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Change Rules, Change Governments, and Develop?

SQUARE PEG REFORMS IN ROUND HOLE GOVERNMENTS

Government often dominates developing countries. Sometimes government is the only game in town. Countries suffer when rules of this game are deficient and governments are ineffective or predatory. Because this frequently seems to be the case, public sector institutional reforms have emerged as central to development. These reforms are an essential element of interventions by players like the World Bank and other multilateral and bilateral agencies. They focus on improving governmental rules of the game and establishing effective governments that facilitate economic growth. These goals are often not met, however, even when countries adopt advised reforms, at considerable expense, and with great anticipation. *This book asks why institutional reforms in development often do not lead to improved governments and how they can be better structured to achieve such goal.*

These questions emerge when looking at recent cases. Consider Afghanistan, where the international community proposed in 2003 that institutional reform would help "within seven years . . . [to] build a stable centralized state . . . arranged around the rule of law and a technocratic administration."[1] Seven years; billions of dollars; and many new laws, regulations, and structures later, the government is still criticized as corrupt and inefficient. Although promises suggested the country could be a new Korea, "[i]t is now hoped that good development in Afghanistan might allow it over decades to draw level with Pakistan."[2] Think also of Georgia, where government streamlined taxes, reorganized public organizations, and cut regulations in 2004 to catalyze private industry and create jobs – with talk of becoming a Caucasian Singapore. Georgia's government received the

[1] Stewart 2010, 1.
[2] Ibid.

World Bank's *Doing Business* Most Improved Business Reformer award in 2008 and enjoyed rapid growth between 2004 and 2007. Unfortunately, this was driven by foreigners buying up privatized assets and not by expanded local economic activity.[3] Domestic innovation, market competition, and employment stagnated between 2004 and 2008.[4] Government regulations may no longer burden entrepreneurs, but reforms have not led to a government that effectively catalyzes employment-generating production either. Why? What could be done differently in the future?

These are important questions to ask in many countries beyond Afghanistan and Georgia, where public sector institutional reforms have not delivered better government. As a matter of fact, this book is not the first piece of work to ask these questions. Others have raised them before, with different opinions on why reforms do not work. The list of critics is long and includes prominent voices like Bill Easterly, Dani Rodrik, Peter Evans, and Merilee Grindle.[5] The list of reasons offered for failure is even longer, and these are often presented as exclusive of each other, with limited explanation for why reform persists despite mixed and often disappointing results.[6] This book builds on such work. It offers a specific argument about why many reforms fail, and draws on lessons from more successful experiences to identify a potentially new, improved approach to doing reform in the future:

- The argument builds on existing views that reforms often fail because they do not fit many developing country contexts – looking like square pegs in round holes. It provides a novel explanation for why this poor fit is common and recurrent: many reforms are introduced as short-term

[3] See the International Finance Corporation (IFC) 2009 Sector Competitiveness Overview, http://www.ifc.org/ifcext/georgiasme.nsf/AttachmentsByTitle/1GeorgiaManufacturingSectorCompetitivenessAssessmentEng/$FILE/1GeorgiaSectorCompetitivenessAssessmentFinalReportEng.pdf.

[4] Georgia ranks 5 for ease of doing business but 90 on the World Economic Forum's Global Competitiveness Index, 115 of 133 on internal competition, 98 on market dominance, and 125 for "monopoly problems." See http://www.weforum.org/pdf/GCR09/GCR20092010fullrankings.pdf. Unemployment rates in 2010 ranged from 16.5 percent officially to 29 percent in Transparency International's estimates. See http://www.transparency.ge/en/blog/p2-2-5-georgias-official-statistics-and-unfolding-greek-tragedyp.

[5] Rodrik (2007, 2) opens *One Economics Many Recipes* with a story similar to the Afghan and Georgian vignettes and asks, "What had gone wrong?" Consider also Andrews 2010; Chang 2003; Easterly 2001; Evans 2004; Goldsmith 2010; Grindle 2004; Pritchett and Woolcock 2004; and World Bank 2008.

[6] Some claim, for example, that reforms impose inappropriate ideological models on governments. Others argue that appropriate reforms are not sufficiently owned, or that reforms fail because of capacity constraints, and so on.

signals that ensure developing countries attain and retain external support and legitimacy. The argument posits that reforms introduced as signals are commonly designed with limited attention to context, involve impressive-looking but hard-to-reproduce best practice interventions, and emerge through narrow engagements with agents that outsiders consider champions. Such reforms are prone to having limited success, however. They may produce new forms (like laws) in the short term, but these typically have poor functionality. Governments look better after reform but often are not better.

- An improved reform approach takes shape after the analysis of interventions that have yielded more functional governments. This approach, called problem-driven iterative adaptation (PDIA),[7] is akin to the way one imagines carpenters craft pegs to fit real holes – where the process is as important as the product. This process begins with problem identification, given the argument that reforms are more likely to fit their contexts when crafted as responses to locally defined problems. Relevant solutions – those that are politically acceptable and practically possible – emerge through a gradual process of step-by-step experimentation to solve such problems. This process yields solutions that resemble bricolaged hybrids blending external and internal ideas. The solutions arise through engagements between many agents playing multiple functional roles, and not solitary champions.

The book uses institutional theory to frame the argument and inform this new approach. It not only takes ideas from the new institutional economics as a starting point but also draws from broader work in new institutional theory, applying ideas about institutional logics, isomorphism, institutional entrepreneurship, and decoupling. Such ideas are common in studies crossing political science, sociology, and management fields. They have yet to be applied prominently in the development domain, however, and are presented here to show how interdisciplinary thinking can enrich the development dialogue. The theory is accompanied by empirical studies to illustrate and validate arguments.

Before outlining the book's content in more detail, this chapter introduces the topic and shows why it matters. A first section argues that institutional reforms have become pervasive in development and thus demand attention. A second section shows that reforms involve similar types of interventions across different contexts, reflecting confidence in a specific agenda of action. The third section notes that results of these reforms are varied and often

[7] Andrews, Pritchett, and Woolcock 2012.

lower than anticipated, raising questions about how effective the new agenda really is.

INSTITUTIONAL REFORMS ARE NEW AND PERVASIVE

New institutional economics has informed public sector reform in developing countries since the 1980s. This theory posits that formal and informal rules – institutions – influence all people, organizations, and economies. Governments are the hub of many such rules, bound by some and the maker and enforcer of others. Think of civil service laws, budget rules, norms of information disclosure, building permit requirements, or the tests government inspectors use to assess whether one should get a driver's license. These "rules of the game" determine the size, scope, operation, and influence of government.

Theorists claim that different institutions create incentives for different behavior, leading to different outcomes. A strict driving test may create better incentives for safe driving than a lax one, for example, which impacts the safety of public streets. In so shaping behavior, theory posits that different institutions have different effects on social and economic progress – the sine qua non of development. The key to development, this argument suggests, is "finding the right institutional framework" or rules of the game.[8] Governments have been the focus of this search, and many efforts to improve public organizations are thus called institutional reforms.

In developing countries, these reforms are frequently influenced by external entities like the International Monetary Fund (IMF), World Bank, regional development banks, and bilateral agencies. The influence manifests in many ways. It comes, for example, through external identification of what the right rules are, and through financing, facilitation, and sometimes even implementation of interventions intended to introduce these rules. Such reforms target improvements in core public administration processes, the way governments interface with business, and service delivery mechanisms in areas like health and education.

These reforms are relatively new to development, featuring in fewer than 1 percent of World Bank projects before 1980.[9] This reflected a policy of nonpolitical engagement that dominated international development at the

[8] World Bank 2000a; Yeager 1999, 113.

[9] This is the number of projects benefiting activities in the public administration, law, and justice (PAL&J) sector. This approach to measuring World Bank–sponsored institutional reforms builds on work by Kim Moloney (2009). Only 18 of the 2,782 World Bank projects started before 1980 were classified as such.

time.[10] Such policy kept many development organizations out of the business of government in developing countries. Interventions focused rather on building infrastructure and productive economic sectors, with little attention to rules of the game affecting the use and impact of these assets and sectors.[11] This started changing in the late 1970s, when international organizations noted that governments had become key players in developing countries. A 1988 World Bank report states, for instance, that "[t]he public sector now appears to be as important in developing countries as in industrial countries."[12]

Public sectors were in turmoil during this period, many burdened with overwhelming debt and facing economic slowdown. International organizations offered assistance in various forms. These included much-discussed structural adjustment operations, which contributed to an expansion of institutional reform activities in the 1980s. Such projects constituted about a fifth of World Bank loans in the decade.[13] This was only one part of a growing engagement, however, which was boosted by the Soviet Union's dissolution and various global, regional, and country-specific crises in the 1990s and 2000s. New governments emerged from these events, or replaced old governments that had lost legitimacy. There was a general sense that many of these new states were looking for help in discerning and adopting the kind of institutions that could ensure their effectiveness.

As a result of such events, the last twenty years have seen a number of multilateral and bilateral agencies introducing institutional reform strategies and advisory, aid, and lending mechanisms. Great Britain's Department for International Development has engaged in such reforms since the early 1990s, for instance, and first formalized a strategy on the topic in the mid-1990s.[14] The Asian Development Bank introduced a governance policy to guide such interventions in 1995,[15] and the African Development Bank did the same in 2000.[16]

Engagements like these have ensured the continued growth and influence of public sector institutional reforms in development. These reforms are

[10] Wright and Winters 2010.
[11] More than 750 World Bank projects before 1980 sought to strengthen rural infrastructure and agriculture sectors. A total of 550 constructed railroads, highways, and seaports; 350 established electric power and energy sources; 300 built schools and hospitals; and 220 developed water and telecommunications infrastructure.
[12] World Bank 1988, 5.
[13] A total of 469 World Bank projects had PAL&J sector content in this decade.
[14] Department for International Development 2011.
[15] Asian Development Bank 2006, i.
[16] African Development Bank 2012, 15.

now a major line of business for most development agencies. They can be identified in more than half of the operations carried out by Great Britain's Department for International Development between 2004 and 2010.[17] They are also evident in more than half of the Asian and African Development Banks' project portfolios in the late 2000s,[18] having comprised less than 10 percent of interventions prior to the 1990s.[19] The emergence of such activities is probably most obvious when considering World Bank experience, where projects likely to incorporate public sector institutional reforms comprised 65 percent of all operations between 2000 and 2010.[20] In some respects, these reforms are now the most common part of the organization's agenda.[21] They featured in more than $50 billion worth of World Bank–sponsored projects between 2006 and 2011, a quarter of spending in the period.[22]

The pervasive nature of these reforms is further evidenced in the variety of affected countries. Bilateral agencies and regional development banks typically sponsor such interventions in more than one hundred countries.[23] World Bank projects supporting these reforms can be identified in more than 140 countries.[24] A randomly selected sample of forty countries illustrates the variety of these contexts.[25] It includes Afghanistan, Algeria, Angola, Argentina, Azerbaijan, Benin, Bolivia, Bulgaria, Burundi, Cape Verde,

17 Spending on governance accounted for about 20 percent of the Department for International Development's (DFID) activities, whereas more than 20 percent of the spending focused on economic reforms tended to involve interventions at the interface of the public and private sectors. Beyond this, DFID documents note that institutional reforms are common in sectoral engagements (like water supply and sanitation, health, and education). Department for International Development 2010, 2011.

18 African Development Bank 2012; Asian Development Bank 2012, 34.

19 Governance operations in the African Development Bank between 1967 and 2006 accounted for 15 percent of all loans. Most took place after the mid-1990s. African Development Bank 2012.

20 More than 3,200 projects had some spending in the PAL&J sector in the decade.

21 The World Bank had supported 13,121 projects as of April 2011; 5,981 of these had activities in the PAL&J sector. Essentially, therefore, about one in two projects has sponsored institutional reforms. This exceeds the World Bank focus in any other sector. Fewer than a third of projects have incorporated an agricultural sector focus. Fewer than one in five disbursed in the education, health, transportation, electricity, and water sectors.

22 This is the project spending benefiting activities in the PAL&J sector, as reported in the World Bank's 2012 financial report. The amount could be much greater if capturing institutional reform content in various thematic areas. For instance, $28 billion was spent on the public sector governance, $1.7 billion on rule of law reforms, and more than $51 billion on financial and private sector reforms.

23 African Development Bank 2012; Asian Development Bank 2012; Department for International Development 2010; Inter-American Development Bank 2012.

24 One can see this when searching for projects in the PAL&J sector in the World Bank projects database.

25 The forty-country sample was chosen using a random number technique.

Central African Republic, Chile, China, Georgia, Ghana, Guinea, Haiti, Honduras, Kyrgyz, Laos, Madagascar, Malawi, Mauritius, Moldova, Mongolia, Mozambique, Nicaragua, Niger, Poland, Rwanda, Samoa, Senegal, Serbia, Sri Lanka, Tanzania, Thailand, Togo, Uganda, Ukraine, and Uruguay. One can think of the incredible variation in the countries listed here – in economic size and complexity, political and social structures, geography, and history. One thing they all share, however, is the recent experience of having engaged with external donors to introduce public sector institutional reforms.

INSTITUTIONAL REFORMS ARE SIMILAR, EVEN IN DIFFERENT CONTEXTS

The country coverage of these reforms is impressive, especially considering their relative newness. One consequence of this is that multilateral and bilateral development organizations are increasingly shaping the ideas, opportunities, demand, and supply of public sector institutional reforms in developing countries. Many would expect this influence to be varied, with different reform types across the wide range of affected countries. This reflects a belief that the "right rules" are different for different contexts. Such sentiment is regularly voiced in formal pronouncements on reform by development organizations like the World Bank. These typically decry attempts to generalize government reform solutions.[26] A more skeptical set of observers argues that generic models do, however, exist and actually dominate reform designs supported by development agencies.[27] Some refer to a strong neoliberal influence on reform content.[28] Others infer that interventions commonly impose modern managerial solutions on developing countries.[29] Although many hold to these beliefs, they are seldom supported by empirical research beyond isolated case studies.[30]

A number of sources facilitate more rigorous identification of similarities, however. World Bank project documents provide information about the way

[26] A 1992 World Bank document notes, "The institutional characteristics for managing development [varies] widely among countries and do[es] not permit easy generalization" (World Bank 1992, 7). Ahrens (2001, 54) writes: "There are still no clear or settled ideas about how effective governance should be defined, let alone how key governance issues can be appropriately incorporated into externally-financed programmes."

[27] Andrews 2010; Chang 2003; Grindle 2004.

[28] Rodrik (2007, 182) claims that a "'neoliberal' socio-economic model" pervades development.

[29] Kenny 2008.

[30] World Bank (2008, 38) argues, for example, that reforms are "likely to be one size fits all," but does not show evidence for such or explain what the generic model looks like.

reforms are designed, for instance. Recent studies of these documents note two common practices:[31]

- First, central agents like government ministers and their policy departments are seen as the key reformers. By contrast, broader constituencies needed to implement reforms are seldom mentioned. For example, budget departments are often identified as vital to budget reform, but agencies affected by such reforms are not considered important reform partners. This suggests that centralized rule makers must lead institutional reform, but it is not important to engage those who must ultimately abide by or implement new rules.
- Second, projects use formal mechanisms to effect institutional change. These include laws, procedures, and systems. This approach underscores a bias toward formal institutions. Such bias is evident in the 1990s literature on fiscal institutions,[32] which describes budgetary institutions as "all the rules" affecting budgeting but only focuses on official processes and laws. Informal mechanisms like political traditions are ignored. This suggests that informal mechanisms do not matter or are actually problematic and need to be replaced by more neutral, technical formal devices.[33]

Beyond these process similarities, one can also identify patterns in the content of institutional reforms. These manifest when examining the reform strategies of development organizations and the themes commonly introduced through externally supported projects. The World Bank project database is particularly valuable in this regard, providing information about themes pursued in more than five thousand projects incorporating public sector institutional reforms.[34] Three reform similarities appear when examining these sources.

First, reforms aim to foster market-friendly governments through interventions like privatization, deregulation, trade liberalization, and the establishment of government entities needed to promote competitive markets. Such interventions address the way governments engage with the private

[31] See Andrews 2011a; 2011b; 2012c. These papers, which examined a set of World Bank project documents, see process commonalities. Design and completion reports provided narratives about reform content and results.

[32] Alesina and Perotti 1999, 14.

[33] As an example, consider the way in which the influential public finance scholar Alan Schick identifies informality as a problem in developing countries. He prescribes basic aspects of formality as a solution – external rules that are routinely enforced by strong central rule makers. See Schick 1998.

[34] As discussed, these are reforms incorporating activity in the PAL&J sector.

sector and are a focal point in 44 percent of all World Bank projects targeting institutional reform.[35] The British development agency explains that these interventions address a "state failure" to facilitate vibrant markets.[36] The African Development Bank considers them necessary to improve the "investment climate and business environment."[37] They were initiated in the first few World Bank projects addressing public sector institutional reforms in all forty sample countries,[38] suggesting that market-friendly rules are a key and consistent element of institutional reforms in development. They are not only the generically relevant "right rules" to adopt in reforms, but they are the common right rules to start reform with – in all countries, no matter when the start date is or what the context looks like. This view is borne out by the fact that such interventions dominated reform in Chile in the 1970s, Uganda in the 1980s, Azerbaijan in the 1990s, and Afghanistan in the 2000s.

Second, reforms aim to create disciplined governments. Examples include staff rationalization mechanisms and budget controls that facilitate spending accountability, touted as vital in the Inter-American Development Bank's 2003 "Modernization of the State" document.[39] Such mechanisms are evident in more than 30 percent of World Bank–projects focused on reforming governments.[40] Ninety percent of the forty sample countries took steps to discipline their public finances and civil service regimes and to streamline debt in the first four years of World Bank–sponsored institutional reform.[41] This timing suggests that reforms intended to discipline

35 This reflects 2,432 projects with at least one major thematic reference to "financial and private sector development," "rule of law," and "trade and integration" of 5,610 PAL&J projects.

36 Department for International Development 2010, 17.

37 African Development Bank 2012, 19.

38 This is apparent when one breaks reform experiences down into defined periods of mostly two years and identifies the period in which a country started its public sector reform and what it did in this and ensuing periods. Azerbaijan's PAL&J reforms began in 1994, for example, and 37 projects with 151 themes have been pursued in eight periods since then. Afghanistan had its first public sector reform in 2002. It initiated more than 40 projects addressing issues in more than 150 thematic areas in the four ensuing periods. In both examples the first four periods of reform were dominated by activities establishing the rules of market-friendly government.

39 Inter-American Development Bank 2003.

40 A key World Bank theme reflecting this is called "Economic Management" and was referenced in 640 projects. The "Public Sector Governance" theme was cited in 1,976 projects, and a large portion of these interventions emphasized creating disciplined civil service and budgetary regimes. Based on these statistics, one can assume that improved discipline was a focal point of as many as a third of 5,610 projects addressing institutional reforms.

41 Madagascar's 1989 *Economic Management and Social Action* project is an example. It formalized budget, fiscal policy, and investment processes. Mozambique's 1994 *Second*

governments go hand in hand with efforts to establish market-friendly government structures. In fact, both types of activities are often integrated in the same early-period operations.[42] They reflect ideas that seem to be at the heart – and start – of public sector institutional reform.

Third, reforms aim to modernize and formalize government processes. In this respect, the Asian Development Bank's 2000 action plan lists various modern solutions for governments to introduce in areas like public financial management and decentralization.[43] Similar documents emerged even earlier from the Inter-American Development Bank and World Bank,[44] advocating the adoption of modern mechanisms like fiscal rules, medium-term budgeting frameworks, and internal audit regimes. Such solutions are the focus of about a third of the World Bank projects fostering public sector institutional reform.[45] These engagements feature prominently in all periods of reform in the forty sample countries. This is not to say that reforms looked the same in all periods, however. Early-period interventions typically reflect what some call first-generation interventions that bring centralized, *ex ante* control to public financial management and administrative processes.[46] Later-period reforms are often different, reflecting "second-generation" interventions that introduce cutting-edge mechanisms like performance management and devolved organizational structures, all slated to improve efficiency.[47]

Economic Recovery Credit aimed to develop a strong macro-monetary capability within the central bank and ensure disciplined fiscal policy. Georgia's 1995 *Rehabilitation Loan* supported a program to restore macroeconomic stability and liberalize prices.

42 Madagascar's early fiscal policy reforms were aligned with efforts to liquidate or privatize public enterprises. Bulgaria's *Rehabilitation Loan* sought to improve monetary policy mechanisms and accelerate privatization.

43 Asian Development Bank 2000.

44 Inter-American Development Bank 2003; World Bank 2000b.

45 A total of 1,976 World Bank projects addressing the "Public Sector Governance" theme introduced new laws, processes and systems to modernize and formalize government, as did many projects stressing reforms in the "Urban Development" thematic area (which was a key theme in 920 projects).

46 First-generation reforms include standardized annual budgeting and treasury processes, basic procurement rules and cash-based expenditure controls, control and rationalization of the wage bill, and formalization of pay and employment systems. One sees such initiatives in Argentina's 1991 *Public Sector Technical Assistance Loan*, Tanzania's 1992 *Parastatal and Public Sector Reform Project* and the 2004 *Second Emergency Public Administration Project* in Afghanistan. They also characterize content in Lao's 1992 *Structural Adjustment Credit* and Georgia and Moldova's 1999 *Structural Adjustment* operations.

47 Recent projects in Argentina, for instance, introduce performance management, monitoring and evaluation, e-government and other modern processes. Tanzania's 1999 *Public Sector Reform Program* is another example, focused on policy de-concentration, performance monitoring, and establishing meritocratic civil service processes. Afghanistan's