INSTITUTIONAL DEVELOPMENT

AND PUBLIC ADMINISTRATION REFORM:

ISSUES IN REFORM

Edilberto Segura

1. This note provides a framework for work on Institutional Development (ID) in the context of economic reforms in developing countries (DCs). The first section makes a distinction between Policy Reform and Institutional Development. The second section proposes an operational definition of ID. Section three discusses the broad scope of institutional development activities. The final sections suggest country strategies for ID, including priority areas, and training aspects.

Background and Definition

Policy Reform

2. During the last decade, economic policy reforms in many DCs concentrated on: (i) achieving macroeconomic stability; (ii) opening international trade; (iii) achieving domestic deregulation and liberalization; and (iv) providing adequate regulatory and legal frameworks. These policy reforms aim at providing the private sector with an **enabling environment** within which greater efficiency will be encouraged by a market-oriented system that enhances incentives under increased competition. In fact, a free competitive market works with an invisible hand, with its own checks and balances. That is, it works by combining an incentive mechanism (free prices and trade to seek profits) with a control mechanism (competition). On the one hand, the invisible hand holds rewards. On the other hand, it holds a control mechanism with penalties. This control mechanism is the big maze of competition -- those that are not improving efficiency and seeking continuous improvements to satisfy their clients, will be thrown away from the market through bankruptcy. Although a lot of efforts have been devoted to develop this enabling environment for the private sector, very little work has been done to develop an equivalent enabling environment for the public sector.

3. The Multilateral Agencies have played an important role in the design and enactment of the major economic policy reforms that many DCs have implemented during the last decade. They played key roles in disseminating best policy practices across countries, which was instrumental in the achievement of a consensus about the type of policy reforms most appropriate for achieving stability and growth.

4. The design and enactment of these economic reform measures have required substantial political commitment. However, in most countries, these initial tasks could be carried out by a limited number of capable and dedicated government staff, acting as a small, cohesive team. This was the case, for example, in Argentina and Peru, where the policy reforms were conceived and approved thanks to the efforts of a handful of senior Government officials.

Institutional Capacity

5. In contrast with the few staff required for the design and enactment of policy reforms, the implementation and sustainability of these policy reforms over time require much larger and continuous Government management and administrative capacity. This capacity, however, has seriously eroded in many DCs during the 1980's and 1990's. In fact, for many countries, the legacy of these decades was not only weak economies but also considerably weaker government institutions. Macroeconomic mismanagement and the subsequent need to correct fiscal imbalances fostered low government salaries at all levels for public servants, which in turn led to high staff turnover. As a result, many governments now lack an adequate number of skilled, managerially talented people in their ministries and agencies; instead, they typically have an overabundance of personnel who lack qualifications to carry out their public responsibilities effectively. In addition, austere fiscal conditions constrained not only recurrent costs but also capital investments to upgrade public institutions, so that some agencies lack resources to carry out their programs. Poorly staffed and underfunded, many government institutions have not been able to appropriately define and carry out their objectives. Some are no longer relevant but continue to exist. Economic mismanagement and poor staffing have led to cynicism in many Government institutions. Many continue to operate in a "black box," and privacy and confidentiality considerations have served to encourage inefficiency and corruption.

6. In addition to the weakening of the institutions themselves, the appropriate and desirable role of government institutions has changed significantly during the last decade, with the shift towards more market-oriented development strategies. These new strategies may imply a re-orientation of many public agencies from a focus on rigid and detailed control to that of monitoring and support. These changes suggest the elimination of some institutions in the public sector and the establishment of private ones, and the restructuring of others to operate in liberalized and more competitive environments.

7. Given the inadequacy of current government institutions in many developing countries, there is the risk that their economic policy reforms will be undermined over time. In fact, many DCs may be taking the risk of policy reversals. Institutional development is a key element to consolidate and ensure the sound implementation and sustainability of policy reforms over time.

Defining Institutional Development Work

8. What should be the span of Institutional Development work? How do we define it? In practice, institutional development is a term with meanings that vary widely as used by different people in different contexts:

- At one extreme, a narrow definition equates institutional development with the process of strengthening individual government organizations or entities.

- At the other extreme, a broader view defines institutional development to include improvements in both public and private organizations as well as in the rules, regulations, practices, values, and customs that shape and influence an entire society.

9. The development of institutions in the broader view is obviously extremely important to economic development over the long term, with many of the conditions for its development involving the private sector and NGOs. Some conditions go beyond the range of issues that Governments can effectively deal with. Development of institutions in the narrow sense, on the other hand, would include only the process of creating and strengthening individual government organizations by providing them with appropriate roles, legal structures, organization, staffing, finance, and the like.

10. Multilateral Agencies have traditionally pursued ID in the narrow sense in virtually every project. While this practice was necessary it has also proven insufficient to achieve sustainable results. Typically, attempts to strengthen institutions in a given sector in connection with a project either fail in the short run, because of factors such as civil service pay scales that go beyond the particular sector, or they fail in the long run when the ad hoc arrangements created to assure implementation of the project expire. When a strong government institution is created, it is often at the expense of other weaker ones. For example, creating a strong "Project Unit" to overcome the inefficiency or corruption of line and regulatory agencies may enable it to get its job done. But it will also get in the way of attempts to strengthen the regular line and regulatory agencies.

11. A more sustainable definition of "Institutional Development" would be one which includes not only the process of strengthening individual government organizations but also the more systemic efforts needed to create an improved institutional environment for the public sector. The goal would be the creation of an **enabling institutional environment** under which the incentives and the controls influence positively the behavior of individual government organizations. Taken together, these two elements of ID should improve the way the Government works within a defined policy framework. ID is therefore concerned with "Government Reform", as opposed to "Policy Reform".

A More Selective Focus on Institutional Development

12. An alternative route to ID that has gained some support is to link ID to policy reform. Under this policy-linked approach, after identifying the critical policy reforms undertaken in a country, ID work would concentrate on tightly-focused institutional strengthening needed to support only that particular set of policy reforms. For example, the Bank and the Government might agree that the two most urgent policy reforms on the immediate horizon are achieving fiscal balance and improving foreign exchange management. We would then attempt to identify for each of these policies the key components, functions, or actions needed to ensure that the policies are soundly implemented and ultimately sustainable. The next step would be to identify the specific offices or units within government agencies that are likely to become bottlenecks or weak links. ID efforts would then be focussed on these specific offices and units.

13. A major advantage of this approach is that it permits a strong concentration of

resources on the targeted offices and units and on ID efforts needed to support critical policy initiatives. The major disadvantages are those of traditional project-related ID: it tends to create "islands" of efficiency that may not be sustained in the long term, ignores the benefits of making systemic improvements (the enabling institutional environment), and tends to create precedents for special treatment that cannot be extended more generally to other areas.

Scope of Work in Institutional Development

14. **A Vision for ID.** Ultimately, institutional development work should improve the way a government works. More specifically, ID should try to achieve a vision of a government that is leaner in terms of the number of staff, better equipped in terms of the motivation, quality and productivity of staff, with a role concentrated only on those activities that warrant government involvement, and more effective and efficient in delivering essential services and carrying out the basic functions of government. It should improve the Government's ability to operate on a day-to-day basis, to innovate, to address changing conditions, and to deal with unexpected outcomes without external assistance.

15. To achieve its objectives, the proposed work on ID includes two elements: (i) the enabling institutional environment for the public sector, and (ii) organizational strengthening. The scope of ID work under these two elements is further elaborated below.

(1) The Enabling Institutional Environment

16. This category of ID is aimed at improving the institutional environment within which public organizations work. It refers to improving “hygienic” factors, such as the incentive system, information needed for accountability, and the normative and legal framework that influence the behavior of individual government organizations. In fact, in the same fashion in which macroeconomic policy provides a consistent framework for the private sector, this category of horizontal, cross-sectoral ID actions provides the macroinstitutional framework to ensure the appropriate development of the public sector. The principal actions on the Enabling Institutional Environment agenda are as follows.

(a) **Improving Incentive Systems.** One of the major concerns of DCs is to restore incentives for good performance. An adequate incentive system is required to attract talented people to key posts, to retain them and to encourage their behavior towards efficiency in optimizing institutional objectives. This requires taking the incentive problem as seriously in the public sector as we do in the private sector. Adequate compensation linked to performance is a main ingredient of the incentive system. Salaries should be set at appropriate levels -- initially at least for key personnel. This would help to reduce undue compression of the ratio between top and bottom grade salaries in most governments. The merits of a Senior Executive Corps, modeled after the US Government's SES, should be considered as a short term solution; under this approach in return for higher salaries, job security is given up.

To motivate performance, a key measure is to link a substantial part of the compensation (about 20%-30% for most staff) to the achievement of measurable objectives. This will require defining, measuring, and monitoring performance indicators.
Other elements of the incentive system include ensuring un-biased and professional standards and processes for staff recruitment, selection, and promotions as well as developing appropriate incentives to minimize staff turnover.
Non-monetary incentives should also be enhanced; in particular, the perceived stature and professionalism of Government employment should be strengthened by involving employees in setting objectives and work programs, and by providing them with sufficient autonomy and accountability to produce the expected outcomes. Greater autonomy should be accompanied by increased flexibility to the managers of the agencies in doing their job (for example, by permitting them to contract out services to achieve greater cost-effectiveness). Hopefully, with better incentives, the LAC Region may be able to complement ongoing repatriations of capital with repatriation of minds, by persuading qualified Latin Americans living abroad to return to work to their countries.

(b) **Improving Control Mechanisms.**

First, the control mechanism involves a set of laws and regulations to affect the “competitive” environment for public agencies, their behavior, and the way of conducting business. Greater competition can be achieved, for example, by permitting open enrollment in schools or health clinics; or by establishing more than one Government agency providing a service in competition among them. These laws and regulations are normally embodied in public sector laws, public procurement laws, auditing laws, external and internal control laws, national budget laws and civil service laws.

Second, the control mechanism should include measures to improve information for accountability. Public institutions normally are not subject to the test of the marketplace to evaluate performance and ensure accountability. In the absence of a market test, transparency and openness of information and public processes are the best ways to ensure accountability for performance. In fact, they act as market surrogates. Therefore, open and transparent processes should be developed to define agency performance, outputs and costs, and to measure, monitor and publish them widely. Agency management would be held accountable through "open files" involving the publication and monitoring of such information. Lack of performance should be meaningfully penalized, including dismissal of those responsible.
Use of other competition surrogates -- particularly "voice" (the active participation of clients, users and beneficiaries in agency's activities) and market contestability should be encouraged. Emphasis should also be given to enhanced accounting and auditing processes in the public sector through changes in laws and procedures.
Improving information transparency and openness will also be an important weapon to combat corruption, which is a major cause of distortions in public

sector behavior.
Information disclosure should also aim at building popular support -- among businesses, unions, students, the press, the civil service -- for policy reform and for the role of the Government.

(2) **Organizational Strengthening**

17. The aim of this second component of ID is to strengthen the management and operations of public sector agencies and public enterprises. It should be noted however that without taking actions to create an enabling institutional environment, the actions at the organizational level will not be sustainable. The elements of the enabling environment discussed above need to be brought to the individual agencies.

18. Organizational strengthening involves: (a) improving the overall government structure; (b) improving the management and operations of government agencies; and (c) improving the management and operations of public enterprises. Important organizational development activities under these three categories are discussed below.

(A) **Improving the Structure of Government**

19. Experience has shown that public sector performance is enhanced by removing redundancies through leaner governments. This involves rationalizing the *role and size* of the public sector and decentralizing responsibilities to local governments, which are closer to the beneficiaries. Privatization, the sub-contracting of activities, and/or the closure/decentralization of some government agencies will help to reorient the role of the state towards "public goods". This will require elaborating a new definition of "public goods" consistent with post-adjustment economic systems, under which the private sector is entrusted with a more comprehensive set of commercial activities. Rationalization of the public sector will also involve the merger of agencies to eliminate overlapping functions as well as measures to improve coordination among them.

20. Government rationalization would also involve "downsizing". The reduction of over-sized government agencies by separating excessive staff is a politically difficult but necessary step. Progress in some countries has been achieved by carrying out a civil service census and functional reviews -- matching tasks and objectives with staff necessary to meet them. These actions are intended to eliminate "ghost" employees and vacant positions, freeze recruitment, retrench temporary workers, establish automatic and voluntary retirement programs for some staff, and finally by straight-forward dismissal. These staff reduction measures tend to be costly: a Bank study showed that severance packages are the single most important factor in implementing staff reduction programs. However, if properly done, over the long term they should yield considerable benefits from a cost and efficiency standpoint. A second important element of downsizing is the reduction of over-extended government programs. For example, the reduction of public social security systems can be key in many countries.

(B) **Improving Management and Operation of Government Agencies**

21. Within individual agencies, the main ID task is to strengthen them so that they

can effectively and efficiently achieve organizational outcomes. It is proposed that work with individual agencies be concentrated on those that: (a) play a pivotal role in policy analysis and formulation or (b) generate, allocate or utilize resources. ID work would include:

(a) An open, transparent, and specific definition of institutional goals, objectives and methods. This will require establishing expectations and procedures for public agencies to openly and transparently define in a precise manner their institutional objectives, delivery mechanisms, methods and work programs. In many cases, specific undertakings such as "Contract Plans", "Performance Agreements", or "Consumer Bill of Rights" will be important to establishing and limiting agency objectives.

(b) Based on the overall incentive framework for the public sector, improve the quality of management and staffing of individual agencies: implement appropriate salaries and incentives to change behavior towards efficiency, with clear transparency, accountability and performance criteria; define staff recruitment and selection criteria and procedures; facilitate the provision of training; and develop schemes to minimize staff turnover.

(c) To provide Government agencies with sufficient managerial responsibility and autonomy, many of them should be incorporated under laws that permit them to operate without political interferences. This will be key to provide staff with a solid administrative career, since it will allow for specification of recruitment, training, separation policies, etc.

(d) Improving Training. In addition to incentives, agencies will require new skills before results are achieved. In addition to new staff, training of existing personnel can be crucial to improve the quality of civil service personnel. Agencies need to identify skill gaps, provide training opportunities comparable to the private sector, and evaluate the results. Training should be results-oriented and targeted to improve individual skill deficiencies and better match an agency's employee skills to emerging technologies.

(e) Improve information for internal management, including the quality of planning, operational and monitoring systems, information and decision-support systems and other management support processes. Where appropriate, transfer state-of-the-art information technology to these institutions.

(e) Since in most developing countries, fiscal budgets will remain constrained for the foreseeable future, a key to the financial health of many government agencies will be their ability to generate its own sources of revenues. Governments should consider providing some of its agencies with the capability to raise its own resources, through user fees, tolls, tariffs, etc. The legal framework should permit the setting of these prices in an autonomous way, with full cost recovery. This has been the case in the most successful public utilities; but it could also be applied to other government services such as roads, education, health, etc, provided that the impact on the poor is not neglected.

22. Government agencies that may require ID work can be found at three basic levels of Government: (i) central core agencies, (ii) sectoral agencies, and (iii) decentralized sub-national agencies, as noted below.

(i) **Central core agencies.** These include core agencies such as the Ministry of Finance. In these agencies, the ID work should be carried out by reviewing and strengthening the generic functions carried out by these core agencies, principally relating to resource mobilization and allocation, such as: (i) management of revenues, including tax and customs administration; (ii) management of public expenditure levels, composition and quality, including improvements in financial planning and budgeting; (iii) management of macroeconomic policy analysis and formulation.

(ii) **Sectoral agencies.** This includes key Sectoral Ministries and Agencies that expend resources for sector activities, such as education, health, roads, power, water. This is a key area, given the need to reconstruct the physical infrastructure of most LAC countries and alleviate chronic poverty. This is also the area where the Bank has extensive experience, since it is traditionally the focus of project and sector investment work.

(iii) **Decentralized sub-national agencies.** In many countries and sectors, decentralization of government services and resources to sub-national levels of government is a key element in restructuring the public sector. Usually the objective is to bring decision-makers into closer contact with problems and intended beneficiaries (improving information and shortening the political feedback loop), or to increase opportunities for local initiatives, or to reduce internal communication and decision-making costs (reducing the time and money costs of consultations and approvals from the center). Cost recovery will be enhanced by decentralization of government services to the lowest levels that are economically feasible. When the services are managed closest to the users, they will be more inclined to pay for the services. This is the case for most basic services, such as water, sanitation, education, health, etc. In fact, decentralization of public services, especially social services, is rapidly becoming a major goal of many countries in the Region. However, decentralization is one of the institutional reforms that may have the highest potential for failure and distortion, principally through conflicts among levels of responsibility, authority, and control. Moreover, wholesale decentralization is usually ill-advised since -- lacking adequate incentives and resources -- it may lead to even greater inefficiency. The Bank should try to ensure that decentralization initiatives are carefully carried out, considering not only the transfer of authority and responsibilities, but also the mechanisms to provide adequate technical assistance, management and financing to enable local agencies to assume effectively their new responsibilities.

(C) **Improving Management and Operations of Public Enterprises**.

23. Public enterprises that cannot be privatized in the near or medium term will require ID work different from that applied to government agencies. This type of ID work includes:

(a) **Development of a competitive or transparently-regulated environment**. The steps to be taken here are largely in the area of policy reform (e.g., price liberalization, transparency of regulation, labor and other factor market liberalization, freedom of entry and exit), but they need to be complemented by ID activities such as converting public enterprises to independent, limited-liability companies.

(b) **Management Autonomy and Accountability**. This will mean shifting Government oversight of public enterprises from ex-ante control to ex-post assessment of performance based on previously agreed criteria. The complementary roles of the Government, the board of directors and management will have to be defined along their respective responsibilities as shareholders, policy-makers and operators. Performance agreements should be established with substantial incentives linked to results. Management information systems should be upgraded to permit assessment of performance.

(c) **Financial Autonomy and Accountability**. To ensure financial accountability, state enterprises must be subjected to "hard budgets". Fiscal subsidies must be eliminated. With improved financial planning, state enterprises should be allowed to raise resources on a commercial basis, without government guarantees.

Country Strategy and Priority Focus

24. Institutional development concerns the reform of the Government and therefore has many political implications. Therefore, ID work can only be successful if there is strong Government commitment from the highest levels of Government. Securing this commitment should be the first step to get successfully involved in a more comprehensive approach to ID.

25. Furthermore, ID work needs to be elevated above individual project/sector work for many of the same reasons that we have been changing to a country-wide portfolio approach in our supervision work: many problems are inter-related and cross-sectoral, solutions are often most workable at the national level, and the range of tools available to us in dealing with a borrower is greatest at the country's portfolio level. It is also at the country level that we are most likely to consider, say, reforming civil service pay scales overall rather than making specific arrangements for working around them in agency after agency.

26. Local country conditions will determine the best approach, sequencing and priorities to achieve institutional development. Therefore, it seems that the first step in many countries should be to carry out a broad analysis of institutional issues and weaknesses. In fact, under the Bank's Institutional Development Fund, it is proposed that reviews be carried out to assist Governments to identify, diagnose and address institutional constraints. This work will be carried out with substantial involvement of

local consultants and possibly with the involvement of IDB and UNDP. The work would include:

(a) identification of the main constraints to institutional development, including generic institutional weaknesses, major bottlenecks, the quality of institutional resources, etc.

(b) prioritization of issues to be addressed, with emphasis given to systemic issues that command broad-based support in the country.

(c) determining where action should be focussed and agreeing on a Plan of Action for ID. In the plan of action, innovative approaches should be encouraged. It should also include the development of tracer and monitoring schemes to facilitate learning from the reform experience.

Human Resources and Institutional Development

27. Over the longer term, the most important determinant of a country's level of institutional development is the adequacy of its Human Resources, such as education and health, and the health of its incentive system. As is true in many developed countries, the wide availability of capable and well trained citizens, coupled with reasonable salaries and other incentives in the public sector, should attract and hold a cadre of talented professionals who are prepared to work effectively for the Government. Although it may take years for developing countries to achieve this, ongoing efforts in HR sector will be the key over the longer term to achieve solid institutional development.