

CHAPTER 4

FOSTERING MARKETS: LIBERALIZATION, REGULATION, AND INDUSTRIAL POLICY

FEW DISPUTE THE CENTRAL ROLE OF THE STATE IN securing the economic and social fundamentals discussed in Chapter 3. There is much less agreement, however, about the state's precise role in regulation and industrial policy. A counterpart to the rise of state-dominated development strategies in the early postwar years was a dramatic expansion in government regulation in many countries. As countries have liberalized, those aspects of the regulatory framework that have proved counterproductive are being abandoned. But governments are learning that market reforms and fast-changing technology pose their own regulatory challenges. States cannot abandon regulation. The task, rather, is to adopt approaches to regulation that fit not merely the shifting demands of the economy and society but, critically, the country's existing institutional capability.

Attention to the proper match between the state's role and its institutional capability helps reconcile some seemingly clashing prescriptions for state action. Many, for example, would argue that, in complex industries such as telecommunications, regulators ought to have considerable flexibility in devising and implementing market rules. Yet where institutional capability remains weak, the scope for flexible initiatives is limited; the focus should instead be on winning credibility with firms and citizens, convincing them that the state will follow through on its commitments and will refrain from arbitrary and capricious action.

The same applies even more forcefully to more interventionist policies—those aimed at not merely laying the foundations of industrial development but actively accelerating it. In principle, there seems to be room for government to play such a role. But in practice its scope for doing so turns out to rely heavily on a range of stringent institutional conditions being fulfilled. Except where role and capability have been skillfully matched, activist industrial policy has often been a recipe for disaster.

Many countries with weak institutional capability are saddled by their history with governments whose reach is overextended; for them, privatization and market liberalization is a key part of the policy agenda. As capability develops, public organizations and officials will be able to take on more challenging collective initiatives, to foster markets and to make increasing use of efficient—but difficult to manage—regulatory tools.

Privatizing and liberalizing markets in overextended states

Interest has revived in finding ways for the government to work with the private sector in support of economic development, and to provide regulatory frameworks supportive of competitive markets. Yet in all too many countries, state and market remain fundamentally at odds. Private initiative is still held hostage to a legacy of antagonistic relations with the state. Rigid regulations inhibit private initiative. And state enterprises, often buttressed by monopoly privileges, dominate economic terrain that could more fruitfully be given over to competitive markets. At the extreme, a mass of inefficient state enterprises blocks private dynamism entirely, even as it imposes an unmanageable fiscal and administrative burden on the rest of the public sector. In such countries the first step toward increasing the state's effectiveness must be to reduce its reach.

The recent economic performance of such countries as China and Poland provides dramatic evidence of the benefits of shrinking the state in former centrally planned economies. But relaxing government's grip, whether that grip is maintained through public ownership or regulation, can also yield large dividends in more mixed economies. It can:

- *Free up public resources for high-priority activities.* Diverting subsidies away from money-losing state enterprises and toward basic education would have

Table 4.1 Estimates of welfare gains from deregulation in the United States

(billions of dollars)

Industry	Gains to consumers	Gains to producers	Total gains	Further potential gains
Airlines	8.8–14.8	4.9	13.7–19.7	4.9
Railroads	7.2–9.7	3.2	10.4–12.9	0.4
Trucking	15.4	-4.8	10.6	0.0
Telecommunications	0.7–1.6	..	0.7–1.6	11.8
Cable television	0.4–1.3	..	0.4–1.3	0.4–0.8
Brokerage	0.1	-0.1	0.0	0.0
Natural gas	4.1
Total	32.6–43	3.2	35.8–46.2	21.6–22.0

.. Not available.

Source: Winston 1993.

increased central government education expenditures by 50 percent in Mexico, 74 percent in Tanzania, and 160 percent in Tunisia.

- *Pave the way to better, cheaper services.* Divestiture of state assets had positive effects in all but one of twelve carefully studied cases in Chile, Malaysia, Mexico, and the United Kingdom. The benefits came in the form of increased productivity and investment as well as more efficient pricing. Deregulation in five hitherto tightly regulated sectors in the United States had by 1990 yielded gains of \$40 billion (Table 4.1). In Argentina, liberalizing harbor terminals in Buenos Aires led to an 80 percent reduction in fees.
- *Unlock opportunities for private sector development.* Excessive regulation can inhibit market entry, fuel the growth of informal activity, and even create new industries solely devoted to helping firms navigate the regulatory maze. Eliminating these excesses enables markets to function more flexibly, at lower transactions costs.

The challenges of scaling back the overextended state are as much political and institutional as they are technical. Success relies on the ability to proceed with reform in the face of opposition from powerful groups who benefit from the status quo. Chapter 9 examines how reforms in general can most effectively be initiated and sustained. Here we focus more narrowly on programs of market liberalization and privatization.

Initiatives to foster market liberalization and privatization can be segmented into three overlapping phases: preparing for reform, establishing an enabling business environment, and privatizing (or liquidating) state enterprises. Transparency is the vital ingredient as governments begin to prepare for reform. Ideally, transparent preparation includes:

- An explicit statement of the main objective—to unleash a competitive market economy—with fiscal

and other objectives preferably at most secondary in importance

- Clarification of the criteria to be used in assessing which regulations are useful, which should be discarded, and which should be strengthened to complement privatization
- Preparation of financial statements and public budgets (including information on borrowing from banks) to assess which state enterprises are money-losers and uncover the reasons for their losses
- Specification of open and competitive mechanisms (such as auctions) for divesting state enterprises.

Such efforts have an added rationale. Often they will show whether or not a country is truly ready for reform—whether key political actors want reform and find it politically feasible to translate that desire into action. If political will is lacking, further efforts will be wasted. Indeed, they may prove counterproductive if interpreted as another in a long line of arbitrary shifts in policy.

With the initial preparation done, the second phase of reform is to put in place a business environment that supports competitive private markets. Such an environment includes rules of the game that facilitate entry and competition, and a complementary institutional, legal, and regulatory framework that can undergird property rights and markets, including (notably) financial markets.

The economic advantages of early reform of the business environment—even before privatization—are substantial. One advantage is that fostering external and domestic competition ensures that many of the benefits of privatization will be passed on to consumers, rather than simply result in a transfer from public coffers to private monopolies. Otherwise the latter are likely to become powerful, entrenched interests, willing and able to stifle subsequent efforts to introduce more competition into the economy. A second advantage is that, if clear regulatory structures are in place, bidders will have a better idea of

the economic potential of companies being privatized—the risk premium will be lower—and government will receive higher bids.

More broadly, liberalization of the business environment can be a powerful catalyst, setting off a virtuous spiral whereby each reform makes the next one easier. The stronger the business environment, the greater the range of opportunities and supports available to entrepreneurs, bureaucrats, and workers—and thus the weaker the political opposition to dismantling dysfunctional rules and agencies and liquidating or privatizing state enterprises. The challenge is finding a way to set this virtuous spiral in motion. For at the outset those who prosper under the dysfunctional system will have much to lose, while the eventual winners are unlikely to have reached the critical mass needed to lobby for their own interests. Box 4.1 describes how Mexico was able to overcome initial resistance to the rollback of regulatory controls.

Because it takes time for the business environment to become supportive—and because privatization becomes easier as the environment improves—reformers may be tempted to give privatization a backseat. This is precisely the approach adopted by China and, in earlier years, by the Republic of Korea and Taiwan (China). In the early 1960s, state enterprises accounted for about half of manufacturing production in Taiwan (China) and one-quarter in Korea. By the mid-1980s their share had fallen to about 10 percent in both economies—not as a result of privatization, but because of the rapid expansion of their private sectors.

A strategy of “growing out” of state dominance appears to have worked in some East Asian economies. But elsewhere economic and political considerations will favor keeping privatization on the front burner. Delay imposes three major economic costs. First, money-losing state enterprises may continue to drain money from the public coffers (or from banks in the form of never-to-be-repaid “loans”). Unless such losses can be contained, the resulting fiscal instability can undermine an entire reform program. Second, anticipating privatization down the road, managers and workers in state enterprises can be tempted to steal the company’s most valuable assets while the going is good. Third, poorly performing state enterprises may obstruct liberalization and restructuring in other sectors. In Zambia market liberalization created opportunities for smallholder farms to expand production and exports of cotton. But before being exported, cotton must be processed, and for some years after liberalization virtually all the country’s processors were under the control of a monopoly state enterprise. Once the sector was restructured, the pace at which farmers and businesses took advantage of new market opportunities picked up dramatically.

Given the importance of keeping privatization on the front burner, its sequencing in relation to liberalization thus poses some difficult dilemmas. On the one hand, privatization will yield greater economic benefits, and impose fewer hardships on society, if it is preceded by liberalization and regulatory reform. On the other hand, the longer privatization is delayed, the more entrenched management of state enterprises can become. Box 4.2

Box 4.1 Mexico’s deregulation czar

In 1988 the president of Mexico appointed a “deregulation czar.” Each month this official reported directly to the president and his economic council of ministers. Every business in Mexico, large or small, had equal access to the czar’s office to complain about burdensome rules and regulations. When the office received a complaint, it was obliged to find out why the rule existed, how it interacted with other regulations, and whether it should continue in effect. The office operated under a strict timetable: if it did not act to maintain, revise, or abolish the disputed rule within forty-five days, the rule was annulled automatically.

The work of the deregulation czar over his first four years is widely credited with greatly accelerating Mexico’s reforms. It provided struggling private businesspeople with an effective, responsive champion at the highest level of government. The factors behind this success include:

- Unequivocal presidential support, signaling to both bureaucrats and citizens the need to comply with the czar’s decisions
- The fact that his decisions could be overruled only at the highest level of government
- The setting of tough penalties for officials who failed to implement the rulings
- The time limit, which ensured quick and visible results
- The czar’s staff, who were skilled in the economic consequences of regulations, their interactions with other regulations, and their administrative requirements—no one person can effectively carry out a government-wide program of deregulation
- Finally, the fact that the czar won credibility with officials and with the public by giving a fair hearing to the powerless and the influential alike, and setting a consistent record of impartiality.

Box 4.2 Six objections to privatization—and how to address them

“We can’t throw public sector workers into the street. It’s wrong—and they won’t stand for it.”

Winning the acquiescence of employees is essential to successful privatization. Some countries have given shares to employees or privatized through employee and management buyouts. Others have offered generous severance pay. Privatization becomes easier as countries develop programs to protect the vulnerable, of the kind described in Chapter 3.

“Privatization is just another way for powerful politicians and businessmen to scratch each other’s backs, and get rich at the expense of the people.”

Process matters. Privatization must be based on competitive bidding, with the criteria for selecting buyers carefully specified in advance. And it all should be done in the open, in full view of the media and citizens.

“Our citizens won’t accept our handing over precious national assets to foreign (or local) fat cats.”

Broad-based ownership can help win popular support for privatization. One approach, adopted in the Czech Republic, Russia, and Mongolia, is to distribute privatization vouchers to citizens to be redeemed for shares. Another approach, adopted in Argentina, Chile, and the United Kingdom, is to make an initial public offering of shares to citizens at attractive prices. Both approaches can be designed to make room for a strong strategic partner with the incentive and expertise to effectively restructure the enterprise.

“Our local private sector is too weak. Without state enterprises, our economy will grind to a halt.”

Certainly, privatization is easier if a well-functioning market economy, including financial markets, is already in place. Thus, a key complement (and, if appropriate, antecedent) to privatization is market liberalization, perhaps accompanied by the activist initiatives to foster markets described later in this chapter. Even so, in most settings it is precisely the heavy hand of the overextended state that is restraining private activity—the objection confuses cause with effect.

“All that privatization will do is replace a public monopoly with a private monopoly.”

Regulatory reform is another important accompaniment to privatization: deregulation to remove artificial monopoly privileges, and development of a regulatory system that credibly restrains the abuse of economic power in noncompetitive markets.

“Why put ourselves through this trauma? Let’s just manage our state enterprises better.”

True, if governments are willing to put hard budget constraints in place, to allow competition from private firms, and to give managers appropriate incentives, the performance of state enterprises can improve. The sad reality is that, although some committed governments have reformed their state enterprises in the short term, making these reforms stick is much harder. *World Development Report 1983* spotlighted a number of well-performing state enterprises around the world; by 1993 a majority of these had sunk into decline.

describes how reformers opting to push ahead with privatization have tried to contain the risks.

Rolling back overextended states: Two central lessons

Experience worldwide with attempts to scale back overextended states suggests that success contains two vital ingredients. First is a commitment to competitive markets and an accompanying willingness to eliminate obstacles to their operation. Market liberalization enables new entrants to create jobs and wealth. It also eases the difficulties of privatization while increasing the potential economic gains. The second lesson is that, although the overextended

state needs to own less, and although there is no good economic reason for state ownership to persist in tradable-goods industries, there is no single “correct” stage in the reform program to start privatizing. The appropriate timing will depend on the dynamics of reform in each country.

Better regulation

Skillful regulation can help societies influence market outcomes to achieve public purposes. It can protect the environment. It can also protect consumers and workers from the effects of information asymmetries: the fact that banks, for example, know much more about the quality of

their portfolios than do depositors, or the fact that business managers may know more about health and safety risks in production or consumption than do workers or consumers. Regulation can also make markets work more efficiently by fostering competition and innovation and preventing the abuse of monopoly power. And more broadly, it can help win public acceptance of the fairness and legitimacy of market outcomes.

With economic liberalization, many areas of regulation have been recognized as counterproductive, and wisely abandoned. Yet in some areas the traditional rationales for regulation remain, and market liberalization and privatization have themselves brought new regulatory issues to the fore. The challenge, illustrated here with reference to three important regulatory domains—banking, utilities, and the environment—is not to abandon regulation altogether. Instead it is to find regulatory approaches in each country that match both its needs and its capabilities.

Some new rationales for regulation

FINANCE: FROM CONTROLS TO PRUDENTIAL REGULATION. Our understanding of financial sector development has changed dramatically over the past decade. We now know that the depth of a country's financial sector is a powerful predictor and driver of development. Just as important, we know that the control-oriented regulation widely adopted in the early postwar years—directing subsidized credit to favored activities at very negative real interest rates, limiting the sectoral and geographic diversification of financial intermediaries—may often work against financial deepening. The near-universal response has been to move away from controls over the structure of financial markets and their allocation of finance, and embark on a process of liberalization.

Yet liberalization in the financial sector is not the same as deregulation. The case for regulating banking is as compelling as ever. Only the purpose has changed, from channeling credit in preferred directions to safeguarding the health of the financial system.

The banking system needs effective prudential controls because banks are different. Without appropriate regulation, outsiders will be less able to judge for themselves a bank's financial health than that of a nonfinancial company. Why? First, because outstanding loans are banks' primary assets. So long as banks receive interest on their loans, outside observers may well judge their portfolios to be healthy, even if (unknown to the observers) the borrowers lack the resources to repay the principal or, worse, are effectively bankrupt and are only keeping up the interest payments by taking out new loans. Second, because unlike many companies, banks can be hopelessly insolvent without running into a liquidity crisis. So long as insolvent bankers can disguise their condition to outsiders,

they can continue to attract deposits—and even aggressively pursue them by offering favorable interest rates. Failing banks often engage in ever-more-reckless gambles to salvage their position, throwing good deposits after bad, and driving up their losses before the inevitable crash. And third, because banks' balance sheets can be difficult to interpret, especially because a rising share of their portfolios may now be taken up with derivatives and other new financial instruments that are hard to monitor.

This information asymmetry can be destabilizing. Depositors, fearing for the safety of their funds, might rush to withdraw them when they begin to hear stories about troubled banks. Bank failures tend to be contagious. When one insolvent bank goes under, nervous depositors may start runs on others. As liquidity drains out of the system, even solvent banks may be forced to close. And a systemwide run can have severe macroeconomic consequences. For all these reasons—the difficulties in assessing a bank's financial health, the adverse spillover and distributional effects of bank failures—banks' behavior needs to be tempered by regulatory and other public actions, outlined later in this section.

UTILITIES: REGULATION WITH COMPETITION. For utilities, too, regulation has taken on renewed prominence. Here, however, the reason is revolutionary technological and organizational change, not just conscious shifts in policy. The argument for utility regulation used to be straightforward. Utilities were natural monopolies. Consequently, unless they were regulated, private utility operators would act as monopolists, restricting output and raising prices, with harmful consequences for economy-wide efficiency and income distribution. Today, changes in technology have created new scope for competition, but would-be competitors may need special reassurance from regulators before entering.

In telecommunications, dozens of countries throughout the Americas, Europe, and Asia—plus a few in Africa, including Ghana and South Africa—have introduced competition in long-distance, cellular, and value added (fax, data transmission, videoconferencing) services. A few countries—Chile and El Salvador, for example—are even exploring options for competition in local fixed-link networks. Electric power generation (but not transmission or distribution) is also now viewed as an arena for competition. In China, Indonesia, Malaysia, and the Philippines, private investors are adding generating capacity through independent power projects, alleviating acute shortages and enabling private finance to fill the gap left by shortfalls in public resources.

In this new environment the degree of natural monopoly has been drastically reduced (although perhaps not eliminated entirely). But regulation is still crucial, for two reasons. First, it can facilitate competition. Consider the

problem of interconnection. By failing for more than a decade to establish workable rules to allow different networks to connect with one another, Chile's telecommunications regulators seriously obstructed competition, leaving dominant incumbent firms in control of how the system evolved. After numerous court disputes a multicarrier system was introduced in 1994: customers can now choose their long-distance provider. Within months, six new providers had entered the market, and the price of long-distance calling had dropped by half. Similar interconnection problems can arise in the electric power industry when generators supply customers through common-carrier transmission lines. This is an issue that Argentina, among others, has had to grapple with in the wake of privatization.

A second reason for improved regulation is that competition may not suffice to insure private investors against "regulatory risk": the danger that decisions by regulators or other public agencies will impose new and costly demands some time down the line. A utility's assets are unique to its business, and nonredeployable in other uses. This means that utilities will be willing to operate as long as they can recover their working costs. That, in turn, makes them peculiarly vulnerable to administrative expropriation—as when, for example, regulators set prices below long-run average cost. Consequently, countries without a track record of respecting property rights may fail to attract private investors into utilities, regardless of any commitment to competition in utility markets. As the next sections show, a well-designed mechanism that commits the regulator to a clearly defined course of action can offer the reassurance that potential investors need.

THE ENVIRONMENT: BALANCING SCIENCE, ECONOMICS, AND CITIZEN PRESSURE. Economists have long recognized pollution to be a negative externality. Without some form of regulatory protection, the environment can become an innocent victim of bad business practices. Buyers seek goods that are attractively priced, and producers seek ways of providing these goods at lower cost to themselves than their competitors can provide them. Unless there is some countervailing incentive, the temptation to cut corners by producing in a cheaper but environmentally "dirtier" way can be great.

Even countries with strong institutions find environmental regulation immensely challenging. Noxious fumes, poisoned water, earsplitting noise—and their consequences—are easy to spot. But the costs of many other forms of environmental damage are diffuse, and may be invisible even to those closest to the source of pollution, who may suffer serious long-term effects. Polluting emissions can also be tricky to measure. And the environmental consequences may depend heavily on the demographic and ecological features of the surrounding area.

A further complication is that the political incentives of community, business, and political stakeholders can foster

ambiguity and negotiated outcomes rather than predictable and consistent implementation. Poor communities daily confront a dismal bargain, borrowing immediate survival against long-term environmental degradation. Private firms weigh the predictable costs and the benefits of complying with well-defined environmental regulations against the prospect of cutting costs by avoiding regulation altogether. Consequently, politicians may often conclude that environmental inaction (perhaps veiled behind the appearance of activism) is the politically expedient course.

In this climate of ambiguity, as later sections will show, purely technocratic approaches to environmental regulation have little hope of success. Especially in developing countries where the institutional foundations for regulation are weak, the potential for successfully containing the environmental hazards of unfettered private markets may be greater with approaches that rely at least as much on public information and citizen participation as on formal rules.

Where capability is strong, regulation can raise credibility and efficiency

So how should states respond to continually changing, and often conflicting, regulatory demands? Three principles are key. First, different ways of regulating have different costs and benefits, which countries should assess explicitly before proceeding. Second, this assessment should also incorporate the administrative dimension: some forms of regulation are intensive in their requirements for information, whereas others require much less (or much more easily monitorable) information; likewise, some regulatory approaches depend on command-and-control, others more on market-like mechanisms. In general, information-light and market-like approaches are easier to implement, and often at least as efficient. Third, states differ markedly both in their institutional capabilities and in the structure of their economies. Their approaches to regulation should reflect these differences.

We begin to show how these principles can be applied in practice by considering some "best-case" scenarios: the range of regulatory options for banking, utilities, and the environment that only work well with strong institutions. These institution-intensive approaches combine three central elements (Table 4.2):

- Relying on public administrators to manage complex technical problems
- Giving regulators considerable flexibility to respond to changing circumstances
- Using an array of checks and balances to restrain arbitrary behavior by regulatory agencies and build their credibility.

BANK SUPERVISION. Banking sector regulation around the world tends to be institution intensive. Later sections

Table 4.2 The variety of regulatory experience

	Utilities regulation	Environmental regulation	Financial regulation
Institution-intensive options	Price-cap regulation, with the regulator setting the price adjustment factor Regulation by independent commission, with public hearings	Precise rules (command-and-control or, preferably, incentive based) established by the regulatory agency or legislature	Detailed regulation monitored by competent, impartial supervisory authorities (possibly including some deposit insurance)
Institution-light options	Regulation based on simple rules, embodied in transaction-specific legal agreements and enforceable domestically or through an international mechanism	Bottom-up regulatory approaches: public information, local initiatives to strengthen citizens' voice, and initiatives by local authorities	Incentives structured so that bankers and depositors have a substantial stake in maintaining bank solvency

discuss some new ideas for maintaining the solvency of banks where supervisory agencies are weak. In many countries, however, formal supervision remains a vital bulwark. The idea behind it is that well-designed regulation, monitored and enforced by competent supervisory authorities, can overcome the information asymmetries inherent in banking, and detect—or at least contain—potentially ruinous banking crises (Box 4.3). Key elements of such systems include:

- *Capital adequacy and entry criteria.* Minimum capital requirements impose discipline on banks by ensuring

that their owners have something to lose in the event of failure. Authorities should also be required to consider the qualifications and track record of proposed owners and managers.

- *Restraints on insider lending.* Restrictions on lending to bank insiders can cut down on fraudulent loans. Similarly, many countries also limit a bank's lending to a single client (commonly to a maximum of 15 to 25 percent of the bank's capital); this prevents any one client from becoming "too big to fail," prompting the bank to make unsound loans solely to keep that client afloat.

Box 4.3 How government supervision averted financial disaster in Malaysia

In 1985 a sudden fall in world commodity prices reversed Malaysia's decade-long boom. The Malaysian stock index, which had surged from 100 in 1977 to 427 in early 1984, fell below 200 by early 1986; the value of prime commercial property in Kuala Lumpur fell by even more. Banks, which had moved heavily into real estate lending in the boom years, faced the specter of rising nonperforming loans and doubtful debts.

Because Malaysia had maintained a fairly high degree of banking supervision, provisioning for nonperforming loans rose rapidly: from 3.5 percent of total lending in 1984 to 14.5 percent by 1988. Even so, supervisory inspections in 1985 identified three commercial banks whose solvency was threatened by problem portfolios (but whose management was reluctant to acknowledge the full scope of the problem). Additionally, twenty-four nonbank deposit-taking cooperatives—with over 522,000 depositors and about \$1.5

billion in assets, but subject to much less supervision than the commercial banks—were in severe distress.

Bank supervisors at Bank Negara, Malaysia's central bank, devised a series of complex rescue packages for the three ailing commercial banks and the twenty-four cooperatives. All told, losses as a result of the banking crisis amounted to 4.7 percent of Malaysia's 1986 gross national product (GNP).

Malaysia's experience underscores the value of good supervision. Losses in the tightly supervised banking sector amounted to only 2.4 percent of deposits—far less than the 40 percent of deposits lost in the lightly supervised nonbank cooperatives. And macroeconomic disaster was averted. The economy recovered in 1987, and stock and property prices and bank balance sheets recovered with it. Prompt action had made it possible to identify and address problems early, while disciplined rescue was still affordable.

- *Rules governing asset classification.* Requiring that banks classify the quality and risks of their loan portfolio according to specific criteria, and define and identify nonperforming loans, can provide early warning of problems.
- *Audit requirements.* Minimum auditing standards and disclosure requirements can make reliable and timely information available to bank depositors, investors, and creditors.

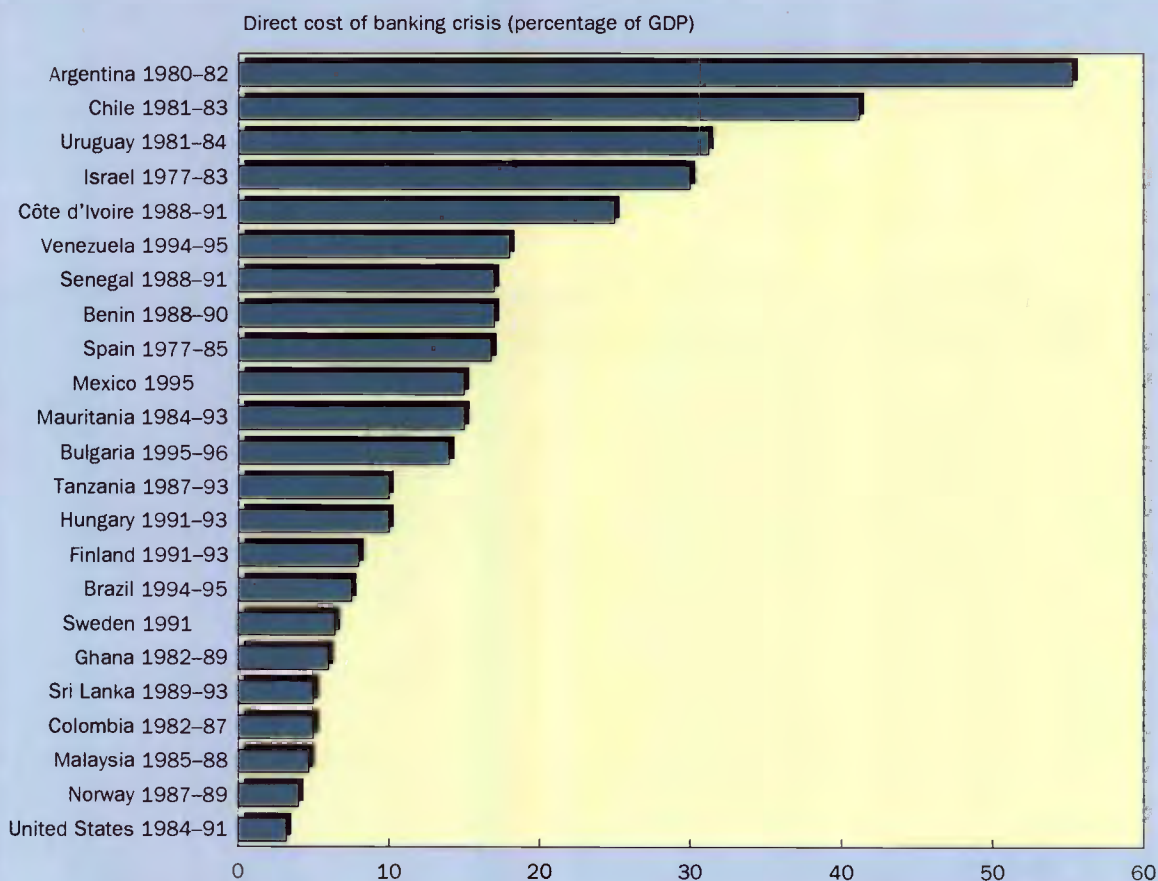
Building a robust system of prudential regulation and supervision is administratively demanding. It means having reasonably reliable accounting and auditing information on the financial health of a bank's borrowers. And it means having a sufficient number of supervisors, not only skilled enough to do their job but politically independent enough to do it impartially.

Many countries have relied exclusively on prudential regulation and supervision to undergird their banking sec-

tors, without having these prerequisites in place. The consequences have often been disastrous. A recent World Bank study identified over 100 major episodes of bank insolvency in ninety developing and transition economies from the late 1970s to 1994. In twenty-three of the thirty countries for which data were available, the direct losses sustained by governments in these episodes exceeded 3 percent of GDP (Figure 4.1). In absolute terms, losses were largest in the industrial countries: official estimates put nonperforming loans in Japan in 1995 at about \$400 billion; the cost of cleaning up the 1980s U.S. savings and loan debacle came to \$180 billion. But in relative terms the largest losses were in Latin America: Argentina's losses in the early 1980s amounted to more than half of its GDP, and Chile's exceeded 40 percent. Later sections examine some ways to guard against bank failure that are not so heavily dependent on formal supervision.

PRICE CAPS FOR REGULATING UTILITIES. The use of price caps in utility regulation illustrates both the scope of

Figure 4.1 Bank crises are all too common and carry enormous fiscal cost



Source: Caprio 1996.

authority of an independent regulator and the role of institutional checks on arbitrary action. Price-cap regulation gives the utility an incentive to be efficient and can encourage innovation, but it rests substantial discretionary power with the regulator. In the United Kingdom, which pioneered price-cap regulation, regulators impose an overall ceiling on utility prices, based on the annual rate of inflation minus an adjustment factor. The regulators decide the level of the adjustment factor, which they can change at defined (usually five-year) intervals.

The U.K. regulators are constrained by carefully designed checks and balances: any decisions that the utility opposes must be cleared by both the Monopolies and Mergers Commission and the Secretary of State for Trade and Industry. These checks have been strong enough to permit a highly flexible approach to regulation while still attracting substantial private investment. If countries with weaker checks and balances sought to adopt this type of regulation, private investors might reasonably expect the adjustment factor to increase dramatically at the first renewal of the price cap. Consequently, investors either would not invest or would demand very high rates of return to ensure a quick payback.

INSTITUTION-INTENSIVE APPROACHES TO ENVIRONMENTAL REGULATION. A central challenge for environmental regulation has always been finding ways to combine technical expertise with political legitimacy, to avoid the sense that scientists and technocrats are making decisions without regard for community or broader public concerns. In industrial countries, strong institutions have been the key to striking this balance. In France, Germany, and the United Kingdom, for example, elected legislators delegate the details of policy to environmental authorities, who consult with affected parties and respond to direct political pressure. Decisions by the U.S. Environmental Protection Agency are, like many other executive agency decisions, legally binding only if the public is given advance notice of rule changes and interested parties are able to make formal comments. The Dutch government provides more than half the funding for thirty to forty environmental NGOs and routinely consults them and other affected parties when preparing environmental legislation.

Viewed through the narrow lens of economic efficiency, even these mechanisms have produced imperfect outcomes. Both Germany and the United States, for example, have been strikingly successful in reducing emissions of some important pollutants. Yet partly because of the need to be seen as responsive to citizen concerns, both countries continue to rely overwhelmingly on command-and-control approaches to environmental regulation, even where market- and incentive-based regulation could achieve similar gains at much lower cost.

The shortcomings of top-down environmental regulation have been even more obvious in developing countries, many of which responded to the surge of interest in environmental issues by establishing new regulatory agencies modeled on this approach. Poland's regulatory agency, for example, although technically competent, found it had limited leverage in negotiations with plant managers in communities that were heavily dependent on one or a few large enterprises, which funded many community services. Chile's highly regarded environmental agency has spent four years trying, and failing, to implement a system of tradable permits for industrial emissions, because of difficulties in setting and later measuring baseline emissions.

The regulatory "fit" when institutions are weak

Countries with weaker institutions face a much greater risk that relying on administrators' skill and discretion will result in a mass of unpredictable and inconsistent regulation. The challenge for financial and environmental regulation in such countries is to prevent costly opportunism by private actors—be it banking fraud or pollution—when the regulatory agencies' authority cannot be relied upon. With regard to utilities, the trick will be to convince potential investors that regulators will not engage in arbitrary and expensive rule changes. Table 4.2 summarized some of the regulatory options available in such cases, each of which is discussed below.

FOSTERING INCENTIVES FOR PRUDENT BANKING. The incentives and interests of bank owners, managers, and depositors can themselves be a vital complement to supervision if they are aligned to be compatible with prudent banking. The history of banking offers examples of some unusually sophisticated self-enforcing arrangements for winning credibility. More recently, the World Bank and the European Bank for Reconstruction and Development collaborated on a project in Russia designed to influence banks' incentives: banks were chosen to on-lend funds provided they agreed to submit to annual audits by international accounting firms and to adhere to prudential norms.

Using regulation to raise the stakes for bankers is another institution-light way to protect the health of the banking system. It is less expensive to monitor the net worth of a bank than to monitor each of its transactions. A bank that has adequate net worth will have the right incentive to behave prudently. The following measures can all help raise net worth, and hence the cost of bank failure to bankers:

- Very strict capital requirements on banks: not the modest 8 percent of deposits recommended by the Basel Committee for industrial countries, but 20 percent or more

- Tough restrictions on entry, in part to raise the franchise value of a banking license for incumbents and thereby strengthen the incentive to stay in business
- Ceilings on interest rates for deposits, not only to keep banks in business but also to create powerful incentives for banks to extend branch networks, so as to boost total deposits and accelerate financial deepening.

Another option that builds on prudential incentives is punitive contingent liability for bank owners, directors, and managers in the event of bank failure. Before the mid-1930s, U.S. authorities routinely imposed double liabilities on the shareholders of failed banks. Perhaps in part as a consequence, some 4,500 voluntary bank closures occurred between 1863 and 1928, but only 650 bank liquidations. New Zealand today imposes stringent requirements on banks for transparent reporting, coupled with tough sanctions on bank managers who violate them.

COMMITMENT MECHANISMS TO ATTRACT PRIVATE UTILITY INVESTORS. The Jamaican telecommunications industry vividly shows how private investment can affect the interplay between institutional capability and regulatory roles (Box 4.4). There the government was able to use regulatory commitment mechanisms capable of attracting

sustained private investment, but only at the cost of limiting flexibility. Since independence the industry has been on a regulatory roller coaster, thriving when the country was willing to forgo flexibility, but lagging behind when the mood shifted in favor of greater discretion.

Unlike Jamaica, the Philippines has until recently been unable to put in place a regulatory commitment mechanism capable of convincing private investors that the rules of the game would endure beyond the term of the current president. Consequently, from the late 1950s until the early 1990s the country's private telecommunications utility rode a political investment cycle. Investment was high immediately following the inauguration of a government aligned with the group controlling the utility, but tailed off in that government's later years, and stagnated in periods when relations with those in power were more distant. In the electric power industry, the government resolved the problem of commitment by agreeing on rigid legal "take-or-pay" agreements with private investors, sometimes enforceable offshore. Another option is to use third-party guarantees—such as those offered by the World Bank Group—to protect private investors and lenders against noncommercial risks, including the risk of administrative expropriation.

Box 4.4 Telecommunications regulation in Jamaica

During much of the colonial period and in the years immediately following independence, the terms under which Jamaica's largest telecommunications utility operated were laid out in a legally binding, precisely specified, forty-year license contract. Then as now, the ultimate court of appeal for Jamaica's independent judiciary was the Privy Council in the United Kingdom. This system was adequate to ensure steady growth of telecommunications services, and the number of subscribers tripled between 1950 and 1962. Yet a newly independent Jamaica chafed under the apparent restrictiveness of a concession arrangement that afforded virtually no opportunity for democratic participation. Consequently, in 1966 the country established the Jamaica Public Utility Commission. Modeled on the U.S. system, the commission held regular public hearings and was afforded broad scope to base its regulatory decisions on inputs from a wide variety of stakeholders.

However, Jamaica lacked the other institutions needed to make such a system workable. Whereas the U.S. system has a variety of constraints on regulatory discretion (including well-developed rules of administrative process and constitutional protections on property), Jamaica had virtually no checks and balances on

commission decisions. The result was that price controls became progressively more punitive—to the point that in 1975 Jamaica's largest private telecommunications operator was relieved to sell its assets to the government. In 1987, after a decade of underinvestment, Jamaica reprivatized its telecommunications utility, this time using a precisely specified, legally binding license contract similar to those used prior to 1965. In the next three years, average annual investment was more than three times what it had been over the previous fifteen.

Private investment came at a cost, however. To maintain long-standing (and politically difficult to eliminate) cross-subsidies between local and long-distance services, upon privatization Jamaica awarded a single telecommunications provider a twenty-five-year concession to operate the entire system. Revenues from the highly profitable long-distance network were used to extend the unprofitable local fixed-link network. Debate continues on whether, even within its political constraints, Jamaica could have retained room for competition in some value added services, thereby preserving at least a modicum of pressure for innovation and productivity improvements in an era of rapid global technological change.

COMMUNITY PRESSURE TO HELP PROTECT THE ENVIRONMENT. In settings where institutions are weak, public information and community pressure can be powerful spurs to ever more credible and efficient environmental regulation.

Experiments with transparent, information-intensive initiatives can help moderate industrial pollution even when enforceable formal rules are lacking. In Indonesia, for example, a largely voluntary Clean Rivers program, launched in 1989, had reduced total discharges of the 100 participating plants by more than a third by 1994. A program announced in mid-1995 to set, and publicize, environmental ratings for factories also seems to have induced many poorly rated factories to improve their performance. In both programs the secret to success was the reputation effect of making public to business peers, communities, and consumers the extent to which individual firms were good environmental citizens.

Environmental programs built entirely around public information have obvious limits. Nearly half the firms participating in the Clean Rivers program did not reduce the intensity of their polluting activities. Information-driven programs do help signal where the most severe problems are to be found, but often additional measures are necessary to get heavily polluting firms to clean up. And clearly, as countries develop they will need to move toward more institutionalized approaches that integrate community pressures with more formalized mechanisms for enforcing compliance.

In a pattern seen throughout the world, initiatives from the bottom up can set the stage for formal action at the national level. In the first two decades after World War II Japan rushed headlong into industrialization, with little concern for the environmental impact. At the national level this period of neglect ended in 1967, with the landmark Basic Law for Environmental Pollution Control. But well before then, grassroots initiatives in many localities had set in motion sustained environmental reform (Box 4.5).

Lessons: Clarifying regulatory options

The reality of imperfect markets brings regulation onto the development policy agenda. At the same time, however, the reality of imperfect government cautions against hasty enactment of institution-intensive regulatory systems in settings where institutions are weak. The key to success is to focus the regulatory agenda and adapt the available regulatory tools to fit the country's institutional capability. Two questions can help guide countries in the search for better regulation.

Are formal rules necessary to correct the market imperfections? Regulation's mixed record suggests that the use of formal rules to regulate markets is better viewed as a complement to other measures (or even as a last resort)

Box 4.5 Environmental activism in Yokohama, Japan

In 1960 local medical associations in Yokohama began to petition against oil refinery emissions and the health damages they caused. Shortly thereafter the municipal government, which had been dragging its feet on environmental issues, was ousted in elections by a reformist mayor who pledged to implement pollution prevention policies. A flurry of activity followed, punctuated by the establishment of a new pollution control unit within city government (which by the end of 1964 had a staff of ten), a residents' environmental organization, and a joint advisory group composed of community representatives, academics, and business experts.

Although the city had no legal authority to impose controls on pollution, by December 1964 it had entered into a formal, voluntary agreement with a new coal-fired power plant to drastically reduce emissions. This agreement offered a precedent for subsequent voluntary agreements with other new and existing large factories, which reduced emissions to just 20 percent of their earlier projected levels. Over the next two decades Yokohama progressively increased the stringency of these voluntary agreements—and consistently maintained higher environmental control standards than did Japan's national government (which itself was continually raising its standards).

than as an automatic response to problems. Moreover, countries' experiences with financial, utility, and environmental regulation show how competition, voice, and self-regulation can achieve social objectives once thought to require rule-based solutions.

Does the country have the institutional and political underpinnings necessary for formal rules to serve as a basis for credible regulatory commitments? On the political front, the relevant question is whether the country has the political will to follow through on what it enacts. On the institutional front, a critical issue is whether the country has an independent judiciary, with a reputation for impartiality, whose decisions are enforced. If not, other commitment mechanisms (sometimes extraterritorial) may be needed. In countries where political coalitions capable of amending rules are difficult to stitch together, legislation may suffice; in other countries it may be desirable to embed formal rules in binding legal agreements with individual firms.

If formal rules are called for, these must be workable not just in theory but in practice. In an ideal world flexible rules are preferable to rigid ones. But what constitutes a good regulatory “fit” in the real world may bear little relation to ideal conceptions of efficiency. In countries that lack appropriate checks and balances, flexibility may have to be sacrificed in the interests of certainty and predictability. What appears at first blush to be less than efficient may thus turn out to be the single best solution from the standpoint of matching the goals of regulation to the strengths and weaknesses of existing institutions.

Can state activism enhance market development?

Where externalities, lack of competition, or other market imperfections drive a wedge between private and social goals, most people accept that states may be able to enhance welfare through regulation. Much more controversial is whether states should also try to accelerate market development through more activist forms of industrial policy. The theoretical case for industrial policy rests on the proposition that the information and coordination problems identified above can be pervasive—more so in developing economies—and can go beyond those addressed by well-functioning institutions to protect property rights. In essence the argument centers on the fact that, in underdeveloped markets with few participants, learning can be extremely expensive. Information, more readily available in industrial countries, here becomes a zealously guarded secret, impeding coordination and market development more generally.

In theory, governments in such economies can act as brokers of information and facilitators of mutual learning and collaboration, and thereby play a market-enhancing role in support of industrial development. But whether governments can play this role in practice will depend, as ever, on their institutional capability. Even aggressive proponents recognize that activism can enhance markets only if three critical background conditions are in place.

First, and perhaps most important, companies and officials need to be working on a basis of mutual trust. Firms need to be confident, not only that additional coordination has merit, but that the government and the other firms involved will make good on their commitments. The participants also need confidence that a given set of arrangements will be flexible enough to adapt to changing circumstances. Ordinarily this will mean a credible government commitment to involve the private sector in implementation.

Second, initiatives to promote industrial development must be kept honest through competitive market pressures. Competition can come from other domestic firms or from imports, or take place in export markets. Unless firms are systematically challenged by one or more of these

forms of competition, they will have little incentive to use resources efficiently or to innovate, productivity will not improve, and industrial expansion will not be sustained.

Third, a country’s strategy for industrial development has to be guided by its evolving comparative advantage—by its relative abundance of natural resources, skilled and unskilled labor, and capital for investment. Some proponents of activist measures have favored efforts to nurture a nascent comparative advantage by encouraging firms to risk more on a new market than they might otherwise have been willing to invest. Very few, however, would support wholesale leapfrogging: low-income countries, say, seeking to subsidize investments in highly technology-intensive activities. And there is broad agreement that high levels of protection to promote infant industries, without compensating pressures to encourage efficiency, can be fatal to a country’s chances of achieving sustainable industrial development.

Industrial policy in practice

The many and varied approaches to activist industrial policy can be grouped under three broad headings: investment coordination, network thickening, and picking winners. In both the first two approaches the government attempts to enhance market signals and private activity—although the institutional demands of investment coordination are much greater than those of network thickening. The third approach involves government seeking to supersede the market altogether.

INVESTMENT COORDINATION INITIATIVES. The classic, “big push” rationale for government activism was that investment in an underdeveloped country posed a huge collective action problem. With markets undeveloped, firms could not perceive the demand for more and better products that the very act of producing them would create. Thus, it was argued, countries could benefit from coordinating such investments, which are mutually beneficial to firms but which they are unlikely to undertake by themselves. Postwar Japan’s development of its steel, coal, machinery, and shipbuilding industries illustrates this rationale for intervention, as well as the stringent institutional prerequisites for success (Box 4.6):

- A domestic private sector capable of efficiently managing complex, large-scale projects
- A private sector willing to cooperate with government in pursuit of the shared goal of competitive industrial development
- Strong technical capabilities in public agencies for evaluating private analyses of investment options and, on occasion, generating independent industrial analyses
- Sufficient mutual credibility to enable each party to base its investment decisions on the other’s commit-

Box 4.6 Japan's postwar big push in metals industries

A coordinated restructuring of the machinery, steel, shipbuilding, and coal industries contributed greatly to Japan's economic recovery after World War II. Machinery companies identified the high cost of steel as a major impediment to penetrating export markets. Steel companies, in turn, identified the high cost of coal as a principal reason for high steel prices. High coal prices were a consequence of continued mining from expensive Japanese mines and the high cost of shipping imported coal to Japan.

Building on institutional arrangements nurtured during wartime, in 1949 Japan's Ministry of International Trade and Industry (MITI) put in place a joint public-private deliberative structure, the Council for Industrial Rationalization. Composed of representatives of industrial associations, leading enterprises from each industry, and public officials, the council included twenty-nine sectoral branches and two central branches. Three of the council's branches—iron and steel, coal, and coordination—worked closely together and agreed on the following commitments:

- The steel and coordination branches identified the price of coal that would make it possible to produce export steel competitively.

- The coal industry committed itself to invest 40 billion yen to rationalize production from domestic mines, provided the steel firms agreed to purchase coal from them afterward at the new prices, which would be 18 percent below prevailing levels.
- The steel and coal industries agreed on an overall target price that steel firms would pay for coal, to be achieved by mixing domestic purchases and imports.
- The steel industry committed itself to invest 42 billion yen to upgrade its facilities. With this investment, and lower coal prices, it would be able to export steel at competitive prices.
- In return for lower steel prices, the machinery and shipbuilding industries were in a position to embark on large, export-oriented investment programs. These commitments provided the domestic market that the steel industry needed to embark on its investment program, and confidence that the shipping cost of imported coal would decline.

Once the Japan Development Bank (after careful technical analysis, and in consultation with both MITI and the Bank of Japan) agreed to participate in these projects, providing financing at only moderately subsidized interest rates, Japan's largest banks took the lead in mobilizing the investment funds.

ments, and to adapt its actions in response to changing circumstances without undermining the overall commitment to collaborate.

Pursuing this style of investment coordination presupposes levels of public and private institutional capability that are beyond the reach of most developing countries. The Philippine experience of the late 1970s and 1980s shows what can happen when the ambitions of policy do not match up to institutional reality, and efforts to coordinate investment are pursued where government is swayed by powerful private interests.

Driven in part by the desire to create new business opportunities for domestic allies, in 1979 the Philippine government announced a new \$5 billion program of "major industrial projects," all in heavy, capital-intensive industries. Within a year of the announcement the government, responding to pressure from critics, agreed to subject the projects to another round of economic and financial scrutiny. Soon thereafter the political and finan-

cial turmoil surrounding the fall of President Ferdinand Marcos' regime intervened. By late 1987 five of the eleven initial projects, accounting for almost \$4 billion of the \$5 billion, had been shelved as infeasible. A sixth project had been abandoned because its lack of economic potential became apparent. A fertilizer plant, completed at a cost of \$550 million, was suffering losses that were being shouldered by government. Only four projects, accounting for just \$800 million, were operating profitably.

NETWORK-THICKENING INITIATIVES. Activist initiatives need not be large in scale—imposing commensurably large demands on public and private institutional capabilities—or solely devoted to increasing investment. They can also aim to strengthen the private-to-private networks that flourish in mature market systems. Domestic, regional, and international networks create numerous sources of learning and opportunity for firms: specialized buyers open up new market niches and offer information on product standards, equipment providers transfer technological know-how, input suppliers help with product and

process innovations, and competitors are a rich source of new ideas. Often, clusters of firms, buyers, equipment suppliers, input and service providers, industry associations, design centers, and other specialized cooperative organizations come together in the same geographic region.

Countries whose markets are underdeveloped may need some catalyst, public or private, to set this cumulative process of market thickening and network development in motion. There are three leading examples.

The first is special support for exports. Participating in export markets brings firms into contact with international best practice and fosters learning and productivity growth. It can also be a useful measure of the effectiveness of government efforts at industrial promotion. Many countries have directed credit in favor of exporters and set up export promotion organizations. With few exceptions, most of them in East Asia, these bodies became expensive white elephants. Other export support measures have also been tried, with mixed results. World Trade Organization rules may well rule out future experiments along these lines.

A second type of effort focuses on strengthening local infrastructure: physical, human, and institutional. The history of Korea's once-lagging Cholla region illustrates the impact local infrastructure can have. In 1983 this southern region opened its first large-scale industrial estate. Its success set in motion a cumulative process of learning by local authorities about how to plan, finance, build, and operate such estates—three more followed. It also helped catalyze a transformation of the business environment, from one bogged down by red tape and other bureaucratic obstacles to one of close cooperation and coordination between the local government and the private sector. By 1991 Cholla accounted for 15 percent of industrial land in Korea, up from 9 percent in 1978, and the rate of growth of regional manufacturing output was above the national average.

Third, and increasingly popular, are public-private partnerships, with the public partners drawn from either local or regional governments. These can take a variety of forms, including:

- *Initiatives directed at individual firms or groups of firms.* Sometimes these are focused events, such as joint participation in a trade fair. Others are aimed at achieving a broader shift in the business culture to favor increased cooperation. A promising approach involves giving matching grants to firms, typically on a 50-50 cost-sharing basis, to help penetrate new markets and upgrade technologies. Easy to implement, with management delegated to private contractors, and demand-driven, with participating firms paying for half of any initiative, such programs are now under way in coun-

tries as diverse as Argentina, India, Jamaica, Mauritius, Uganda, and Zimbabwe.

- *Using public procurement to foster competitive private sector development.* In Brazil's state of Ceará an innovative cost- and quality-driven procurement program worked through associations of small producers to transform the economy of the town of São João do Araru. Before the program the town had four sawmills with twelve employees. Five years later forty-two sawmills employed about 350 workers; nearly 1,000 of the town's 9,000 inhabitants were directly or indirectly employed in the woodworking industry; and 70 percent of output was going to the private sector.

SUPERSEDING MARKETS. Sometimes information and coordination problems are so severe—markets so underdeveloped, and private agents so lacking in resources and experience—that market-enhancing initiatives are unlikely to yield any response. As a way of kickstarting industrial growth, states have been tempted to supplant market judgments with information and judgments generated in the public sector. These efforts rarely work, although the success of some ventures by Korea's *chaebol* (interlinked business groups), made at the initiative of government, suggests that the quest to pick winners is not inevitably a fool's errand.

What distinguished Korea's success from others' failures was that these initiatives were channeled through the private sector, whereas most such efforts (including some in Korea) have been implemented by state enterprises. When state firms are used as implementing agencies, the opportunities for venality—or fanciful romanticism—are virtually limitless. A number of countries have subsidized money-losing state enterprises, to the severe detriment of fiscal performance. The generally sorry experience with investment in state enterprises has convincingly demonstrated that the production of tradable products is best left exclusively to private firms.

Walking the industrial policy tightrope

These experiences highlight why the debate over industrial policy has been unusually heated: industrial policy is combustible. Economic theory and evidence suggest that the possibility of successful, market-enhancing activism cannot be dismissed out of hand. But institutional theory and evidence suggest that, implemented badly, activist industrial policy can be a recipe for disaster. How, then, might countries proceed?

Taken together, the economic and institutional perspectives suggest drawing a sharp distinction between initiatives that require only a light touch from government (for example, some network-thickening initiatives) and initiatives that require high-intensity government support

(such as coordinating investment or picking winners). High-intensity initiatives should be approached cautiously, or not at all, unless countries have unusually strong institutional capability: strong administrative capability, commitment mechanisms that credibly restrain arbitrary government action, the ability to respond flexibly to surprises, a competitive business environment, and a track record of public-private partnership.

By contrast, light-touch initiatives (those that are inexpensive, and supportive rather than restrictive or command-oriented) offer more flexibility. The essential institutional attribute for success is an unambiguous commitment by government to public-private partnership. When this commitment exists, when countries do not overreach their institutional capabilities, and when the business environment is reasonably supportive of private sector development, the benefits of experimentation with light-touch initiatives can be large, and the cost of failure low.

Strategic options: Focusing on the workable

In the realm of liberalization and privatization, regulation, and industrial policy—indeed, in the full range of state actions probed in this Report—there is no one-size-fits-all formula. Privatization and liberalization are the appropriate priorities for countries whose governments have been overextended. Every country must also look to build and adapt its institutions, not dismantle them. This chapter has distinguished between institution-intensive and institution-light approaches to regulation and industrial policy, stressing how the choice of approaches might appropriately vary with a country's institutional capability.

Successful institution-intensive approaches generally share two characteristics. They require strong administrative capability. And they delegate substantial discretion for policy and implementation to a public agency, embedded in a broader system of checks and balances that prevents that discretion from degenerating into arbitrariness. If institutions are strong, these state actions can contribute to economic well-being. If they are not, the evidence and analysis of this chapter suggest that such actions are likely

to prove ineffective at best, and at worst a recipe for capture by powerful private interests or predation by powerful and self-interested politicians and bureaucrats.

How, then, should countries proceed if they lack the administrative and institutional wherewithal to make such approaches work? The long-run strategy, explored in Part Three, is to strengthen and build the requisite institutions. In the meantime this chapter has indicated two possible pathways toward reform. One is to focus on the essentials and take on a lighter agenda for state action. The second, which need not conflict with the first, is to experiment with tools for state action that are better aligned with the country's capability. Much remains to be learned, but this chapter has highlighted two strategies that appear to have great potential even where institutional capability is weak:

- Specify the content of policy in precise rules, and then lock in those rules using mechanisms that make it costly to reverse course: in utility regulation, for example, these might include take-or-pay contracts with independent power producers.
- Work in partnership with firms and citizens, and, where appropriate, shift the burden of implementation entirely outside government. In industrial policy this may mean fostering private-to-private collaboration rather than building a large industrial bureaucracy. In financial regulation it means giving bankers an incentive to operate prudently, rather than just building up supervisory capability. And in environmental regulation it means using information to encourage citizen initiatives, rather than promulgating unenforceable rules from the top down.

The policies that rely on these approaches may not be first-best policies in a textbook sense. But as state capability grows, countries can switch to more flexible tools, capable of squeezing out further efficiency gains. Throughout, states must maintain the confidence of firms and citizens that flexibility will not be accompanied by arbitrary behavior—else the foundation for development crumbles.