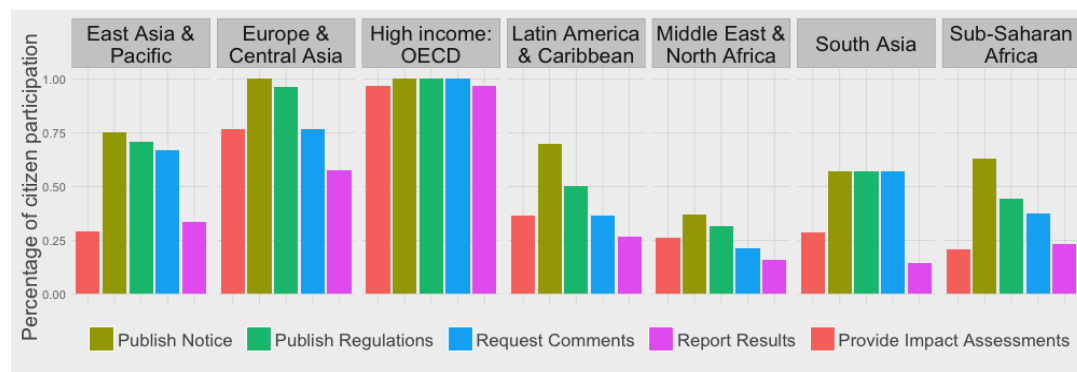
0.44 *Implementable policies can help reduce capture, enhancing growth.* Security is a precondition for prosperity but it is not enough, economic growth must follow. When it comes to growth, if the possibility of capture looms large, policies that are first-best on the basis of economic efficiency may be 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.

0.45 The experience of the Russian Federation and Eastern European countries in their transition toward market economies is illustrative.²³ 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 procompetition 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.²⁴

0.46 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 0.6).

Figure 0.6 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 rule making data.

²³ Roland and Verdier 1999.

²⁴ Jackson, Klich, and Poznanka 2005.

0.47 Capture is 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.

0.48 *Controlling clientelism can help solve commitment problems to deliver on redistributive policies.* Mechanisms that control clientelism can enhance equity by making commitment to long-term objectives credible in the political arena. Providing information, enhancing transparency and involving communities in policy design and monitoring can work to strengthen the quality of service delivery, provided the rules establish 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, for example, was remarkably successful in improving both health services and outcomes in the participating communities.²⁵ In this respect, information can be 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.²⁶ Enhancing the bargaining power of users by involving them in management can also help improve services and reduce clientelism. For example, when school councils of parents are well trained and have credible sanctions, they can improve school results.²⁷ 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.²⁸

0.49 Over time, policies that effectively improve equity also reduce power asymmetries, making the policy arena more contestable. 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 for better governance.²⁹ Conversely, 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

0.50 If changes in incentives, contestability, and preferences are the key levers of change for correcting power asymmetries in the policy arena to more effectively enable commitment, coordination, and cooperation, how can these be brought about? The Report identifies three encouraging drivers for bringing about significant change that is conducive to development: elite bargains (which take the distribution of power in the policy arena as given); citizen engagement

²⁵ Björkman and Svensson 2009.

²⁶ Andrabi, Das, and Khwaja 2015.

²⁷ Bruns and others 2011.

²⁸ Duflo, Dupas, and Kremer 2015.

²⁹ Ferreira and others 2013.

(which tries to change the distribution of power in the policy arena); and international interventions (which indirectly affects the distribution of power in the policy arena) (box 0.7)

Box 0.7 Elites and citizens: Who is who in the policy arena?

Participants in the policy arena can be grouped into elites and citizens according to their relative degree of influence in the policy-making process. 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. The source of their ability to influence policy comes not only from formal rules such as delegated authority (de jure power), but also from other means such as the control over resources (de facto power). Thus, even if the government changes, those who are able to influence decisions may stay the same: they keep their seat at the table. A few years ago, an entertainment magazine in a Latin American country captured this dynamic in an interview with an unlikely political observer: the chef of the presidential residence. After a tight election, the new president and his family had just moved into the residence. The interviewer asked the chef whether it was difficult for him to adjust the menu to the new presidential family's tastes. "It is really not that problematic," he reflected, "because even though the presidents change, the guests are always the same."

Certainly, the 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 capture how their relative power differs from one policy to another. As Stephen J. Gould 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."^a 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, and thus its definition of elites and citizens is a positive (rather than normative) one. Elites are not necessarily bad or self-interested, and citizens are not necessarily good and public spirited. Both groups exercise their influence as people do in other spheres of life: understanding their motivations matters to anticipate their conduct.

a. Gould (1987, 8–9).

0.51 All countries, regardless of their level of economic and institutional development, are subject to elite bargains. Change is unlikely to occur unless powerful actors—elites—in the country agree to that change. When influential actors resist change, suboptimal policies and governance institutions that are detrimental to development tend to persist. Under certain circumstances, however, elites may voluntarily agree to limit their influence in their own self-interest. Citizens can also organize to bring about change, playing an important role in applying pressure to influence the outcome of favorable bargains in the policy bargaining process. Moreover, governance does not occur solely within the boundaries of nation-states. While international actors cannot engineer development from the outside, these transnational actors play an important role in influencing the domestic bargaining dynamics by strengthening (or weakening) local coalitions for reform.

0.52 Change occurs over time as coalitions are formed among different actors, but this is often a long and self-determining "endogenous" process. For instance, success at achieving security in Somaliland arose from the collective action of a wide range of tribal and clan leaders. Sharing power among these actors helped reduce the incentives for violence by raising the benefits of security. In Nigeria, Muhammadu Buhari won the 2015 election by creating a broad coalition through a campaign platform focused on tackling corruption, potentially indicating an enhanced ability to overcome corrupt vested interests that benefit from oil rents. And in India, the Right to Information and Right to Education Acts, pushed through by grassroots coalition movements over

many years, have helped poor citizens demand better services and education for their children, improving living conditions within slums

Elites may adopt rules that constrain their own power

0.53 In December 1976, after the demise of General Francisco Franco—who had been in power since the late 1930s—a referendum was held in Spain to introduce a political reform that would allow previously banned political parties to participate openly in Spain’s political life. To the surprise of many, the Spanish *cortes generales* (Spain’s parliament, which was led by members appointed by Franco) allowed this referendum, even though it would constrain their power and likely imply the end of the existing regime. Analysts have argued that members of the *cortes* accepted the referendum because it was within the existing legal setting, which they had to protect. The conservative General Pita Da Veiga, Minister of the Navy and personal friend of Franco, publicly declared: “My peace of conscience is rooted in the fact that the democratic reform is being made within the *Franquista* legality”.³⁰ The *Franquista* legality he was praising was coming to an end precisely because of that reform, which received overwhelming public support: 97.4 percent of Spaniards voted in favor, with a turnout of 77 percent of the registered voters.

0.54 Just as in the case of the Spanish transition, there are many cases in which elites choose to constrain their own power. While changes to the “rules of the game” reflect bargaining outcomes that result from elites acting in their own interests (box 0.8), 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 tomorrow. 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 0.8 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,”^a to recent grand theories of economic and institutional co-evolution.^b 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.^c 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 more than 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.

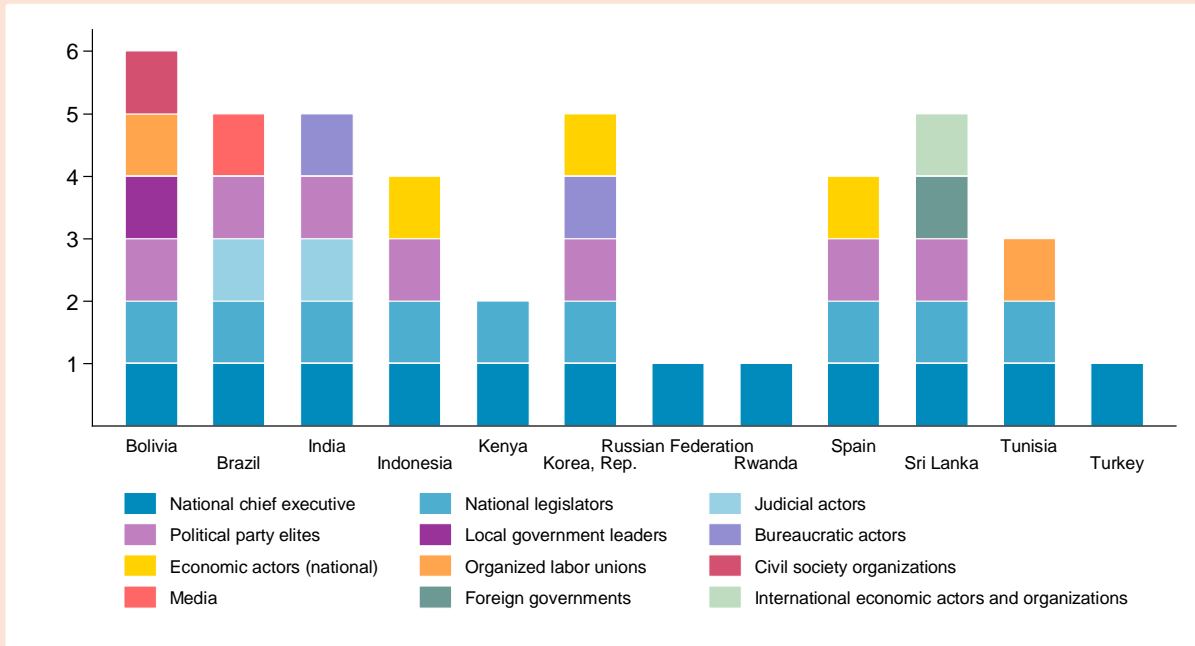
The survey reveals that the identity of the influential elite actors within a ruling elite coalition that decides policy at the national level differs greatly over space, time, and issue area. For instance, although national chief executives are part of the elite ruling coalition in all 12 countries surveyed as of 2015, the other actors vary greatly, both in number and representativeness (figure BO8.1, 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.

³⁰ Preston 2003.

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 B0.8.1 Elite actors within national ruling coalitions vary greatly across countries and over time

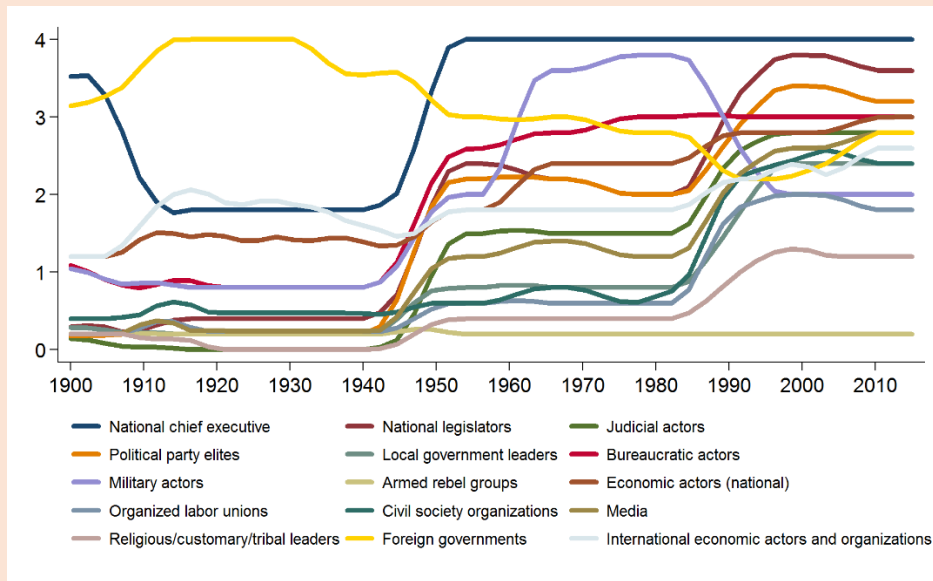
a. Twelve-nation comparison of number of groups in ruling coalition in 2015



Source: WDR 2017 team.

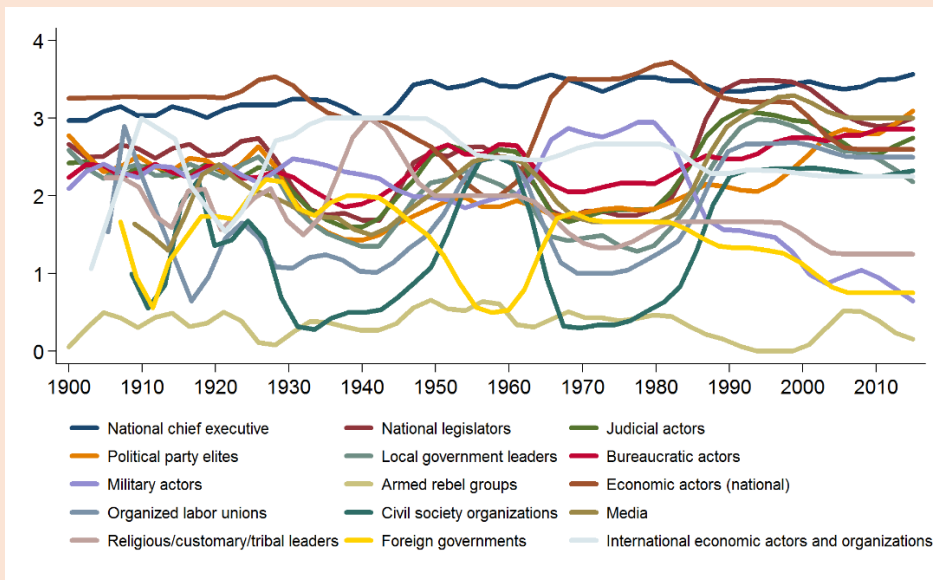
Note: Panel a shows the number of elite groups that have relative strength greater than 3 (on a 0–4 scale), but does not show the relative strength of these groups.

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.

- a. See Michels (1911), Pareto (1927), and Mosca (1939).
- b. See North, Wallis, and Weingast (2009) and Acemoglu and Robinson (2012).
- c. Di John and Putzel 2009; Khan 2010; Parks and Cole 2010.

0.55 To maintain their own power and 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.

0.56 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 heralded by the threat of revolution and social upheaval, in the form of revolutionary activity in neighboring countries³¹ and strikes in the home country.³²

0.57 Although in many cases elites introduce rules to maintain their position of power, sometimes, acknowledging threats to their continued dominance, they may adopt rules to constrain their own influence as a type of political insurance. The hope is that those rules 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 institutional 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.³³ 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.³⁴

0.58 Leaders can also spur elite-driven change by solving coordination challenges or by transforming the preferences of followers. *Transactional leaders* use an array of bargaining tactics and strategies to coordinate among elite actors to overcome common agency problems and reach positive-sum outcomes (win-win solutions). These leaders change the incentives of other elites by taking into consideration who wins and who loses over time. By overcoming information and coordination challenges through “good politics,” they can help find areas of agreement among conflicting elites, without shifting norms or preferences. U.S. President Lyndon Johnson’s deals, trades, threats, and ego stroking—“good politics”—helped the U.S. congress overcome a natural risk aversion and pass civil rights legislation, a clear example of transactional leadership. *Transformational leaders*, in contrast, can actually change elite preferences or gain followings by shaping beliefs and 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. Nelson Mandela provided a vision for South Africa, using charisma,

³¹ Aidt and Jensen 2014.

³² Kim 2007.

³³ Rawls (1971) proposes that citizens in an original position behind a Kantian “veil of ignorance”, ignorant of their lot in life—such as class, race, social status, distribution of assets, gender—would opt for a society that maximizes the level of welfare achieved by the worst-off person in society (Maximin principle), as the accepted social contract.

³⁴ Berliner and Erlich 2015.

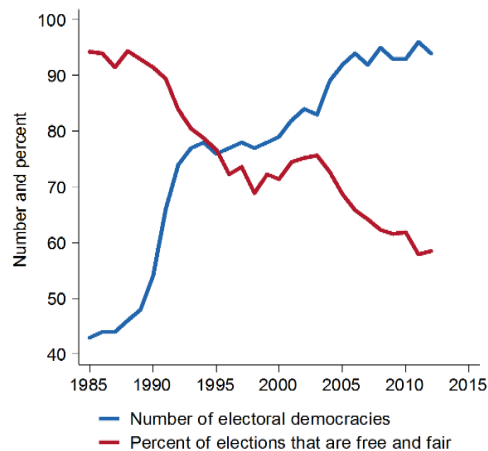
moral persuasion, and powerful symbols to motivate and inspire his fellow citizens during the transition away from apartheid.

Agency and collective action: Citizens influence change by voting, organizing, and deliberating

0.59 While individual citizens may not have the power to influence the policy arena on their own, different mechanisms of collective engagement—such as elections, political parties, social organizations, or public deliberation—can help overcome collective action problems and amplify citizens’ bargaining power. These mechanisms can enhance contestability—such as when civic associations or spaces of public deliberation open up more inclusive bargaining spaces. They can bring about changes in 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 also reshape the preferences of actors—such as when political parties help to frame collective claims and interests in the policy arena. However, these mechanisms are imperfect, and may end up reinforcing rather than rebalancing existing power relations.

0.60 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 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. Evidence from Kenya, for example, suggests that multiparty elections successfully constrained the ability of leaders to divert public resources for partisan goals.³⁵ However, elections alone are an insufficient mechanism to produce responsive and accountable governments. Although they have become the most common mechanism to elect authorities around the world, they are increasingly perceived as unfair (figure 0.7).

Figure 0.7 Electoral democracies are spreading, but the integrity of elections is declining



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

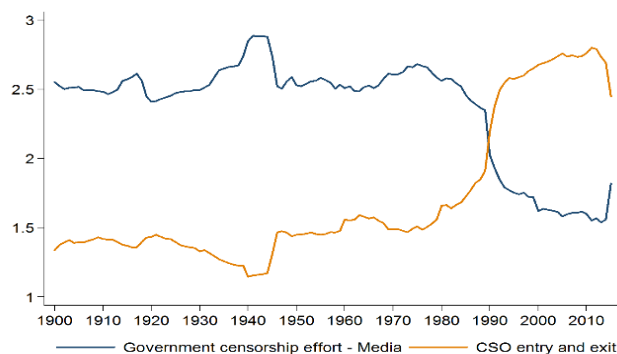
³⁵ Burgess and others 2015.

0.61 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. Political organization, for example through political parties, can help solve citizens' coordination problems, and integrate different groups into the political process, encouraging a culture of compromise and reduced societal tensions. The evidence shows that *programmatically parties*—those organized around a well-defined agenda of policy priorities—are associated with better development outcomes. Ordinary citizens and marginalized groups sometimes find political parties unwilling to reflect their preferences, acting instead as “gatekeepers” to protect vested interests and existing power structure. This may help explain the disenchantment of citizens with political parties, which rank globally as the least trusted political institution.

0.62 Social organization can also help to solve collective action problems by mobilizing citizens around specific issues. This can 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 0.9 explains how pressure from social organization by international and domestic women's groups eventually achieved female suffrage in Switzerland, leading to other important policy changes for gender equality. However, after a continuous expansion over the last decades, civic space has shrunk in the past few years (figure 0.8). 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.

0.63 While social organization might be successful in giving voice to less powerful groups and putting pressure on public authorities, they often fail to consider the trade-offs associated with the proliferation of competing interests in the policy arena. Public institutions might be quickly overloaded with multiple pressures, undermining the coherence and effectiveness of public policies. Moreover, social organization is not necessarily motivated by a vision of more equal and just society. On the contrary, social organization can be used by narrow interest groups for exclusionary or violent purposes.

Figure 0.8 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.

Box 0.9 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,” one study notes.^a 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 1985, 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.^b

Sources: Stämpfli (1994); World Bank Women Business and the Law 2015 dataset.

a. Stämpfli (1994, 696).

b. World Bank 2016b.

0.64 Public deliberation—spaces and processes that allow group-based discussion and weighting of alternative preferences—can also help level the playing field in the policy arena. Citizens’ participation in local governance can be instrumental in improving the quality of deliberation and the legitimacy of decisions made, by clarifying needs and demands of local constituencies. However, 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.³⁶ Such failures are not necessarily ameliorated by the availability of new technologies. On the contrary, as discussed in WDR 2016 on the digital divide, information and communication technologies might actually reinforce socioeconomic inequalities in citizens’ engagement. In Brazil, for example, the use of internet voting on municipal budget proposals revealed stark demographic differences between online and offline voters; online voters were more likely to be male, university educated, and wealthier.³⁷

³⁶ Mansuri and Rao 2013; Devarajan and Kanbur 2012.

³⁷ WDR 2017 team, based on Spada and others 2015.

0.65 Ultimately, in order to strengthen their influence in the policy arena, citizens need to engage through multiple mechanisms designed to solve collective action problems. Since all these mechanisms are imperfect, it is their strategic combination that maximizes the chances to effectively bring about changes in contestability, incentives, and preferences. Policy actions targeted toward strengthening transparency by increasing the availability and relevance of reliable information—such as generating evidence on the performance of public officials, strengthening the independence of media outlets, and aligning the targeting and timing of information with the political process—can be a fundamental first step toward promoting an enabling environment for strengthening citizen engagement.³⁸

0.66 By amplifying citizens' influence in the policy arena to make leaders more accountable and responsive to their demands, healthy citizen engagement—that is, *when leaders are selected and sanctioned on the basis of performance in providing public goods*—is a key for driving governance change in a positive direction for development.³⁹ As evidence from a range of institutional settings suggests, “fostering healthy political engagement rather than suppressing it is more likely to result in better development outcomes”.⁴⁰

Change with outside support: International actors in the domestic policy arena

0.67 The domestic policy arena, where elites and citizens bargain, does not exist in a vacuum. Increasing transnational flows of capital, trade, ideas, and people have had profound effects on domestic growth, equity, and security outcomes—both directly and indirectly through their effects on governance. The world today is very different from the one in which today's developed countries emerged: cross-border flows were low; they received no aid; and 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.

0.68 As the velocity of flows across borders increases, so too do the instruments and mechanisms that are used to manage these flows. To influence domestic politics and governance, international actors can introduce transnational rules, standards, and regulations (hereafter referred to as *transnational rules*). These rules can help induce domestic reform through incentives to generate credible commitment of domestic actors—such as through trade and regional integration. They can serve as focal points for domestic actors to improve coordination by changing ideas and diffusing norms. They can seek to achieve a global good through enhanced cooperation—such as preventing *races to the bottom* when countries compete to attract investment and gain access to markets, leading to reductions in corporate tax or environmental and labor standards.

0.69 For example, 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 demonstrates the power of these types of inducements. Prospective member-countries must change domestic rules to abide by 80,000 pages of regulations in the *acquis communautaire*. For the countries that decided to undergo these changes, the potential economic benefits of joining the EU outweighed any loss of domestic autonomy in specific areas,

³⁸ Khemani and others 2016.

³⁹ Khemani and others 2016.

⁴⁰ Khemani and others 2016.

and the benefits of accession were used by elites to overcome domestic resistance to the required reforms. Moreover, for member-countries, accession helped change elite incentives by changing the relative power of domestic actors, as some parties benefited much more than others. EU membership contributed to the institutional consolidation of former dictatorships in the European periphery, such as Greece, Portugal, and Spain in the 1980s. It also played a role in the transition in Central and Eastern Europe after the elimination of the communist regimes in the 1990s and 2000s.

0.70 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.⁴¹ While the literature on aid effectiveness is voluminous, it tends to be inconclusive. Ultimately, the literature suggests that aid is neither inherently good nor inherently bad for development. What matters is how aid interacts with prevailing power relations and affects governance.

0.71 In some cases, donor engagement supports the emergence of more accountable and equitable governing arrangements that become embedded 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.⁴² In other 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.⁴³

0.72 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 0.9). The empirical evidence linking aid flows to decreased taxation is mixed (box 0.10). Aid has thus been likened to a natural resource curse: a windfall of unearned income that may enable inefficient government spending, unconstrained by the kind of state-citizen social contract that engages citizens in policy discussions and makes the policy arena more contestable.⁴⁴

⁴¹ Foreign aid refers to official development assistance as defined by the Organisation for Economic Co-operation and Development (OECD).

⁴² Fearon and others 2009.

⁴³ Moore 2004.

⁴⁴ The “aid curse” argument is made by Collier (2003); Moss and others (2006); and Djankov, Montalvo, and Reynal-Querol (2008).

development goals; they may harm the poor in the process of collecting domestic resources; or they may be politically unable to pass reforms to increase revenues. 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 by transferring resources domestically from the rich to the poor.^f Moreover, in many developing countries, poor individuals are often impoverished by the fiscal system, when both government taxation and spending are taken into account.^g Finally, political power might be concentrated in the hands of a few rich individuals whose interests collide with those of the poor. In such instances, where there is need to mobilize a larger set of individuals to counterweigh the political influence in the hands of the few, domestic resource mobilization might be very difficult to achieve.^h

a. Most notably, Gupta and others (2004).

b. Morrissey and Torrance 2015.

c. 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, and conclude that the relationship is negligible.

d. Martin 2014; Paler 2013.

e. Lustig 2016.

f. Ravallion 2010; Ceriani and others 2016.

g. Lustig 2016.

h. Ceriani and others 2016.

0.73 For a long time, the need for intervention has been justified on the basis of classic market failures, where governments intervene to lead to socially desirable outcomes that cannot be achieved by relying on solely markets. Later, the literature showed the existence of government failures, where government interventions also failed due to lack of capacity, informational asymmetries, or distorted incentives.⁴⁵ One of the issues that this Report analyzes is the difficulties faced by the international community when trying to influence change in the presence of government failures. Indeed, many times, well-intentioned interventions become ineffective because they reinforce an equilibrium that sustains the outcome the intervention attempted to change. These situations can arise from interventions that do not take into account the existing power balance.

0.74 These development assistance challenges are *not* unavoidable or intractable. Like market failures and government failures, they can be addressed. Development assistance can be more effective when donor engagement supports the emergence of more accountable and equitable governing arrangements that become embedded in the domestic context—for example, by making relevant information available to citizens to strengthen their capacity to hold political leaders accountable.⁴⁶ 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.

0.75 The development community has recently been 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. The way forward may require a more adaptive or agile approach, in which strategies are tried out locally, and then adjusted upon based on early evidence. Moving beyond technocratic approaches, and learning how to take into account the openings and constraints presented by

⁴⁵ Devarajan and Khemani 2016.

⁴⁶ Devarajan and Khemani 2016.

shifting politics, are key to the ability of foreign aid to induce and sustain governance reforms that promote development.

Rethinking governance for development

0.76 Seventy years after the Bretton Woods conference that launched the World Bank and the International Monetary Fund, the international community recognizes that promoting sustained development requires taking seriously the underlying determinants related to governance. 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. This WDR shows that taking into account how the distribution of power in the policy arena enables or constrains institutions to effectively promote commitment, coordination, and cooperation is critical for ensuring progress toward achieving security, growth, and equity.

0.77 Past *World Development Reports* 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 is part of a trilogy of recent reports, alongside *Mind, Society, and Behavior* (2015) and *Digital Dividends* (2016) that examine how policy makers can make fuller use of behavioral, technological, and institutional instruments to improve state effectiveness for development. This Report starts by acknowledging that policies such as those to strengthen labor markets, overcome gender barriers, or prepare countries against 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. Successful reforms thus are not just about “best practice.” They require adopting and adjusting institutional forms in ways that solve the specific commitment and collective action problems that stand in the way of pursuing further development.

Three guiding principles

0.78 The WDR 2017 proposes three simple principles to guide those thinking about reform. First, it is important to think not only about what form institutions should have, but about the functions that institutions must perform: “Think of function, not only form.” Second, while capacity building matters, how to use the capacity and where to invest in capacity depends on the relative bargaining powers of actors: “Think of power, not only capacity.” Third, in order to achieve the rule of law, countries must first strengthen the different roles of law to enhance contestability, change incentives, and reshape preferences: “Think of the role of law, not only the rule of law” (table 0.2).

Table 0.2 Three principles for rethinking governance for development

Traditional approach	Three principles for rethinking governance for development
Invest in designing the right <i>form</i> of policies.	Think not only about the form of institutions, but about their <i>functions</i> .
Build the <i>capacity</i> to implement those policies.	Think not only about capacity building, but about <i>power asymmetries</i> .
Focus on strengthening the <i>rule of law</i> to ensure those policies and rules are applied impersonally.	Think not only about the rule of law, but about the <i>role of law</i> .

Source: WDR 2017 team.

0.79 When facing a specific policy challenge, what do these principles mean in practical terms? The first aspect is to identify the underlying functional problem. What is standing in the way of the development objective: is there a problem of time consistency or policies being changed due to changes in incentives? There could be a lack of voluntary compliance or low levels of take up of specific public programs. Second, in addressing the institutional function that needs to be performed, what are the available interventions or changes in rules to solve the specific functional challenge. While institutional pathways can take many forms—including international best practices—the emphasis is on finding the institutional arrangement that allows to effectively enable commitment, coordination, or cooperation. The “form” of policies is certainly not to be ruled out, but it is crucial to also think about their “function”: for instance, beyond what the fiscal rule looks like, is commitment to the rule credible? This implies considering the specific constraints and context.

0.80 When thinking about potential reforms of policies, it is helpful to consider three “levels” of rules.⁴⁷ First-level rules, or R1, refer to specific policies (for example, budgetary allocations and restrictions). Medium-level rules, or R2, refer to organizational forms—such as central bank independence. Higher-level rules, R3, relate to “rules about changing rules”, namely constitutional and electoral norms. Some functional challenges may require a combination of reforms at all three levels.

0.81 Understanding how the policy arena constrains the functions of institutions is the next critical aspect to consider in order to enhance policy effectiveness. In addition to constraints that are typically considered—such as physical and administrative capacity—policies may still be ineffective if groups with enough bargaining power have no incentives to pursue adoption or implementation. Taking into account power asymmetries means focusing on implementable (if not necessarily ideal) policies that can generate incremental progress towards inclusive growth and equitable development. Looking at the incentives, as well as at the norms and preferences of actors is instrumental to understand what agreements are feasible in the policy arena.

0.82 Different levers of change can help reshape the policy arena to expand the set of policies that can be implemented. Instead of taking the existing policymaking environment as given, the idea is to analyze how to lift the existing constraints to expand the space of what is politically feasible. Different levers of change can contribute to this shift. Often, institutional capacity that is

⁴⁷ Acuna and Tommasi 1999.

spurring change exists at the local level, and building upon it can further enhance credible commitment, cooperation and cooperation towards development goals. Levering change includes looking at what opportunities do elite interests and dynamics of the bargain point to? What opportunities are there for citizen collective action? What is the role of international influence?

0.83 Finally, when designing and evaluating policies, anticipating opposition and considering potential unintended consequences must be part of the process. Particularly, when thinking about evaluation, it must be understood that trajectories might not be linear and thus assessment requires complex methods. Anticipating the changing balance of power around the reform process and adopting an adaptive approach, such as building coalitions in anticipation of the reform, can reduce the risk of reversal. Box 0.11 offers a simple diagnostic roadmap for bringing these insights more concretely into development programming in an effort to enhance effectiveness.

Box 0.11 What does the WDR 2017 framework mean for action?: The policy effectiveness chain

This Report argues that policy effectiveness cannot be understood only from a technical perspective, but rather must consider the process through actors bargain about the design and implementation of policies, within a specific institutional setting. The consistency and continuity of policies over time (commitment), the alignment of beliefs and preferences (coordination), as well as the voluntary compliance and absence of free riding (cooperation) are key institutional functions that influence how effective policies will be. But what does that mean for specific policy actions?

Figure 0.10.1 presents a way to think about specific policies in a way that includes the elements that can increase the likelihood of effectiveness. This “policy effectiveness chain” reads from right to left, starting with a clear definition of the objective to be achieved and following a series of well-specified steps.

Step 1 What? Define the development objective.

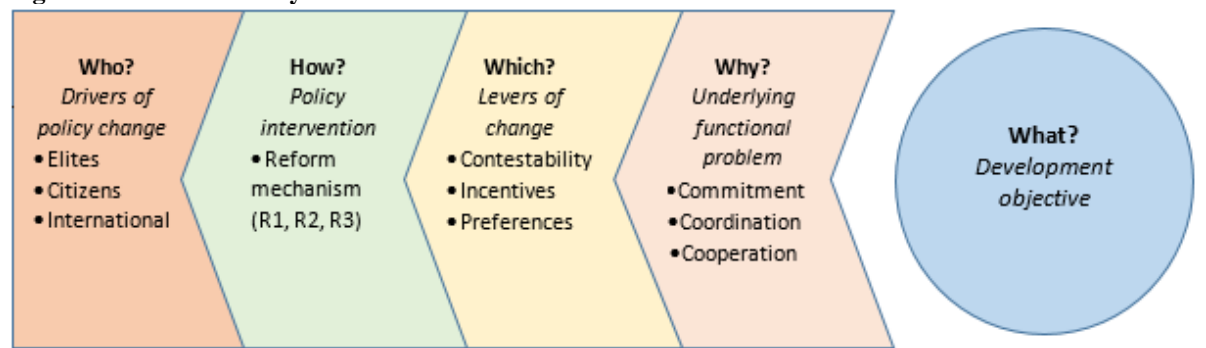
Step 2. Why? Identify the underlying functional problem (commitment, coordination, cooperation).

Step 3. Which? Identify the relevant entry point(s) for reform (incentives, preferences/beliefs, contestability).

Step 4. How? Identify the best mechanism for intervention (menu of policies and laws).

Step 5. Who? Identify key stakeholders needed to build a coalition for implementation (elites, citizens, international partners).

Figure B0.11.1 The Policy Effectiveness Chain



Source: WDR 2017.

Note: R1 = first-level rules; R2 = medium-level rules; R3 = higher-level rules.

Creating conditions for adaptability

0.84 When can meaningful changes occur in the nature of governance? 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 may 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—where the stakes are sufficiently high—leading to violent conflict. *Middle-income traps* can be understood as situations in which interest groups, currently benefiting by extracting rents, have incentives to oppose new economic conditions and thus prevent efficiency oriented reforms from happening, leading to an unproductive equilibrium.

0.85 Adaptability to changes in the relative bargaining power, incentives, and preferences of different actors matter. 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. 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.

0.86 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 is critical for ensuring inclusive and sustainable development progress. Traditional development orthodoxy has so far emphasized the centrality of three assumptions in improving governance for development: the forms of 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.” This Report moves beyond these approaches, and emphasizes 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.

Navigating this Report

Part I. Rethinking governance: A conceptual framework

0.87 Part I of the Report presents a conceptual framework for rethinking the role of governance and law in development. Chapter 1 motivates by unpacking critical questions facing the development community today, while chapter 2 proposes a new analytical approach to answer them. The framework takes a “functionalist” approach rooted in the game theory, arguing that the

functional role institutions play in terms of ensuring credible commitment, inducing coordination, and enhancing cooperation is fundamental to the effectiveness of policies to promote development. Moreover, the framework explores how the unequal distribution of power in society (power asymmetry) is a key factor which underpins the effectiveness of these functions, and identifies different entry points for mitigating potentially harmful consequences. Chapter 3 approaches the conceptual framework from the perspective of law, and explains the different roles that law plays in shaping and reshaping the policy arena.

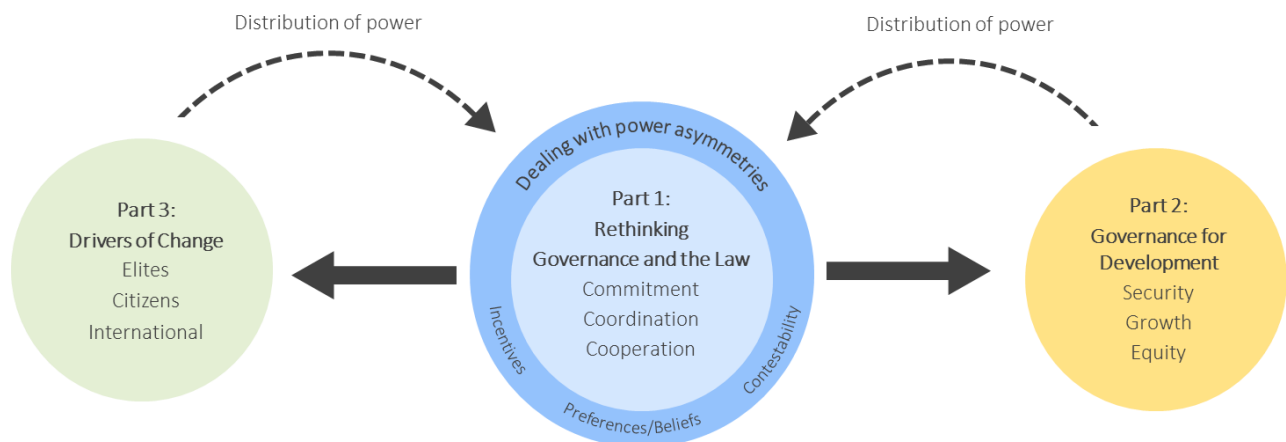
Part II. Governance for development

0.88 Part II applies the conceptual 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.

Part III. Drivers of change

0.89 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. While the dynamics of governance can be very persistent and are intricately interconnected, change is possible over time. Part III of the Report explores how these types of changes can be brought by about looking at the conditions under which elites may choose to establish limits on their own power in chapter 7, how citizens can overcome collective action problems to pressure for reform in chapter 8, and how international influences can reshape local bargaining dynamics in chapter 9. In the end, change is manifested by introducing new formal rules that reshape de jure power. A roadmap to the Report is presented in figure O.10.

Figure O.10 A roadmap to the Report



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