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**Civil Society and Improved Governance  
in Developing Countries**

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**Keynote Address**

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MR. FUKUYAMA: Thanks very much. I am really delighted to be asked to talk about a subject that is really central to my own interests and research concerns. I guess I will begin by telling you a story because it is actually perfect for the topic of this conference and for the panel that we had on civil society this morning. Toward the end of last week I got a visit from three gentlemen who worked for the finance ministry of the State of Buenos Aires, which is the province surrounding the capital that holds actually the majority of Argentina's population, and they actually work for the part of the finance ministry that is involved in tax collection, so it is the Argentine equivalent of the IRS.

As you may know, in Argentina the rate of tax extraction is extraordinarily low. Tax evasion is a kind of national pastime, and particularly, wealthy and powerful individuals often times get away with basically paying no taxes. These gentlemen came to me, they had read my book "State-Building" and they said we have actually tripled the rate of tax extraction in our province over the past 3 years which was quite a remarkable achievement. But beyond that, usually the tax collector or tax auditor is one of the most hated people in the society, but their experience was that actually when they would go places people would line up and start cheering them. In fact, an Argentine TV network had created a reality show based around tax collection where they would send cameras, and when the tax auditor finally caught up with some famous scofflaw that was not paying his taxes, they put him on TV and everybody would cheer that this guy was finally being made to pay their taxes.

It teaches a couple of lessons. First of all, that actually corruption and tax evasion on the part of the wealthy and powerful is every bit as much corruption as taking bribes by public officials, it has very bad distributional consequences, it is easier for the rich and powerful to do than the poor, and so there actually is a democratic interest in having good governance even if that means that you are going to be audited on your taxes more frequently, and it also makes the point about independent media being extremely critical to building this demand for good governance. So I like collecting these little stories where you have actually had improvements in public services.

The topic I want to address today is a slightly broader one than the topic of the conference, but it is really where the governance agenda in international development came from and where it is going. It has obviously become a very big concern to donors and to international financial institutions in both the Wolfensohn and Wolfowitz tenures, and the board is

actually meeting on that agenda today at the Bank. So I want to locate this issue intellectually, talk a little bit about its history, and then talk about some real concerns I have for the way that it is being pursued.

*How did we get to the issue of governance in international development?*

I think it is safe to say back 30 or 40 years ago in neoclassical economics; the discipline was largely institution-free. That is to say, the basic neoclassical models assumed perfect information and zero transaction costs, but it turns out that that actually was not very useful when applied to developing countries because developing countries are lacking not just in capital and resources, they are lacking precisely in information and they have extremely high transaction costs, so it is really Doug North who first began explicitly modeling transaction costs and institutions and trying to bring it within that neoclassical framework.

I think there has been so much academic discussion and research into the question of institutions that their importance and the role they play in development I believe has been fairly well established. There has been a lot of econometric work by Daron Acemoglu, James Robinson, Bill Easterly, Ross Levine, doing these large correlations between governance and various development outcomes and I think that they have proved to my satisfaction the centrality of certain kinds of institutions for economic growth.

The real debate has been over whether institutions are exogenous or endogenous to the growth process. This is using endogenous in a slightly different sense than Tom Heller was using it this morning. It is not that it is generated within the society, but the question is, does economic growth produce good institutions or do good institutions produce growth? Are they a necessary precondition? Obviously, the causality goes in both directions. The main proponent in recent years of the endogenous view of institutions has been Jeff Sachs who has argued explicitly in a way against the governance agenda saying that the institutions will rise of their own accord if only you get to a path of sustained growth.

Having looked in some detail at the economic arguments and the data back and forth, it does seem to me that this is a pretty hard argument to sustain, and you can just think of some examples of South Korea, for example, that began its rapid growth period I think with strong institutions, it was actually poorer than the Belgian Congo at the end of the Korean War, compared to a place like Nigeria that has had hundreds of billions in oil revenues over the past 30 to 40 years and yet has had deteriorating per capita GDP and actually deteriorating institutions. And if you ask how you get these very different outcomes, it cannot be because institutions are endogenous to the growth process; I think that there is a degree to which they have to be created through a political process that is independent of the process of growth.

That is where they came in theory. In practice, in many ways it was Hernando de Soto in the 1980s who first began pointing out the need for formal institutions. I am sure everyone in this room is familiar with his basic argument that if you do not have good formal institutions particularly in the area of property rights, it will drive economic activity into the informal sector that raises transaction costs and creates a number of other obstacles to development.

This agenda was being put forward at the time of the famous Washington Consensus, and so in a way the focus of the development policy community was on other kinds of issues. I do not want to rehearse the whole argument over the Washington Consensus. I believe it was actually quite appropriate for the set of Latin American problems that it was really designed to address, but I think it is true that in many respects by focusing on liberalizing economic policies, the Washington Consensus in a way took for granted the existence of strong institutions and I think as we discovered in the 1990s, if you do certain kinds of liberalization, if you liberalize your capital account prematurely in the absence of strong bank regulation, for example, or if you privatize without having the adequate state capacity to carry out a clear and fair auction and protect minority shareholder rights and the like, then you could actually end up worse off than you would have been had you not liberalized in that sense at all.

And I think furthermore in the 1990s the development policy community also had to deal with certain extremely severe governance problems in the form of failed states, the Balkans, Kosovo, Afghanistan, Liberia, Sierra Leone, Timor-Leste, all of which had collapsed governments in which in Timor-Leste's case, UNTAET actually provided a government for this newly independent country lock, stock, and barrel, so it was being thrown directly from the frying pan into the fire. So now we have now got this big governance agenda, there have been big changes not just under the current president, but under the preceding one, to put public-sector reform and governance at the core of what the Bank does to the point that I believe now up to about 50 percent of all new Bank lending is public-sector reform related. This has been parallel to changes in other development agencies, at DFID, at USAID and other bilateral donors. USAID has a big democracy and governance branch that provides by far the bulk of assistance for politically related development programs. The Millennium Challenge Corporation includes governance criteria in its awarding of compacts and the like.

I am reasonably confident based both on the theory and the actual practice of development that the governance problem is really at the core, and that if you could solve these governance problems in states that have weak governance or highly-corrupt governments or governments that are simply not interested in developmental objectives, then you would solve a great deal of the development problems such that inputs of resources would then have a much more linear relationship to good development outcomes. If you just think of something like the Millennium Development Goals that were mentioned in the session this morning, if countries were actually to meet this .7 percent target, developed countries in terms of resources made available for development, it would amount in a certain way to something like a natural resource boom because there would be this big influx of money to solve various public health and other kinds of problems. And if you do not have the right governance mechanisms in order to manage that flow of expenditures and to actually set up the public health systems and to make sure that the resources reach the poor people at which they are targeted, you in a way could end up worse off than previously once that money goes away. One thing we know from the history of development is that these fads do not last forever. So fixing the governance problem is pretty important.

With regard to that, I think that there is both good news and bad news, that there actually has been a fair amount of improvement in many aspects of governance in various parts of the developing world over the past 20 to 30 years. I think this is particularly true in Latin America, and I just ask you to consider the difference now.

Latin America has been exposed to external shocks; some of them are good as we heard this morning, higher copper prices and so forth, but also higher energy prices which have led to current account problems and so forth. We have seen this problem before. This was really the origin of the debt crises. The oil shocks or the energy shocks that occurred in the 1970s laid the ground for the fiscal mismanagement that was then monetized that then led to the defaults on sovereign debt that occurred in the early-1980s in Mexico and Brazil and other places. If you compare the management of macroeconomic policy, central banks, finance ministries and the like between then and now, there is absolutely no comparison. Part of it is political. There is also a greater political consensus even on the part of left-of-center leaders in the region in favor of greater fiscal responsibility, but there is an enormously greater degree of actual capacity to manage budgets, to track expenditures and the like.

And there are other areas where I think governance reform has paid off. There have been very interesting experiments with decentralization in countries like Colombia and Brazil and the like, and I think in some respects you can see the glass is either half-empty or half-full. Bolivia, for example, is frequently spoken of as a country with a high degree of social exclusion, but if you actually look at the statistics for the percentage of the Bolivian population that is attending primary school, the percentage of the Bolivian population that votes in elections, it has been rising very steadily over the past three or four decades. In fact, Evo Morales could not have gotten elected if the latter were not true.

The real problem, however, is that the quality of those state services, those public services, that are provided is so bad that the legitimacy of the state as a whole was severely compromised and I think many of the problems in the Andes, in Venezuela, and in other countries were very much related to the inability of states to deliver on basic public goods the way governments are supposed to do that.

One other, I think, piece of good news is that we also have better information about governance. The World Bank has been developing its Global Governance Indicators; there are other data series that measure different aspects of the political and institutional side of development. Of course, there are problems with all of these measures, various technical problems, because essentially you are trying to put numbers to something like judicial reform that is inherently I think a qualitative kind of phenomenon, but some numbers are better than no numbers at all, and it is possible to do certain kinds of benchmarking in this area that simply was not possible earlier.

On the other hand, I think if we get over into the bad news side, it is pretty clear that despite the policy emphasis on good governance and the amount of intellectual energy and resources that have been devoted to it, a lot of the results have been very disappointing in many areas. I tried to lay out in my book "State-Building" a conceptual framework to try and understand why it was easier to reform certain parts of the public sector rather than others. So there is a certain category of activities that what I call high specificity. That is to say, you can measure quite easily the effectiveness of the government, and also low institution volume, a central bank is a premier case of this, and I argued that it was much easier to air drop a bunch of Ph.D. economists to fix that kind of an institution than it is a high-transaction volume, low-specificity type of public-sector like a legal system or primary development or a countrywide public health system. That is why all of the reforms and the important gains that we have seen in governance have tended to focus on those kinds of more technical activities that can

be done usually in the national capital without having to be spread out over the entire country, and the real challenge for the second- and third-generation reforms is tackling institutions that fall into that high-transaction volume, low-specificity basket.

Again, I think if you look at various initiatives that have been undertaken, comprehensive civil service reform, a lot of things connected with the HIPC initiative to help fix financial management, fiscal management in very low-income countries, and if you read the Bank's own analysis of how well they have done in this area, it is pretty disappointing. A lot of countries have really made very, very little progress.

Then the question is why is it that governance reform is so hard to do, or why have these results been so disappointing? I would say that there are basically three categories of reasons why institutions are hard for outside donors to reform or transfer or build in client countries. The first has to do with the degree of fit that exists between an institution and the underlying society. Note I think it is the degree of fit in which there has to be a process of mutual adjustment between the society and the institutions. I think that a lot of donors have a kind of idealized view of what their own institutions are like that is based on some version of a rational, bureaucratic state in which all public officials operate for the public good in which they regard -- and unfortunately, there are very few countries including developed ones that really work that way, and there is much more design latitude in the way that institutions are actually formulated and implemented in different countries than I think we often are willing to admit. I will just give you two examples.

The township and village enterprises in China that was the backbone of China's move toward a more market-based economy is all based on local regional Chinese government and it is an institution that absolutely nobody in Washington would ever have thought of as being adequate to see China over this transition, but the Chinese were very pragmatic and when they worked they went with them, and when they did not, they stopped doing them, and they came up with this particular institutional form.

Another example from East Asia would be rule of law in Japan. Japan is a very strong rule-of-law country, but they have something on the order of one-tenth the number of lawyers per capita that the United States does, and this is a result of deliberate design on their part. They wanted to avoid the kind of litigation costs of the American tort system and so they pushed a lot of things that get put into our tort system into a subsidiary set of arbitration institutions. They essentially get to the same outcome but in a form that looks very, very different. Of course, there are civil lawsuits rather than the common-law system, so you have differences from the get-go, but their legal system really looks quite different from ours. So I think that the adaptation that has to take place, it is not just that developing countries have to change their social practices and get with the game of the way we do it in developed countries, I think that the institutions really have to be adjusted to take account of the underlying social realities as they do in developed democracies already. So that is the first reasons that institutions are hard to transfer.

The second really has to do with problems of ownership and transmission mechanisms. I think actually more people agreed with this point than perhaps was evident, but ultimately institutional reform does not take place unless there is strong domestic demand for it either from the bottom up in terms of civil society or sometimes as in East Asia you get elite-

driven demand for reform, you get the right minister in Uganda or somewhere else that has an agenda and wants to push it forward and has the power and opportunity to do it, and that is how this institutional reform happens. So in countries where you do not have this domestic demand, donors are always scratching their heads trying to say to themselves how do we generate demand for reform where it does not exist? So this is what gets you into conditionality in lending so maybe you can strong-arm them into wanting things that they otherwise would not want. I think the subject of the conference is another version of that where you are trying to promote bottom-up demand for good governance for all of the reasons that I think are quite evident in that Argentine example, that if you have media attention and public pressure on state officials, that will create opportunities for reform from the inside.

I guess one thing that I would note about this process is that in a way, the people who have traditionally done economic development are discovering civil society and this whole issue of demand for reform, and they discovered it in the last 5 to 10 years. It's quite interesting because there is another part of the policy community that has been doing this for the last couple of generations. The whole industry in this town and overseas that is devoted to democracy promotion has focused on civil society promotion, promotion of independent media, monitoring by citizens' groups, anticorruption campaigns based in the business community, all of this sort of thing. The attitudes that exist on one side of the fence are actually quite different than on the other because I think people who have been involved in democracy promotion and this I know because I have been on the board of the National Endowment for Democracy for the past 6 years now and I think in economic development, a lot of people who work in donor agencies regard what they do as a form of engineering, that they are going to put in these inputs and they are going to change things and it is going to have a direct relationship to the outputs.

I think in the democracy policy business it is regarded more as a species of gardening or maybe kind of throwing seeds in a big forest and hoping that some of them will come up because I think there is a realization that as far as political reform is concerned or the political demand for reform, you simply cannot snap your fingers and have that emerge. There is no real direct relationship between the kinds of investments you make in civil society and their ultimate emergence. Nobody would have predicted the Orange Revolution occurring in Ukraine at the end of 2004 the way it did, but there had been a very patient investment in open media or free media in civil society groups, in election monitoring, and all of the other things that made the Orange Revolution possible for the 15 years prior to it actually happening. So there is an effort and some success in addressing that, but I think the truth of the matter is that it does not work on donor timetables and if you expect it to work on a shorter timetable in this area you are going to be very, very disappointed. The final reason that institutions are hard to transfer has to do with politics. Most deep institutional dysfunctions are not technical matters; they are embedded in the political system. If a bureaucracy is prone to corruption or patronage it is because some powerful politician finds it in his or her interest to have things that way.

Therefore, if you treat public-sector reform as a kind of technical issue, you will never get anywhere because you will not address the underlying political incentives, and again this is a point that was made this morning, but you will never get at the underlying political incentives that keep things the way they are. That is a real problem I think for an institution

like the World Bank since its articles of agreement explicitly prohibit it from getting into this political arena. That is the reason why the Bank has come up with this very clever nomenclature to hide what it is really doing, so instead of talking about freedom of the press it talks about transparency, and instead of talking about democracy it talks about participation and accountability. They are different words, but they actually mean the same thing, and it indicates the kinds of political constraints that exist on that institution for moving too rapidly into this area. Even organizations like NDI or the Soros Foundation, IFIS, that are in the business of promoting political change I think have relatively modest expectations asking what can be accomplished within a given timeframe because in many ways you have to behave much more opportunistically.

So this brings me to the end. The future of this governance agenda, what do we do about this now? The first thing I would do is be extremely careful about overpromising from this agenda. It really worries me that so much of the World Bank's lending is public-sector reform related. If you lend Jamaica or Barbados \$50 million to do judicial reform, you are making a couple of assumptions. First of all, if they do judicial reform, it will actually lead to increases in economic efficiency that will ultimately increase that country's growth rate that will allow in public finance terms the repaying of that loan. Secondly, you are betting that whatever institution is overseeing the reform actually knows how to get judicial reform, and I do not think that either of those points are proven.

Therefore, it seems to me that the donor community in a certain way, although it has identified a very important problem that would be very critical if you could solve it, is proceeding as if it knew how to solve these problems in a way that I think is setting up grounds for a great deal of disappointment down the road and I can foresee a point a few years from now when there is actually going to be a fair amount of backlash against this entire governance agenda because people are going to say we spent all of this money, we have saddled all of these countries with a lot of debt, and there has not been any movement whatsoever in any of the indicators and very little evidence that any of these countries have made a big breakthrough toward governance. So we have to be careful, it is an important agenda to stick with, but I think it needs to be approached rather cautiously.

The second point is that in terms of institutional reform, not only does the impetus not come primarily from Washington, knowledge about how to do them ultimately cannot come from Washington, it really has to come from people who understand both the formal and informal rules by which their societies work and are governed. Therefore, the locus of research and work on this area has to be done by social scientists, journalists, and other people in developing countries themselves. There have been a number of efforts to promote this sort of thing like the Global Development Network that has been supported by the World Bank, but we need much, much more of that.

The third conclusion I could come to is that the political and the economic sides of development really need to be much better integrated both conceptually in terms of strategies, and in the field in terms of the coordination of groups that work on either the political or the economic side of development. Conceptually, every project needs to be preceded by a clear political economy analysis that identifies the political obstacles and the kinds of strategies that are necessary to overcome the political obstacles to development, and I think it is perfectly legitimate that if the analysis says there is nothing you can do about it

because it is the guy at the top who is the source of the problem to just walk away from it and say, sorry, we cannot do anything this year because the political conditions are not right. In the field, as I was saying, I think there is such a divide between the democracy-promotion community or I would call them the political-development community and the economic-development community, the multilateral banks and the bilateral donors, and they really do not need to reinvent the wheel. For example, it is not clear to me what comparative advantage the World Bank brings to civil society promotion that other kinds of groups that are out there already possess, and I think what you need is a more careful division of labor and a better assessment. Just in terms of conferences, people who go to conferences on the political side in this very city, do not go to conferences on the economic, and so they simply do not know what one or the other is doing and so that needs to be better integrated.

The final thing I would say is this is not the silver bullet and once we solve this it is going to fix the problem of development. It is really, really tough. In a certain way when you look at the difficulties of doing governance reform, you are sometimes tempted to say, let's just go back to building dams and electrifying the countryside because at least we can do that. But of course you have to remember the reason that we stopped building dams and doing big electrification projects is that someone has to manage those systems over the long-run, everything has a governance component, and if you do not make headway on that, all of those other things will not follow.

Thank you very much for your attention.