

*The Mahbub ul Haq Memorial Lecture*

## **Governing for Results in a Globalised and Localised World**

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This paper addresses three complementary themes in bringing about responsive and accountable public governance in developing countries—namely globalisation, localisation and a results oriented management and evaluation (ROME). The first theme recognises interdependencies in an interconnected world and discusses how these influences would shape partnership within and across nations. The second theme is concerned with public sector realignments within nations to meet the challenges associated with heightened expectations from an informed citizenry. The third theme relates to creating a new culture of public governance that is responsive and accountable to citizens. The paper argues that a road to ROME holds significant promise of overcoming the ills of a dysfunctional, command and control, overbearing and rent seeking public sector in many developing countries. ROME de-emphasises traditional input controls and instead is concerned with creating an authorising environment in which the public officials are given the flexibility to manage for results but are held accountable for delivering public services consistent with citizen preferences. Further under ROME incentive mechanisms induce public and non-public (private and non-government) sectors to compete in the delivery of public services and match public services with citizen preferences at lower tax cost to society per unit of output.

### **1. INTRODUCTION**

“Government is the coldest of all cold monsters—whatever it says it lies—and whatever it has—it has stolen”. — *F. Nietzsche*

This paper is written as a tribute to the distinguished career of Dr Mahbub-ul Haq. Dr Haq’s ideas steered international development community away from a focus on lending volumes and towards concerns for results on the ground in human and institutional development. This paper provides practical guidance on furthering the governance reform agenda articulated by Dr Haq.

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localisation and a results oriented management and evaluation (ROME). The first theme recognises interdependencies in an interconnected world and discusses how these influences should shape partnerships within and across nations. The second theme is concerned with public sector realignments within nations to meet the challenges associated with heightened expectations from an informed citizenry. The third theme relates to creating a new culture of governance that is responsive and accountable to citizens.

Globalisation, information revolution and localisation are exercising profound influences on economic governance in both the industrialised and the industrialising world. With globalisation, it is increasingly apparent that “nation states are too small to tackle large things in life and too large to address small things”. More simply, nation states are fast losing control of some of their areas of traditional control and regulation such as regulation of external trade, telecommunications, and financial transactions. Globalisation is also making small open economies vulnerable to the whims of the large hedge funds and polarising the distribution of income in favour of skilled workers and widening income disparities. With the information revolution, governments are experiencing diminished control in their ability to control the flow of goods and services, ideas and cultural products. Localisation is also leading simultaneously to citizen empowerment in some areas while strengthening local élites in others. Results oriented management and evaluation (ROME) is slowly exposing the bureaucratic and political culture to citizen/customer orientation and accountability for results. This paper analyses the potentials and perils associated with the impact of these mega changes on the governance structure in the 21st century. It further distills lessons from this experience to capitalise on this mega change to bring about improvement in public sector governance in developing countries.

## **2. SPECIAL CHALLENGES ARISING FROM GLOBALISATION**

Globalisation represents the transformation of world into a shared space through global links in economics, politics, technology, communications and law. This global interconnectedness means that events in one part of the world can have profound influence over the rest of the world. Such links introduce growing decoupling of production in manufacturing and services from location, increasing permeability of borders and diminished influence of national policy instruments. Increasing internationalisation of production has decoupled firms from the factor endowments of any single nation. Drucker (1986, p. 21) noted three fundamental decoupling of the global economy [see also Courchene (1993)]:

- The primary sector has become uncoupled from the industrial economy;

- In the industrial sector itself, production has become uncoupled from employment; and
- Capital movements rather than trade in goods and services have become the engines and the driving force of the world economy.

As globalisation marches on it is introducing a mega change that exposes the fragility of existing systems of global governance. It is adversely impacting national welfare states that have incentives linked to national production. The sheer magnitude of this social and economic change makes it difficult for governments and individuals to cope with its consequences especially those nations and individuals who suffer from a reversal of fortune as a result of this change. In the following, we discuss the implications of this mega change for governance within nations.

### **Decline of the Nation State, Emergence of Supranational Regimes and Strengthening of Localisation**

Globalisation of economic activity poses special challenges to constitutional assignment within nations. With globalisation, it is increasingly becoming apparent that nation states are “too small to tackle large things in life and too large to address small things”. Strange (1996) argues that “the impersonal forces of world markets... are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong...the declining authority of states is reflected in growing diffusion of authority to other institutions and associations, and to local and regional bodies” [see Held *et al.* (1999), p. 3]. More simply, nation states are fast losing control of some of their areas of traditional control and regulation such as regulation of external trade, competition policy, telecommunications, and financial transactions. National governments are experiencing diminished control in their ability to regulate and/or control the flow of goods and services, ideas and cultural products. For example, the East Asian financial crisis manifested a behaviour on the part of financial institutions and hedge funds which would have been subject to regulatory checks within nation states. The role of large hedge funds in destabilising national currencies and lending behaviour of industrialised countries, banking institutions to Indonesian financial institutions in the pre-crisis period with insufficient collateral for loans serve as striking examples of practices which would not have been permitted on internal transactions within a nation state [see Whalley (1999)]. Similarly, an enhanced mobility of capital limits government’s ability to tax capital incomes especially in the presence of fierce tax competition to attract foreign direct investment in most developing countries. Taxation of capital income is also increasingly being constrained due to inability to trace cross border transactions. For example, it would be difficult for the Government of Japan to tax income of a stock broker who deals with trading of British securities on the Brussels stock exchange.

Opportunities for multinationals to indulge in transfer pricing to limit tax liabilities are also expanding. While the internet commerce has exploded, bringing these activities within the tax reach presents itself as a difficult task even for industrialised countries. Thus the ability of governments to finance public goods especially those of redistributive nature may be impaired as governmental access to progressive income taxes (corporate and personal income taxes) is reduced while its access to general consumption taxes (VAT) is improved with economic liberalisation and global integration. The possible erosion of the taxable capacity of governments through globalisation and tax competition might be considered a welcome change by citizens of the countries with poor record of public sector performance in the provision of public services as is the case in most developing countries. Globalisation implies that not much is “overseas” any longer and that “homeless” transnational corporations have the ability to circumvent traditional host or home country regulatory regimes. These difficulties are paving way for the emergence of specialised institutions of global governance such as the World Trade Organisation, Global Environmental Facility with many more to follow, especially institutions to regulate information technology, satellite communications, and international financial transactions. For countries facing economic crisis and seeking international assistance, even in areas of traditional economic policy, the clout of international development finance institutions to influence local decision-making, is on the rise. Globalisation is therefore gradually unbundling the relationship between sovereignty, territoriality and state power [see Ruggie (1993)]. This transformation implies that governance and authority will get diffused to multiple centres within and beyond the nation state. Thus nation states would be confederalising in the coming years and relinquishing responsibilities in these areas to supranational institutions.

### **Information Revolution and Citizen Empowerment**

With information revolution, “the ability to collect, analyse and transmit data, and to coordinate activities worldwide has increased massively, while the cost of doing so have fallen dramatically” [Lipsey (1997), p. 76]. Firms now have the ability to ‘slice up the value added chain’ [Krugman (1995)] to gain international competitiveness. The information revolution empowers citizens to access, transmit and transform information in ways that governments find themselves powerless to block and in the process it undermines authoritative controls. It also constrains the ability of governments to withhold information from its citizens. Globalisation of information—satellite TV, internet, phone and fax—serve also to enhance citizens’ awareness of their rights, obligations, options and alternatives and strengthens demands both for devolution (power to the people) and localisation of decision-making. Consumer sovereignty and citizen empowerment through international coalitions on specific issues work as countervail to global capital. The influence of

such coalitions is especially remarkable on environmental issues such as large dams and sealing industry.

### **Consumer Sovereignty and Democracy Deficit**

In the emerging borderless world economy, interests of residents as citizens are often at odds with their interests as consumers. This is because internationalisation of production empowers them as consumers as performance standards are set by the market rather than by bureaucrats. It disenfranchises them as citizen-voters as their access to decision-making is further curtailed as decision centres both in public and private sectors move beyond nation state creating a 'democracy deficit'. For example a citizen in a globalised world has no direct input into vital decisions affecting his well-being that are made at the headquarters of either the supranational agencies and regimes such as the International Monetary Fund, World Bank or the World Trade Organisation or transnational corporations such as Coca-Cola and McDonald. Similarly, the European Union Parliament is only indirectly accountable to citizens of Europe. In securing their interests as consumers in the world economy, individuals are increasingly seeking localisation and regionalisation of public decision-making to better safeguard their interests.

### **Internationalisation of Cities and Regions**

With greater mobility of capital, and loosening of regulatory environment for foreign direct investment, local governments as providers of infrastructure related services would serve as more appropriate channels for attracting such investment than national governments. As borders become more porous, cities are expected to replace countries in transnational economic alliances as people across Europe are already discovering that national governments have diminishing relevance in their lives. They are increasingly more inclined to link their identities and allegiances to cities and regions. For example, the Alpine Diamond alliance that links Lyon with Geneva and Turin, has become a symbol for one of Europe's most ambitious efforts to break the confines of the nation-state and shape a new political and economic destiny.

### **Knowledge and International Competitiveness**

With mobility of capital and other inputs, skills rather than resource endowments are increasingly determining international competitiveness. Skilled labour especially in "symbolic-analytic" services [Reich (1991) identifies these as problem-solving, problem-identifying and strategic brokerage services] qualifies to be treated as capital rather than labour. Courchene (1996) argues that for resources to remain important, they must embody knowledge or high value added techniques.

These developments imply that even resource rich economies must make a transformation to human capital based economy and that social policy is no longer distinguishable from economic policy. Education and training typically, however, are sub-national government responsibility. Therefore, there would be a need to realign this responsibility by giving the national government a greater role in skills enhancement. The new economic environment will also polarise the distribution of income in favour of skilled workers accentuating income inequalities and possibly wiping out lower middle income classes. Since the national governments may not have the means to deal with this social policy fallout, sub-national governments working in tandem with national governments would have to devise strategies in dealing with the emerging crisis in social policy.

### **A Potential Source of Conflict within Nations**

International trade agreements typically embody social and environmental policy provisions. But these policies are typically the responsibility of sub-national governments. This is an emerging area of conflict among different levels of government as national decisions in foreign relations affect the balance of power within nations. To avoid these conflicts, a guiding principle should be that to the extent these agreements embody social and local environmental policy provisions they must be subject to ratification by sub-national governments as is currently the practice in Canada.

### **Reorienting State as a Countervail to Globalisation**

The progress of globalisation has created a void in the regulatory environment and weakened the ability of small open economies to deal with external shocks [Rodrik (1997)]. Such external shocks typically lead to major disruptive influences on social safety nets, income distribution and the incidence of poverty as witnessed recently in the East Asian crisis. This leads to enhanced demand for public spending especially for social protection and redistribution. Globalisation also empowers skilled workers to command a greater premium. Courchene (1993) has argued that this will result in the wages of unskilled workers falling to a “global maximum” wage rate as they are replaced by cheaper workers elsewhere. Firms may resort to “social dumping” i.e. reduced income security and social safety net benefit support to retain international competitiveness. This places a greater burden on the public sector for social protection. Rodrik’s empirical work [see Rodrik (1998)] for OECD countries provides some support for this view as he finds that economic liberalisation was positively associated with social security and welfare expenditures. The widening gap in the incomes of skilled vs unskilled labour arising from globalisation has the potential for bipolarisation of incomes and disappearance of lower middle income class. Thus Rodrik

(1997a) has warned that the resulting social disintegration will ultimately erode the domestic consensus in favour of open markets to a point that one might see a resurgence of protectionism around the globe. Some reversals on economic liberalisation were observed in response to recent financial crisis in several countries. Some developing countries' governments have attempted to dampen these shocks by introducing capital controls (e.g. Malaysia) and attempting to strengthen social safety nets with international assistance (e.g. Indonesia and Thailand). The role of supranational agencies in dealing with competition policy, regulating short-term capital movements and oversight on the activities of the hedge funds is currently under debate.

The information revolution may also allow national governments to be more responsive to the needs of their citizens and limit demands for decentralisation. This is because the information revolution is leading to a decrease in transaction costs and therefore lowering of costs to correct for information asymmetries and of writing and enforcing better contracts [see Eid (1996)]. Hart (1995) has argued that in such a world organisational form is of lesser consequence and therefore the need for decentralised institutions is diminished.

In conclusion, globalisation by no means implies a demise of the nation state but rather a reorientation of the nation state to deal with more complex governance structure of an interconnected world. Leaders in some countries might even visualise a more activist state role in sanding the wheels of global capital markets to deal with social and economic policy fall-outs, as experienced in East Asia.

### **3. SPECIAL CHALLENGES ARISING FROM LOCALISATION**

A large and growing number of countries around the globe are re-examining the roles of various levels of governments and their partnership with the private sector and the civil society with a view to creating governments that work and serve their people [see Shah (1998) for motivations for such a change]. The overall thrust of these changes manifests a trend towards either devolution (empowering people) or localisation (decentralisation). Localisation of authority has proved to be a controversial proposition. This is because localisation is being perceived both as a solution to problems such as dysfunctional public sector, lack of voice and exit as well as source of new problems such as capture by local elite, aggravation of macroeconomic management due to lack of fiscal discipline and perverse fiscal behaviour by sub-national units. There are also conceptual difficulties in making choices on the right balance as discussed in the following paragraphs [see Boadway Roberts and Shah (1994) for further details].

#### **Conceptual Issues**

The choice of the degree of centralisation versus localisation on the expenditure side, and the precise means by which central governments achieve their

desired influence, will vary from expenditure type to expenditure type. It will involve a trade-off between the benefit of localisation, which include catering to local preferences, the ability to provide services at low cost and creating incentives to innovate, against the benefit of centralisation, which include preservation of internal common market, achievement of national equity, internalisation of inter-state spillovers and the provision of national public goods and services. Different observers and societies will have different views about the ideal balance and the ways the tradeoffs can be overcome. On the tax side, while fiscal responsibility dictates that responsibilities for taxation be decentralised to allow sub-national governments the ability to finance at least some of their own expenditures, this decentralisation leads unavoidably to inequities and inefficiencies. The magnitude of these is greater the higher the degree of decentralisation. The solution to this may partly lie in retaining some control of the tax structure in the hand of the national government. This will induce greater harmonisation of the tax system among various levels of governments thereby contributing to the efficiency of the national economy and reducing the costs of tax collection. It will also facilitate the national government's pursuit of its redistributive objectives through the tax system. On the other hand, the national government can undo some of the inefficiencies and inequities of decentralised tax and expenditure systems through its use of fiscal transfers to sub-national governments. This will be particularly true for inefficiencies and inequities arising from net fiscal benefit differentials across sub-national units.

In general, the role of the national government relative to sub-national governments is predicated on the provision of national public goods and services, the maintenance of the efficiency of internal common market and the pursuit of redistributive equity nationwide. The importance of the latter determines to a great extent the degree of centralisation of a nation. Equity objectives influence the role that the national government should assume in the direct tax system and the system of transfers. They also have a bearing on the national government's interest in the provision of quasi-private goods and services such as education and health, many of which serve a redistributive purpose. And the national government's interest in equity affects its use of the intergovernmental transfer system to influence the way in which sub-national governments behave and to redistribute resources among sub-national jurisdictions in an equalising manner. In other words, the extent of the role of the national government is largely determined by its interest or lack thereof in redistributive matters [see Shah (1994) for a framework and guidelines for an optimal assignment of responsibilities].

Beyond these conceptual issues, a number of practical considerations have a bearing on the quest for balance within a nation. These include the level of popular participation in general elections, feudal politics, civil service culture and incentives, governance and accountability structure and capacities of local governments.



### **Practical Challenges in Institutional Design**

Localisation brings new challenges in institutional design and development to deal with (a) fragile governance with political and constitutional asymmetries; (b) securing economic union; (c) ensuring fiscal discipline under fend-for-yourself federalism; and (d) political and bureaucratic incentives and the culture of command and control and rent seeking. These issues are briefly discussed in the following paragraphs.

#### ***(a) Fragile Governance with Political and Institutional Asymmetries***

Governance structure remains fragile in many parts of the world. This explains the emergence of more than 50 new countries since World War II. Political asymmetry arises from a unit in the federation assuming unequal status due to its population size or economic base or ethnic character of its population. To overcome this inequality, several solutions are tried. These include redrawing of boundaries as done several times in its short history in Pakistan; creating a second chamber with equal representation from member units (US Senate) or equal representation of member governments (as in Germany and RSA); and having formal fiscal equalisation programmes (as in Australia, Canada and Germany). In addition, constitutional solutions that provide increased central powers in some units (e.g. provision of the President's rule in the Indian Constitution), increased regional autonomy for some (as for the Catalonia region in Spain and States of Sabah and Sarawak in the Malaysian Federation); de-facto asymmetry through opting in/out as in Canada or through bilateral agreements as in the Russian Federation, have also been tried.

Pakistan represents an interesting example in this regard. Political asymmetry has been continuing source of tension in Pakistan and response has been to redraw boundaries periodically. At its birth, the country was divided into five provinces with East Pakistan commanding a population share of 54 percent. In 1961, four provinces of West Pakistan were merged into one unit to counterbalance the dominant position of East Pakistan. One unit was subsequently dismembered with the fall of the military rule. In 1971, the majority province (East Pakistan—now Bangladesh) was forced to secede as East Pakistan's dominating party, Awami League, won a plurality in parliamentary elections but was not allowed to form a government. Even now since Punjab commands a majority of the population, its size is not conducive to a dialogue among equals in the federation. Further the boundaries of the provinces in Pakistan simply represent a legacy of the British empire and thereby serve as a source of conflict and polarisation of public opinions. To reduce these tensions, it may well be that Pakistan may be forced to redraw internal boundaries in future once again by breaking up the size of existing provinces perhaps along the lines represented by various administrative divisions.

***(b) Securing Economic Union***

Several dimensions of securing an economic union in a federal system have relevance for macroeconomic governance: preservation of the internal common market; tax harmonisation; transfers and social insurance; intergovernmental transfers and regional fiscal equity. These are briefly discussed in the following paragraphs.

***(i) Preservation of the Internal Common Market***

Preservation of an internal common market remains an important area of concern to most nations undertaking decentralisation. Sub-national governments in their pursuit of attracting labour and capital may indulge in beggar-thy-neighbour policies and in the process erect barriers to goods and factor mobility. Thus decentralisation of government regulatory functions creates a potential for disharmonious economic relations among sub-national units. Accordingly, regulation of economic activity such as trade and investment is generally best left to the federal/central government. It should be noted, however, that central governments themselves may pursue policies detrimental to the internal common market. Therefore, as suggested by Boadway (1992), constitutional guarantees for free domestic flow of goods and services may be the best alternative to assigning regulatory responsibilities solely to the centre.

The Indonesian constitution embodies a free trade and mobility clause. But in a large majority of developing countries, internal common market is impeded both by sub-national government policies supported by the centre as well as formal and informal impediments to labour and capital mobility. For example, in India and Pakistan, local governments rely on a tax on intermunicipal trade (octroi tax) as the predominant source of revenues. In China, mobility rights of individuals are severely constrained by the operation of “hukou” system of household registration which is used to determine eligibility for grain rations, employment, housing and health care.

***(ii) Tax Harmonisation and Coordination***

Tax competition among jurisdictions can be beneficial by encouraging cost-effectiveness and fiscal accountability in provincial/state governments. It can also by itself lead to a certain amount of tax harmonisation. At the same time, decentralised tax policies can cause certain inefficiencies and inequities in a federation as well as lead to excessive administrative costs. Tax harmonisation is intended to preserve the best features of tax decentralisation while avoiding its disadvantages.

Inefficiencies from decentralised decision-making can occur in a variety of ways. For one, states may implement policies which discriminate in favour of their own residents and businesses relative to those of other states. They may also engage in beggar-thy-neighbour policies intended to attract economic activity from other states. Inefficiency may also occur simply from the fact that distortions will arise from different tax structures chosen independently by state governments with no

strategic objective in mind. Inefficiencies also can occur if state tax systems adopt different conventions for dealing with businesses (and residents) who operate in more than one jurisdiction at the same time. This can lead to double taxation of some forms of income and non-taxation of others. State tax systems may also introduce inequities as mobility of persons would encourage them to abandon progressivity. Administration costs are also likely to be excessive in an uncoordinated tax system [see Boadway, Roberts and Shah (1994)]. Thus tax harmonisation and coordination contribute to efficiency of internal common market, reduce collection and compliance costs and help to achieve national standards of equity.

*(iii) Transfer Payments and Social Insurance*

Along with the provision of public goods and services, transfer payments to persons and businesses comprise most of government expenditures (especially in industrialised countries). Some of these transfers are for redistributive purposes in the ordinary sense, and some are for industrial policy or regional development purposes. Some are also for redistribution in the social insurance sense, such as unemployment insurance, health insurance and public pensions. Several factors bear on the assignment of responsibility for transfers. In the case of transfers to business, many economists would argue that they should not be used in the first place. But, given that they are, they are likely to be more distortionary if used at the provincial level than at the federal level. This is because the objective of subsidies is typically to increase capital investments by firms, which is mobile across provinces. As for transfers to individuals, since most of them are for redistributive purposes, their assignment revolves around the extent to which the federal level of government assumes primary responsibility for equity. From an economic point of view, transfers are just negative direct taxes. One can argue that transfers should be controlled by the same level of government that controls direct taxes so that they can be integrated for equity purposes and harmonised across the nation for efficiency purposes. The case for integration at the central level is enhanced when one recognises the several types of transfers that may exist to address different dimensions of equity or social insurance. There is an advantage of coordinating unemployment insurance with the income tax system or pensions with payments to the poor. Decentralising transfers to individuals to the provinces will likely lead to inefficiencies in the internal common market, fiscal inequities and interjurisdictional beggar-thy-neighbour policies.

*(iv) Intergovernmental Fiscal Transfers*

Federal-provincial transfers in a federal system serve important objectives: alleviating structural imbalances, correcting for fiscal inefficiencies and inequities, securing economic union through setting national minimum standards and fiscal

equalisation, providing compensation for benefit spill-outs and achieving stabilisation and fiscal harmonisation. The most important critical consideration is that the grant design must be consistent with grant objectives [see Shah (1994, 1998)].

In industrialised countries, two types of transfers dominate: conditional transfers to achieve national standards and equalisation transfers to deal with regional equity. In developing countries, with a handful of exceptions, conditional transfers are of pork-barrel (PB) variety and equalisation transfers with an explicit standard of equalisation are not practised. Instead, “passing-the-buck” (PTB) transfers in the form of tax-by-tax sharing and revenue sharing with multiple factors and “asking-for-more-trouble” (AMT) grants that finance deficits, are used. With limited or no tax decentralisation, PTB and AMT type transfers in developing world finance the majority of sub-national expenditures. In the process, they build transfer dependencies and discourage development of responsive and accountable governance [see Shah (1997)]. In general, these transfers create incentives for sub-national governments to undertake decisions that are contrary to their long run economic interests in the absence of such transfers. Thus they impede natural adjustment responses leading to a vicious cycle of perpetual deprivation for less developed regions [see also Courchene (1996) and Shah (1996) for a further discussion].

Properly structured transfers can enhance competition for the supply of public services, accountability of the fiscal system and fiscal coordination just as general revenue sharing has the potential to undermine it. The role of fiscal transfers in enhancing competition for the supply of public goods, in particular, should not be overlooked. For example, transfers for basic health and primary education could be made available to both public and not-for-profit private sector on equal basis using as criteria, the demographics of the population served, school age population and student enrolments etc. This would promote competition and innovation as both public and private institutions would compete for public funding. Chile permits Catholic schools’ access to public education financing. Canadian provinces allow individual residents to choose among public and private schools for the receipt of their property tax dollars. Such an option has introduced strong incentives for public and private schools to improve their performances and be competitive. Such financing options are especially attractive for providing greater access to public services in rural areas.

(v) *Regional Fiscal Equity*

Regional inequity is an area of concern for decentralised fiscal systems and most such systems attempt to deal with it through the spending powers of the national government or through fraternal programmes. Mature federations such as Australia, Canada and Germany have formal equalisation programmes. This important feature of

decentralisation has not received adequate attention in the design of institutions in developing countries. Despite serious horizontal fiscal imbalances in a large number of developing countries, explicit equalisation programmes are untried, although equalisation objectives are implicitly attempted in the general revenue sharing mechanisms used in Brazil, Colombia, India, Mexico, Nigeria and Pakistan. These mechanisms typically combine diverse and conflicting objectives into the same formula and fall significantly short on individual objectives. Because these formulas lack explicit equalisation standards, they fail to address regional equity objectives satisfactorily.

***(c) Ensuring Fiscal Discipline Under Fend-for-Yourself Federalism***

Ensuring fiscal discipline represents an important challenge for all developing countries. A federal system due to the presence of multiple principal agents poses special demands to ensure that all principals follow the rules of the game. In this context, underlying framework must ensure that the governments at all levels are made to face financial consequences of their decisions. This is done by establishing an independent central bank with the sole mandate of price stability. An independent central bank with the sole mandate of price stability is likely to bring discipline to public spending by holding the line on central bank advances to governments and by ensuring the integrity and independence of financial markets. The latter requires that governments must not be allowed to own financial institutions or to have a preferential access to these institutions.

Fiscal policy coordination also represents an important challenge. In this context, Maastricht guidelines on deficit and debt or the fiscal rules imposed in Brazil provide useful frameworks but not necessarily a solution to this challenge. Industrialised countries' experience shows that federally imposed controls and constraints typically do not work. Instead, societal norms based on fiscal conservatism such as the Swiss referenda and political activism of the electorate play important roles. Ultimately capital markets and bond-rating agencies provide more effective discipline on fiscal policy. In this context, it is important not to backstop state and local debt and not to allow ownership of the banks by any level of government. Reduced reliance on revenue sharing and increased reliance on own revenues and on conditional block transfers would bring greater accountability. Tax decentralisation is also important to establish private sector confidence in lending to local governments and sharing in the risks and rewards of such lending. Transparency of the budgetary process and institutions, accountability to the electorate and general availability of comparative data encourages fiscal discipline. Finally a societal consensus on the roles and limits of all governments and periodic reviews of these roles is essential to keep a check on deviant behaviours of governments.

**(d) Political and Bureaucratic Culture and Incentives**

In some developing countries, political and bureaucratic culture remains focused on command and control with little concern and almost no accountability for delivery of public services. Establishing citizens' charters and bringing results orientation through new contractualism and managerialism, as discussed at length in a subsequent section, can be of some help.

**Decentralisation—Fine in Theory but What is the Practice?**

Some writers have cautioned against a shift in division of powers in favour of sub-national governments in a developing country environment and have highlighted the "dangers of decentralisation" [Prud'homme (1995), also see Tanzi (1996)]. These authors have expressed concerns ranging from macro mismanagement, corruption, red tape, and widening gulf between rich and poor persons and regions under decentralised fiscal system. These concerns have been analysed by Shah (1998) and Huther and Shah (1998) among others and found to have weak empirical basis as the record of decentralised fiscal systems on all these issues is better than that of centralised fiscal systems. Table 1 from Huther and Shah (1998) shows a strong degree of positive association among governance quality indices and the degree of fiscal decentralisation. It is further surprising to note that about 38 percent of the variance in governance quality is explained by fiscal decentralisation alone.

Table 1

*Correlation of the Decentralisation Index with Governance Quality Indicators  
(Sample Size: 80 Countries)*

|  | Pearson Correlation Coefficients |
|--|----------------------------------|
| <b>Citizen Participation</b>   |                                  |
| Political Freedom  | 0.599**                          |
| Political Stability  | 0.604**                          |
| <b>Government Orientation</b>  |                                  |
| Judicial Efficiency  | 0.544**                          |
| Bureaucratic Efficiency  | 0.540**                          |
| Absence of Corruption  | 0.532**                          |
| <b>Social Development</b>  |                                  |
| Human Development Index  | 0.369*                           |
| Egalitarianism in Income Distribution<br>(Inverse of Gini coefficient) | 0.373*                           |
| <b>Economic Management</b>   |                                  |
| Central Bank Independence  | 0.327*                           |
| Debt Management Discipline<br>(Inverse of Debt to GDP Ratio)           | 0.263                            |
| Openness of the Economy (Outward Orientation)                          | 0.523**                          |
| <b>Governance Quality Index</b>  | 0.617**                          |

Source: Huther and Shah (1998).

\* Significant at the 0.05 percent level (2-tailed test).

\*\* Significant at the 0.01 percent level (2-tailed test).

#### 4. ON GETTING THE GIANT TO KNEEL: APPROACHES TO A CHANGE IN THE BUREAUCRATIC CULTURE

##### **A Primer on Results Oriented Management and Evaluation (ROME)**

Public sector continues to face a crisis of public confidence in both industrial and non-industrial countries. Examples of government inefficiency and waste abound in most countries. For example in the USA, the Federal Aviation Administration still relies upon dinosaur computers with green screens that run on vacuum tubes. These computers are estimated to impose \$3 billion in wasted aircraft fuel, delays, missed connections and labour costs. The U.S. Defense Department (Pentagon) has in the past paid \$89 for a \$1 screwdriver and the US Department of Agriculture until recently had 2700 words specification of “French fries”. Of course, these examples pale in comparison to grand theft carried out by “roving political and bureaucratic bandits” in developing countries. In industrial countries, citizens are expecting their governments to do more with less. In developing countries on the other hand fairly fundamental dysfunctionality of public governance remain areas of major concern. In these countries, a government is either seen as predatory or even criminal. In some countries, the concept of citizenship or civic responsibility does not exist and effective management of state in this context means that ruling elite doles out benefits to its personalised client networks. Perceptions about some governments as “*the coldest of all cold monsters—whatever it says it lies—and whatever it has—it has stolen*” and others which simply exist to extract rents may not be very far from truth.

A major difficulty in these countries is that public theft by “roving bandits” encourages capital and skilled labour flight leading the economy to a state of collapse so that not much is left for either the roving bandit or his subjects unless external help is available. But external help aggravates the temptations of such a bandit as he/she has a short time horizon. It helps if such a bandit makes the country a home and becomes a “stationary bandit” as in such circumstances, the time horizon of the ruler expands and his/her fortune gets tied with the fortune of the nation. This explains the reason why in the countries ruled by roving bandits, people show a great deal of tolerance for military coup d’etat. Such transformation typically leads to a short period of tranquility but little improvement in the quality of life in the long run. The record of industrialised countries shows that democratic participation is the only form of government with a consistent record in ensuring good governance. This is because only the democratic form of government ensures property rights and enforcement of contracts. Democratic governance, however, cannot simply be mandated from above. Putnam (1993, p. 172), in *Making Democracy Work*, argues “that democratic institutions cannot be built from top down. They must be built in the

everyday traditions of trust and civic virtue among its citizens.” Localisation and accountability for results helps in building such trust and virtue.

Over the years, industrial countries have shown a remarkable change in the performance of their public sectors. It is interesting to note that this change was brought about not through a system of hierarchical controls, as is the focus in most developing countries, but more through strengthened accountability to citizens at large. The elected representatives made a commitment along the lines the oath required of the members of the City of Athens which stated that:

“We will strive increasingly to quicken the public sense of public duty;  
That thus ... we will transmit this city  
Not only not less, but greater, better and more beautiful  
Than it was transmitted to us”.

This accountability for results was further strengthened by accountability of executive to the legislative branch. Overall the emphasis of these systems of accountability has been to bring about a change in both bureaucratic culture and incentives public employees face. This cultural change during the 1990s has been brought about by strengthening results orientation to the public sector. This is done by steering attention away from internal bureaucratic processes and input controls (hard controls) to accountability for results (soft controls). While various countries have followed diverse policies to achieve this transformation, the underlying framework driving these reforms is uniform and firmly grounded in the results oriented management and evaluation (ROME) framework. Under ROME, a results based chain provides a yardstick for measuring public sector performance. Such a focus in management dialogue reinforces joint ownership and accountability of the principal and the agent in achieving shared goals by highlighting terms of mutual trust.

#### **Results Oriented Management and Evaluation Chain:**

Programme/project → inputs → activities → outputs → reach → outcome (purpose) → impact (goal)  
→ Citizen feedback and evaluations → Programme design → Programme / Project

Most ROME related approaches have the following common elements:

- Contracts/work programme agreements based upon pre-specified output and performance targets and budgetary allocations.
- Managerial flexibility but accountability for results.
- Subsidiarity principle.
- Incentives for cost efficiency.
- Citizen charter, bottom-up accountability.

Results-oriented management and evaluation (ROME) provides a coherent framework for strategic planning and management based upon learning and



accountability in a decentralised environment. The key to successful implementation of ROME is through the transparency achieved by the public commitment to a few but vital expected outcome results, based on the agency's outcome related strategic goals. Thus internal and external reporting shifts from the traditional focus on inputs to that of outputs, reach and outcomes, in particular, outputs that lead to results. Further, these results are themselves now stated in terms of development achievements. Programmes, activities, processes and resources are thus aligned with the strategic goals of the agency and flexibility in project definition and implementation is achieved through a shift in emphasis through strict monitoring of inputs to performance results and their measurements. Tracking progress towards expected results is done through indicators, which are negotiated between the provider and the financing agency. This joint goal setting and reporting helps ensure client satisfaction on an on-going basis while building partnership and ownership into the project.

The ROME reforms within an institution are underpinned by devolution and delegation of authority. However, this requires a two-way flow of information, achieved through a strengthened accountability mechanism in the form of performance reporting, greater emphasis on monitoring and evaluation of results, and individual performance agreements which focus on results. Thus under ROME, accountability becomes positive and forward looking, based upon continuous and systematic feedback and learning. That is each unit provides information on results achieved against the agency's strategic goals allowing for benchmark comparisons and learning across organisational boundaries. In addition, it also provides senior management with concrete evidence on which to base allocation decisions. Thus devolution, participation and accountability are all important aspects of this process.

Under ROME, budget allocations support contracts/work programme agreements based upon pre-specified outputs and performance targets. Managerial flexibility in input selection including hiring and firing of personnel and programme execution is fully respected but at the same time they are held accountable for achieving results. The subsidiarity principle of lowest level assignment of responsibility unless a case can be made for higher level assignment strengthens accountability for results while enhancing consistency of public service provision with local preferences. Finally, under a ROME framework, cost efficiency is rewarded through retention of savings. For calculation of costs, activity based costing including charges for capital/asset use are required. As the focus of the approach is on learning, failure to meet commitments may be tolerated but a failure to share values invites severe sanctions.

### **Implications of ROME for Civil Service Reform**

Civil servants in developing countries are typically poorly paid for the work rendered but instead receive high perks and further enrich themselves through graft

and corruption. They have life-long tenures. Innovation and risk taking is not tolerated. In an attempt to limit graft, strong input controls and top-down accountability is enforced. In addition, senior civil servants are rotated periodically from one position to another. But such practices weaken accountability further. A ROME framework, in contrast, calls for competitive wages and task specialisation (“stay-with-it culture”), and lack of formal tenures. Public providers are given the freedom to fail or succeed. Instead public employees hold the jobs so long as they are able to fulfill the terms of their contracts. Persistent failures initiate the exit process. Responsiveness to citizenry and accountability for results are the cornerstone of this approach. The ROME framework offers a great potential in developing countries to improve public sector governance by nurturing a responsive and accountable governance. It may also prove to be one of the most potent weapons against bureaucratic corruption and malfeasance. A recent empirical study on the determinants of corruption by Gurgur and Shah (1999) supports this view as it shows that political and bureaucratic culture and centralisation of authority represented the most significant determinants of corruption in a sample of 30 countries. They further find that raising public sector pay and wages as part of an anti-corruption strategy is not likely to yield any gains in reducing corruption.

| <b>Box 1. Making the Dog Wag its Tail</b> |  |
|---|--|
| <b>Current</b>                            | <b>Future</b>  |
| Input controls                            | Results matter   |
| Top-down accountability                   | Bottoms-up accountability                              |
| Low wages but high perks                  | Competitive wages but little else                      |
| Life-long and rotating appointments       | Stay-with-it-culture but exit with persistent failures |
| Intolerance for risk/innovation           | Freedom to fail/succeed.                               |

#### **Experience with Rome**

Several countries have experimented with various versions of ROME. Of these, experiences of New Zealand, Canada and Malaysia offer interesting insights as discussed below:

#### ***The State Under Contract: The New Zealand Model***

The New Zealand model represents one of the boldest experience in transforming the public sector by using a private sector management and measurement approach to core government functions. To introduce a cultural change from input controls to output accountability in the public sector, New Zealand, during the past decade, revamped a tenured civil service and instead made all public

positions contractual based upon an agreed set of results. Even the central bank governor was required to enter into a contract with the parliament. Under the terms of this contract, the tenure of the central bank governor was linked to inflation staying within a band of 3 percent per annum. The policy development and implementation functions, financing, purchasing and providing functions were separated. This enabled the government to focus on policy and financing and bringing the private sector in partnership with public sector in the provision function. Programme management was decentralised at delivery points and managers were given the flexibility and autonomy in budgetary allocations and programme implementation within the policy framework and the defined budget. Capital charging and accrual accounting were introduced to have a complete picture on the resource cost of each public sector activity. Non public functions were either commercialised or privatised. Responsible fiscal management was encouraged through requirement of maintaining positive net worth of the government as part of the contract by the Minister of Finance.

The new contractualism version of ROME introduced by New Zealand led to a remarkable transformation of the Kiwi economy. It was transformed from a highly protected and regulated economy with an expansive range of intrusive and expensive interventions, to an open and deregulated economy with a lean and efficient public sector. [see Walker (1996)]. The central government deficits were eliminated, debt reduced and the government net worth became positive while improving the quantity and quality of public services. Even more remarkable results were achieved at the local level. For example, the Mayor of Papakura by introducing new contractualism brought an astonishing turnaround to the fortunes of the town of Papakura by eliminating debt and reducing taxes while improving the quality and quantity of public service provision.

To be sure there were limited social policy fall-outs with this approach. Social service provision to minority communities experienced some difficulties as cost cutting pressures under commercialisation occasionally led to curtailed access by minority communities. In isolated cases, new contractualism failed as bureaucratic incompetency failed to ensure strict safety standards as witnessed in the collapse of a newly constructed viewing platform at Cave Creek that resulted in deaths of scores of tourists.

### ***Getting Government Right—The Canadian Approach***

Canada in 1994 adopted its own version of ROME to deal with persistent public sector deficits, a large overhang of debt and growing citizen dissatisfaction with the public sector. Canada rejected new contractualism and instead opted for the so-called alternative service delivery framework (ASD) for public sector reforms using the so-called new managerialism approach. The ASD represents a dynamic

consultative and participatory “process of public sector restructuring that improves the delivery of services to clients by sharing governance functions with individuals, community groups, the private sector and other government entities”.

As part of the programme review process under the ASD, departments and agencies were required to review their activities and programmes against the following guidelines.

Six Guidelines of Programme Review

1. *Public Interest Test*—Does the programme area or activity continue to serve a public interest?
2. *Role of Government Test*—Is there a legitimate and necessary role for the government in this programme area or activity?
3. *Federalism Test*—Is the current role of the federal government appropriate, or is the programme a candidate for realignment with the provinces?
4. *Partnership Test*—What activities or programmes should or could be transferred in whole or in part to the private/voluntary sector?
5. *Efficiency Test*—If the programme or activity continues, how could its efficiency be improved?
6. *Affordability Test*—Is the resultant package of programmes and activities affordable within the fiscal constraints? If not, what programmes or activities would be abandoned?

The Canadian experience with ASD to-date has shown remarkable results. Federal deficit was cut from 7.5 percent of GDP in 1993 to a balanced budget in 1998. The number of federal departments were reduced from 38 to 25 and the civil service size was reduced from 220K to 178K. Allocations to social services, justice and science and technology were increased while the remaining services saw a reduction in the budgetary allocations. Citizen-centred service delivery enhancements were achieved through clustering of services around the needs of citizens, regulatory reform to encourage competition and innovation, cost recovery from services benefiting special segments, and continuing re-evaluation of programmes to support alternative service delivery mechanisms. The overall impact of these reforms was an improvement in service delivery and citizen satisfaction.

***From Government to Governance in Malaysia***

ROME was not built in a day and, as discussed earlier, there is now abundant literature on the ROME type innovations pioneered by New Zealand, Australia, and Canada among others. Interesting enough, this literature has not fully recognised the contribution of Malaysia where some of the innovations predate the experience in industrial countries. Malaysian experience is of special relevance to developing countries as Malaysian public sector suffered at least some of the dysfunctionality of

public sector as experienced in other developing countries in late 1980s. Thanks to some bold initiatives undertaken by Ahmad Sarji under the leadership of Prime Minister Mahatir Mohammed, Malaysia had a significant degree of success in getting the public sector giant to kneel so that citizens can get aboard.

Since early 1990s, Malaysia has gradually put in place aspects of results-oriented management to create a responsive and accountable public sector governance structure. Various elements of this approach that have been implemented are:

- *Missions and values*: All public agencies are required to specify their mission and values with a view to justifying their roles and to inculcate positive values in public administration.
- *Strengthening client orientation*: A Client' Charter was established in 1993. This charter requires all agencies to identify their customers and establish their needs. Agencies are further required to notify clients about standards of services available. Public agencies are expected to report annually both on service improvements and compliance failures. A corrective action is required to deal with compliance failures. Clients have a right to redress through the Public Complaints Bureau.
- *Managerial flexibility with strong accountability for results*: This is achieved through the implementation of an output based budgeting system and activity based accounting system. It has further introduced capital charging and accrual accounting. The output budgeting system requires "programme agreements" for delivery of outputs but permits managerial flexibility in achieving agreed upon results. Performance indicators for government agencies and other public service providers are maintained.
- *Decentralised decision-making*. Malaysia has overtime sought to strengthen decentralised decision-making by strengthening local governments and by deconcentrating federal government functions.
- *Strengthening the integrity of the Malaysian civil service*: Malaysia has one of the strongest anti-corruption law and devotes significant resources to implement this law.
- *Partnership approach to service delivery*. A partnership approach to service delivery is attempted through ensuring contestable policy advice, deregulation and active promotion of public-private collaboration in public services.
- *Ensuring financial integrity*. This is achieved through internal and external audit. The Auditor General provides the Parliament with a financial integrity audit. This report is widely disseminated.

In sum, Malaysia is at the cutting edge of public sector institutional development, innovation and performance in developing countries. It has followed

innovative approaches to improve public sector performance. Its challenge is to strengthen the new culture of governance that it has attempted to create by dealing with implementation issues through training and corrective action. In addition it needs to start addressing some of the issues that have received inadequate attention so far. These include (a) strengthening central bank independence and focusing its role solely on price stability; and (b) achieving a better integration of development and operating budget processes.

### **Beyond ROME—Measuring Performance When There is No Bottom Line**

The whole of government performance monitoring is of interest to get an overall measure of public sector performance and citizen accountability of the political regime. Such measurement is becoming increasingly popular in industrial countries. The State of Oregon, USA set up an independent board to develop and monitor measures of social well-being (158 such measures in 1991 now reduced to 20 in 1999) of state residents. The State of Florida initially established 268 indicators dealing with progress in families and communities, safety, learning, health, economy, environment and government. It has more recently abandoned this effort. The Province of Alberta, Canada, has established 27 “measuring up” quality of life indicators. New Zealand reports on the net worth of the government. UN publishes human development indicators and Huther and Shah (1998) developed comprehensive indicators of the quality of governance incorporating citizen participation, government orientation, social development and economic management for a sample of 80 countries.

The experience with the whole of government performance measurement has shown mixed results. This is because media is skeptical about the accuracy of the statistics and the legislatures in political systems with separation of executive and legislative powers, are concerned with the potential abuse of this tool to undermine legislative authority. In general in the absence of major crisis, politics of budgetary decision-making reduces the usefulness of these performance indicators. A major difficulty with aggregate performance indicators arises from “looking for keys under the lamp post reflex” meaning that what may be measurable and is measured may not be relevant for policy or accountability purpose. Outcome measures at conceptual level offer diffused accountability. Instead the focus on outputs and reach as practised in New Zealand and Malaysia offers greater potential for accountability for results.

### **Epilogue—ROME—A Road Map to Wrecks and Ruins or to a Better Tomorrow?**

The success of ROME in practice in a few selected countries has invited a heated controversy and debate among public sector management practitioners with a

fairly vocal group [Schick (1998), is the leading exponent of this viewpoint] arguing against application of such principles in developing countries. A plethora of arguments are put forward to support this view. It has been argued that the real issue of civil service reform is not its efficiency but its underdevelopment. Input control systems are not well developed. There is no sense of public responsibility and as a result managerial discretion will enhance opportunities for abuse of public office for private gain. Due to political interference, potential for contract enforcement is quite weak. The use of ROME will further weaken top down accountability as the focus changes to results rather than inputs, rules and procedures. It is further argued that the use of this approach will not work for craft (research and development) and coping (e.g. disaster relief) organisations as the focus on outputs will discourage innovation, risk taking and timeliness of the response. In social services, it is argued that access to the needy and the poor may not be assured under a system which places high premium on operational efficiency. Finally, others have argued that ROME is a fad and developing countries should simply wait it out until a newer fad emerges.

While there is some merit in the arguments advanced against the use of ROME, but on balance, the case for application of ROME in developing countries is further strengthened in view of the institutional weaknesses highlighted above. The underdeveloped bureaucracy and input controls argument suggests that modern accounting systems that trace the flows of inputs have not proved helpful. This is because the experience shows that performance improvement gains from the implementation of such systems have been minimal and instead these systems provide a cover for the abuse of public funds by facilitating “getting the books in order”. As outputs for a large majority of public services are readily observable and their reach can be measured, ROME provides a much better handle on accountability in governance in weak institutional environments. Hierarchical input based accountability has typically failed to deliver public sector mandates. Indeed craft and coping organisations require care in how their results—based chain is evaluated. In social services, similarly the designs of incentives are critical to forestall any fall-outs and instead encourage access to all through competition and innovation. For example, a grant structure that treats all providers—public and private—on equal basis with continuation of eligibility tied to conditions on the standards of services and access to such services rather than spending levels can overcome the moral hazard (see Box 2). ROME is of course not a fad either as it was practised with great success in traditional societies long before modern bureaucracy was invented. Even in personal and family decision-making ROME is the only approach typically taken by most individuals in decision-making e.g. building and fixing a home and seeking other services. Many developing countries facing large fiscal crisis and in the absence of external help would simply have no choice but to adopt ROME to overcome these crises to set their houses in order. In general bottom up accountability is the key to

**Box 2. Education Grant to Encourage Competition and Innovation**

*Allocation basis among local governments:* population aged 5–17.

*Distribution to providers:* Equal per pupil to both government and private schools.

*Conditions:* Universal access to primary and secondary education regardless of parents' income. No condition on the use of grant funds.

*Penalties:* Public censure, reduction of grant funds.

*Incentives:* Retention of savings

the success of ROME and such accountability requires decentralised decision-making. In conclusion, globalisation, localisation and ROME offer a strong potential for improving public sector performance in developing countries.

## 5. MEGA CHANGE AND ITS IMPLICATIONS

### Emerging Jurisdictional Realignment

The debate on globalisation and localisation and growing level of dissatisfaction with public sector performance is forcing a rethinking on assignment issues and to force a jurisdictional realignment in many countries around the globe. Box 3 presents a newer federalism perspective on the assignment of responsibilities by taking into account the considerations noted above. This box shows that functions such as regulation of financial transactions, international trade, global environment, international migration will need to be passed upwards (centralised) beyond nation states, some sub-national functions such as training should have greater central government inputs (centralisation) and local functions should be completely decentralised and should involve greater participation by the civil society and the private sector. In developing countries, rethinking these arrangements has led to gradual and piecemeal decentralisation of responsibilities for local public services to lower levels in a small but growing number of countries. The development and strengthening of institutional arrangements for the success of decentralised policies has significantly lagged behind. Strengthening of local capacity for purchase or delivery of local services has received only limited attention. Even strengthening of central and intermediate level functions required for the success of this realignment have not always materialised. In fact in some countries, decentralisation is motivated by shifting the budget deficit and associated debt burdens to sub-national governments. Bureaucratic resistance to the implementation of ROME type reforms remain strong and as a result not much improvements have been effected in developing countries.



**Box 3.****Emerging Rearrangements: Globalisation, Centralisation and Localisation**

*Beyond Nation States:* regulation of financial transactions, corporate taxation, international trade, global environment, telecommunications, international standards, international migration, surveillance of governance conditions, global security and risk management, transnational production, investment and technology transfer.

*Centralisation:* Social and environmental policy through international agreements, skills enhancement for international competitiveness, social safety nets, oversight and technical assistance to sub-national governments.

*Regionalisation/Localisation/Privatisation:* All regional/local functions.

**Emerging Governance Structure in the 21st Century**

While rearrangements taking place in the world today embody diverse features of supranationalisation, centralisation, provincialisation and localisation. Nevertheless, the vision of a governance structure that is slowly taking hold is the one that indicates a shift from unitary constitutional structures in majority of the countries to federal or confederal constitutions for a major part of the world. It implies that we are likely to move from a centralised to a globalised and localised world. The role of the central governments in such a world would change from that of a managerial authority to a leadership role in a multi-centred government environment. The culture of governance is also slowly changing from a bureaucratic to a participatory mode of operation; from command and control to accountability for results; from being internally dependent to being competitive and innovative; from being closed and slow to being open and quick; and from that of intolerance from risk to allowing freedom to fail or succeed. Financial crisis around the world are hampering this change and as a result the new vision will take some time to shape in the 21st century (see Table 2) and in many developing

Table 2

*Governance Structure—20th Versus 21st Century*

| 20th Century                              | 21st Century  |
|---|---|
| ◆ Unitary                                 | ◆ Federal/confederal                                    |
| ◆ Centralised                             | ◆ Globalised and localised                              |
| ◆ Centre manages                          | ◆ Centre leads  |
| ◆ Bureaucratic                            | ◆ Participatory   |
| ◆ Top-down accountability                 | ◆ Bottoms-up accountability                             |
| ◆ Focus on rules and procedures           | ◆ Managerial flexibility but accountability for results |
| ◆ Life-long appointments in civil service | ◆ Contractualism  |
| ◆ Command and control                     | ◆ Responsive and Accountable                            |
| ◆ Internally dependent                    | ◆ Competitive   |
| ◆ Closed and slow                         | ◆ Open and quick  |
| ◆ Intolerance of risk                     | ◆ Freedom to fail/succeed                               |
| ◆ Focus on government                     | ◆ Focus on governance                                   |

countries this vision may not actually materialise due to the conceptual and practical difficulties noted in the following sections.

## **6. WHY THE ROAD TO REFORM REMAINS A FIELD OF DREAMS IN DEVELOPING COUNTRIES?: THEORETICAL CONSIDERATIONS**

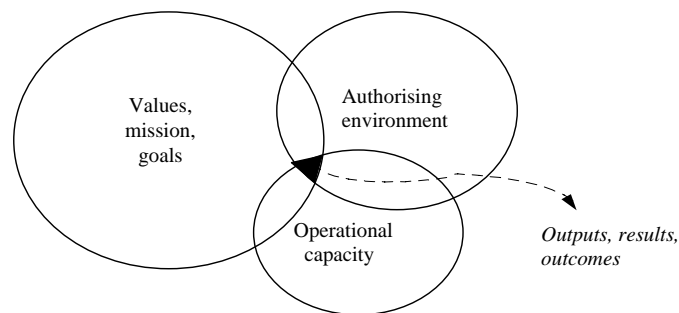
A simple way to see why the public sector is dysfunctional and does not deliver much in developing countries yet is difficult to reform, is to have a closer look at public sector mission and values, its authorising environment and its operational capacity.

- (a) *Public sector mission and values.* Societal values and norms, e.g., as embodied in the constitution or in annual budget policy statements, may be useful points of reference for public sector mandates and the values inherent in these mandates. Unwritten societal norms that are widely shared or acknowledged should also be taken into consideration. In industrialised countries, the mission and values of the public sector are spelled out in terms of a medium term policy framework. For example, there is a formal requirement in New Zealand that a policy statement of this type be tabled in the parliament by March 31 (about 2-3 months in advance of the budget statement). Public sector values in developing countries are rarely addressed. This is because the orientation of the public sector remains towards “command and control” rather than to serve the citizenry. For an official trained in ‘command and control’, the need to develop a code of conduct with a client orientation, may appear frivolous.
- (b) *Authorising environment.* This includes formal (budgetary processes and institutions) and informal institutions of participation and accountability. Do these institutions and processes work as intended in providing an enabling environment for the public sector to meet its goals? Do various levels of government act in the spirit of the constitution in exercising their responsibilities? What are the checks and balances against deviant behaviour? Is the independence of the central bank, the judiciary, and the auditor general guaranteed? Is the central bank focused solely on price stability or is it expected to pursue multiple objectives? Are there formal rules to ensure fiscal discipline? Is the design of transfers consistent with their objectives? Are there private agencies that rate various levels of government for their credit worthiness? Is public sector borrowing subject to financial market discipline? How is government performance measured? Are output and outcome indicators for public services monitored by any one? In industrialised countries, institutional norms are strictly adhered to and there are severe moral, legal, voter and market sanctions against non-compliance.

In a developing country environment, non-compliance is often neither monitored nor subject to any sanctions.

- (c) *Operational capacity and constraints.* What is authorised is not necessarily what will get done as the available operational capacity may not be consistent with the task at hand. Further, even the operational capacity that is available may be circumvented by the bureaucratic culture or incentives that reward command and control, and corruption and patronage. Some key questions, the answers to which will give a better understanding of operational capacity, include: Do the agencies with responsibility for various tasks have the capacity to undertake them? Do they have the right skills mix as well as the incentive to do the right things and to do them correctly? Is the bureaucratic culture consistent with the attainment of societal objectives? Are there binding contracts on public managers for output performance? Does participation by civil society help alleviate some of these constraints? To what extent can these constraints be overcome by government reorganisation and reform? Whereas, in industrial countries, answers to most of the above questions are expected to be in the affirmative, this is not true in the case of a developing country.

The challenge of public sector reform in any country is to harmonise the public sector's mission and values, its authorising environment and its operational capacity so that there is a close, if not perfect, correspondence among these three aspects of governance (see Figure 1). Such a task is daunting for many developing countries since they often have lofty goals, but lack an authorising environment that is capable of translating these goals into a policy framework. This problem is often compounded further by bureaucratic incentives that make any available operational capacity to implement such a framework completely dysfunctional.



**Fig. 1. Public Sector Institutional Environment in Developing Countries.**

Table 3 presents a stylised comparison of the institutional environment in a primitive society, a developing country and an industrialised country. It is interesting to note that while technical capacity in the modern sense was non-existent in a traditional society, due to harmonisation of its goals, its authorising environment and its operational capacity, public sector outcomes were consistent with member preferences. The cultures of such societies more often than not focused on accountability for results. The system of rewards and punishment was credible and swift and much of the business relations were based on informality and trust. Thus while per capita GDP in such societies was quite low, member satisfaction with collective action, the so-called “viagara index” was observed to be high and quite possibly not too far behind the degree of satisfaction with public sector experienced in today’s industrial societies.

Table 3

*Public Sector Institutional Environment—Stylised Facts*

|                               | Traditional Society       | Developing Country   | Industrial Country                   |
|-------------------------------|---------------------------|--|--------------------------------------|
| Goals                         | Clear and realistic       | Vague and grandiose  | Clear and realistic                  |
| Authorising Environment       | Strong                    | Weak   | Strong                               |
| Operational Capacity          | Consistent and functional | Dysfunctional  | Consistent and functional            |
| Evaluation Capacity           | Strong                    | Weak   | Strong                               |
| Public Sector Orientation     | Output                    | Input controls, command and control                            | Input, output and outcome monitoring |
| Public Sector Decision-making | Decentralised             | Centralised  | Decentralised                        |
| Private Sector Environment    | Informality and trust     | semi-formality but lack of trust and disregard for rule of law | Formal and legal                     |
| Evaluation culture            | Snakes and ladders        | “Gotcha”   | Learning and improving               |

This contrast with the picture that can be portrayed for a typical developing country. In such a country, there is discordance in the society’s goals, authorising environment and operational capacity. As a consequence of this disharmony, not much gets accomplished and citizens expectations are belied. Lack of accountability and focus of the evaluation culture on frying a big fish occasionally but doing nothing with the systemic malaise means that any self-correcting mechanisms that may exist are blunted. Semi-formality imposes additional costs on doing business but does not lead to any benefits in business relations due to disrespect for law. Contracts may not be honoured and therefore carry little value. In view of this completely dysfunctional nature of public sector in many developing countries, it is important for

these to leapfrog forward (or even backwards) to a public sector culture that puts premium on client orientation and accountability for results. This is however, unlikely to happen soon for reasons to be discussed later.

In the following section, we take a look at some of the factors that are at play in impeding the progress of realignment of functions and harmonisation of public sector mission, values, authorisation environment and operational capacity in developing countries.

## **7. WHY THE ROAD TO REFORM REMAINS A FIELD OF DREAMS? PRACTICAL CONSIDERATIONS**

We noted that public sectors in most developing countries require significant restructuring. Progress to-date on such reforms have been uneven. A number of factors impede the progress of reform to varying degrees in various countries.

### **Political Factors**

Political ownership is critical to the success of any reform. In Latin America and former centrally planned economies, emergence of democratic governance and political freedoms led to heightened interest in improvement of public sector performance and decentralisation of local public services was seen as an important element of this reform. In Latin America, disenchantment with military rule and dictatorships of various persuasions has led to creation of a political culture that places a premium on decentralised decision-making to forestall a return to the past. In China, decentralisation was seen as a means for social cohesion, faster economic growth and preservation of communist party rule. Politics blocks reform in other countries. In Indonesia, forefathers of the constitution clearly intended it to be a centralised unitary country and dictated against establishment of “states within the state”. These concerns for political unity have dominated the design of institutions. Well entrenched roles of military and civil service in political affairs with a strong belief in command and control from the Centre have sustained centralisation of responsibility. Appointment of governors and mayors also strengthens centralisation and limits local autonomy. In recent years, however, social development and economic prosperity and concerns for improving the delivery of public services are bringing a degree of accommodation for decentralised institutions.

In Pakistan, political instability and feudal interests have contributed to setting aside constitutional dictums and introducing a system of centralised governance. Pakistan has been under military rule for a major part of its existence (25 out of 52 years) and decision-making was further centralised by these regimes. During the periods political activities were permitted, feudal influences dominated the political system and these influences favoured either a centralisation or provincialisation of authority. In rural areas of Sindh and Balochistan, and to a more limited extent in rural areas of

Punjab and NWFP provinces, feudal lords do not allow effective political participation. Centralisation or provincialisation of authority allows feudal lords to dominate politics at the federal and provincial levels. A centralised system allows these lords to have greater effective control than would be possible under a decentralised system where the urban sector would have a more significant voice. To further entrench feudal lords, under the leadership of the former Prime Minister Ms. Bhutto in 1994, local governments were disbanded in all metropolitan areas and not restored even when in 1996 the Supreme Court of Pakistan found this practice to be in contravention of the law. Grants to members of national and provincial legislatures for development projects as practiced until 1997, may have worked against the development of local governments as these members enjoyed a greater degree of autonomy in project execution in the absence of a well functioning system of local government.

### **Bureaucratic Factors**

Many countries in Africa and Asia share a common colonial heritage. The British, Dutch and French colonial systems instituted a system of bureaucratic control to achieve with maximum efficiency colonial objectives of a predatory state. The system created a core of civil service elite which was highly educated and highly dedicated to serving the colonial rulers. Their loyalty to rulers and detachment from the common man was duly rewarded by allowing them preferential access to all public services through elite institutions and by ensuring them financial security through a system of cash rewards and land grants. Thus colonised countries such as India, Kenya, Pakistan and Indonesia inherited civil service regimes that were highly centralised, seemingly efficient, accountable and professional but completely detached from local population. These regimes have remained resistant to change especially to bringing accountability for results. For example, after independence, in Indonesia, civil service over time became an active political partner with military in governing the country. Both partners viewed central control as a key element in holding this country of 14,000 islands together. A centralised regime also was conducive to capturing rents from private sector development. Over time, nevertheless, they discovered that initial degree of centralisation was not sustainable and therefore substantial degree of autonomy to local governments while keeping a weak structure of provincial governments, is necessary to improve delivery of local services. A gradual shift towards local control (localisation) is thus seen as posing no threat to national unity and to the preservation of a command and control oriented bureaucratic regime.

### **Institutional Factors**

Institutional factors also impede effective decentralisation and adoption of ROME. Traditional institutions and mechanism of governance and accountability

over time have withered away but these have not been replaced by newer institutions. Instead, all pervasive role of the state have retarded critical look at public policies and institutions. There is almost complete monopoly of the government on institutions of critical thought and media in many countries. Any critical review of government policies and programmes invites a government backlash. In Pakistan, rural self-government worked well in earlier days of its independence. This system was abandoned in favour of a more centralised system which has resulted in denial to rural population of access to basic services. While lack of institutional capacity was cited as a reason for disbandment of the participatory system, the newer system left a majority of citizens with no voice and participation and no access to basic public services. Indonesia, on the other hand, is now nurturing self-government in rural areas through its village development and poor villages grant programmes [see Shah (1996)].

Another important aspect of institutional factors is the citizens' philosophy towards government. Do people generally (politicians, bureaucrats, public employees generally and the public/voter) view the public sector as one where one does service for fair compensation or a position to exploit for personal gain. Various opinion surveys suggest that the prevailing public perception about the public sector especially in South Asia and Africa tend to support the latter view and citizens tend to associate public sector with a predatory role.

Contrary to common misconceptions, the success of decentralisation policies critically require a strong responsive and accountable government at the national level just as the success of centralised governance critically depends upon responsive, accountable and competent field offices of the central government. This is the least understood "paradox of decentralisation (rearrangements)". This suggests that centralisation requires a higher degree of local (field office) institutional capacity and competence and greater sophistication and integrity of public information monitoring, finance, accounts and audit systems than required under a decentralised system. The success of decentralised structures on the other hand critically depends upon the higher level enabling environment and citizen participation and less so on the local institutional capacity and information network as confirmed by the Colombian experience [see Fiszbein (1995)]. Local institutional capacity and information networks are no doubt important yet these can be overcome by borrowing such capacity from internal and external sources at least during the earlier phases of decentralisation provided a supporting higher level enabling environment prevails.

### **External Participants**

Some external participants may also unwittingly impede development of a decentralised, responsive and accountable public sector in developing countries. A

multitude of factors contribute to this development. First, a centralised hierarchical system lowers transaction costs for external assistance and enlarges the comfort zone for external participants in terms of monitoring the utilisation of their funds for intended purposes. Second, some external participants have concerned themselves with the revenue performance (so-called “resource mobilisation”) of developing countries. Such concerns may lead to larger centralised bureaucracies that pay little attention to efficient delivery of public services. For example in Pakistan, minor improvements in revenue performance of governments have in the past been accompanied by ever deteriorating quality and quantity of public services. Third, centralised systems are more prone to a lack of internal policy agenda due to a lack of citizen participation and more dependent on external advice on policy reform. Typically this leads to quick policy fixes with little sustained reform.

### **8. MAKING DREAMS COME TRUE: GETTING INSTITUTIONS RIGHT**

Adherence to federalism principles and ROME or “getting prices right” or even “getting the rules of the game right” as discussed earlier is a necessary but not a sufficient condition for the success of decentralised decision-making. Complementary formal and informal institutions are needed to ensure that all players in the game adhere to agreed upon set of ground rules and deviant behaviour is properly dealt with. In the following, we discuss selected aspects of this consideration.

#### **Institutions and Processes of Intergovernmental Coordination**

Federal countries require both formal and informal institutions of intergovernmental coordination. In some federal countries, areas of potential conflict among different levels of government is minimised through clear separation of national and sub-national responsibilities (the so-called layer-cake model of federalism as practised in Australia, Canada, India and Pakistan) and the two levels interact through meetings of officials and ministers (executive federalism) and in Australia, India and Pakistan through federal unilateralism. Some countries place a greater premium on a common response through shared or joint tasks such as Germany, a federal country and the Republic of South Africa, a pseudo federal country. In these countries, in addition to executive federalism, the upper houses of parliament (Bundesrat and the Council of Provinces) play a key role in intergovernmental coordination. In countries with overlapping responsibilities (the so-called marble cake model of federalism), such as United States and Brazil, state lobby of Congress and interstate relations serve coordinating roles. In China, where growth concerns have imposed a federalism structure on a unitary country, regional communist party bosses/ governors exercise a moderating influence on otherwise monolithic orientation of the State Council.



Constitutional provisions per se can also provide coordinating influences. For example, in some federal countries, constitutional provisions require that all legislation recognise that ultimate power rests with the people. For example, all legislation in Canada must conform to the Canadian Charter of Rights. In Switzerland, a confederation by law but a federal country in practice, major legislative changes require approval by referenda. In Switzerland, there is also a strong tradition of coordination through consensus initiatives by cantons.

### **Institutions of Accountability**

The institution of accountability is the key to the success of decentralised decision-making. This entails institutions and mechanisms for citizens' voice and exit, norms and networks of civic engagement ("social capital" according to Putnam 1994), social consensus [Williamson (1994) and Weingast (1993)], preservation instinct of a "stationary bandit" who monopolises and rationalises theft in the form of taxes [Olson (1993)], judicial accountability, vertical and horizontal accountability. The citizens' voice and exit require institutions of democratic participation, and accountability provisions for elected officials. The origins and success of decentralisation programmes in Latin America is traceable to the democratic traditions that emerged in the continent in late 1980s. In Philippines, recently enacted local government legislation while empowering these governments have provided for regular elections and recall of elected officials for a breach of public trust [see the Republic of Philippines Act No. 7160, the Local Government Code (1991)]. While norms and networks of civic engagement were reasonably well developed in pre-colonial traditionalist societies found in many developing countries such as the Panchayat Raj in Pre-British India, these institutions withered away either under the colonial rule or subsequently under centralised bureaucratic governance structures. The net result has been rise of opportunism and social distrust culminating in dysfunctional societies when formal institutions of governance failed. The African and the South Asian development fiascoes share this common underpinning. Societal consensus on economic and political rights is also conducive to accountability at all levels. According to Weingast (1993), this consensus need not take any formal expression but would work so long as a majority of people share a common belief as to the limits of governmental intervention and are willing to police those limits by withdrawing their support from a government that fails to abide by them [see Weingast (1993), p. 306]. Preservation instincts of a stationary bandit also respect accountability [see Olson (1993)]. This is because, the stationary bandit strengthens his grip on power, so long as economic performance is strong and citizens see their well being improved. This explains partly the success of the Asian Tigers and the failure of some South/Southeast Asian regimes. The latter regimes were controlled by "roving bandits" whose main aim was to make the loot to pad their Swiss bank accounts and then disappear in a foreign haven.

Judicial accountability strengthens the credibility of public commitments. This is particularly important for transition economies, where framework laws on property rights, corporate legal ownership and control, bankruptcy, and financial accounting and control are not fully developed. Interestingly enough, judicial accountability is much more difficult to enforce in a parliamentary democracy than in a democratic system which respects separation of legislative and executive functions. This is because, under a parliamentary democracy, the executive branch can override judicial accountability by amending the legislation—a game played ad infinitum in Pakistan to undermine a decentralised federal constitution. Judicial accountability is further compromised under a British style civil service organisation as in India and Pakistan where divisional and district commissioners hold simultaneously executive, legislative and judicial powers. As noted by Montesquieu (1970, p. 397), such a situation is ripe for the abuse of powers as,

“... When the legislative and executive powers are united in the same body of magistrates, there can be no liberty;... Again, there is no liberty, if the judiciary power be not separated from the legislative and executive”.

### **Traditional Channels of Accountability**

The audit, inspection and control functions should be strengthened, since they tend to be quite weak in transition and developing economies. The auditor-general should be given greater authority and autonomy in exercising his mandate. At the same time, a case can be made for loosening the constraints of the central planning process in developing countries. Central plans lead to a centralisation of authority, a reduction in flexibility, innovation and autonomy at the local level and delays in private sector activity. On a more specific point, as fiscal responsibility is decentralised to the state and local levels, it would be beneficial to create the institutional capacity for local borrowing so that more reliance is placed on borrowing and less on capital grants to finance capital projects. Examples include loan councils or municipal finance corporations.

### **Oversight of Local Governments: Freedom and Responsibility within Boundaries**

Monitoring and oversight of local governments is an area of concern in both federal and unitary countries alike. For example, the Republic of South Africa Constitution Act 1996 (Section 139(1) (b)) provides for a disbandment of local government in the event of failure to (i) “maintain national standards or meet minimum standards of service”; (ii) “prevent actions prejudicial to the interests of another municipality or the nation as a whole”; and (iii) “maintain economic unity”. It further provides for withholding of tax shares and transfers for non-compliance

with tax effort (Section 227(2)). The fulfillment of constitutional obligations regarding these provisions require a significant and superior evaluation capacity at provincial and national levels. Evaluative measures that can assist in this oversight include requirement of annual commercial corporate audit of local governments; fiscal capacity measurement using a common yardstick i.e. equalisation of municipal assessments; greater emphasis on formula grants over project grants in provincial-local transfers; greater emphasis on public-private-civil society partnership in public provision; opinion polls on service standards and citizen satisfaction; and performance ratings of local governments based upon outputs, outcomes and citizen satisfaction.

## 9. SOME LESSONS FOR DEVELOPING COUNTRIES

The following important lessons for governance reforms in developing countries can be distilled from a review of past experiences.

- *Global institutional evolution is out of step with the pace of globalisation and thereby making the developing countries most vulnerable to the whims of global markets.* The void created by globalisation in international regulation and oversight has adverse economic and social consequences for most developing nations. An urgent attention is needed to develop and/or adapt global institutions and regimes to fill this void. In the meanwhile, developing countries might have to resort to “sanding the wheels” of global market to limit external shocks.
- *Development of national strategies for economic and social risk management is critical to limit fall-outs from globalisation.* Economic risk management includes policies to maintain a positive net worth for the government and appropriate regulatory framework for private sector and financial market operations. Social risk management calls for an accelerated development of social safety nets.
- *Periodic review of jurisdictional assignments is essential to realign responsibilities with changing economic and political realities.* With globalisation and localisation, national government’s direct role in stabilisation and macroeconomic control is likely to diminish over time but its role in social protection, education, training, skills enhancement, coordination and oversight is expected to increase as regimes and sub-national governments assume enhanced roles in some of its areas of traditional responsibility. Constitutional and legal systems and institutions must be amenable to timely adjustments to adapt to changing circumstances.
- *Enabling environment for decentralisation i.e. institutions of citizen participation and accountability must be addressed in any serious reform of*

*fiscal systems*. These elements have not been sufficiently addressed in most reform efforts.

- *Changes in bureaucratic culture to bring accountability for results is critical to a reform of governance in developing countries.* Experience shows that bureaucracy never reforms itself and therefore building political commitment and support is essential to introduce ROME in these countries.
- *Civil service reform is critical to the success of a decentralisation programme.* Such a reform must ensure that the Centre has no direct say in the recruitment and promotions of civil servants, other than overseeing that standards of transparency and fairness are met at the sub-national levels and that wages of sub-national services must be competitive with the central government. Further, civil service incentive structure should reward service orientation and performance and discourage command and control and rent-seeking. This can be accomplished through performance contracts, stay-with-it culture, recognition of specialised skills and evaluation systems that link performance, rewards and budgeting.
- *Traditional administrative capacity matters should not be considered as an impediment to decentralisation.* Administrative capacity to develop and maintain modern organisational practices such as budgeting, auditing and accounting systems is no doubt important but should not be considered as a barrier to decentralisation provided citizen participation and transparency in decision-making is ensured. This is because technical capacity can be borrowed from supportive higher level governments and elsewhere.
- *Asymmetric decentralisation as provided under the Indonesian decentralisation programme and under provincial local government ordinances in Pakistan offers a thoughtful approach to decentralisation.* Regardless of the availability of help from higher level governments, lack of institutional capacity should never be considered as an excuse not to decentralise. Instead, an objective programme of decentralisation which recognises the nature and type of local government, its clientele and its fiscal capacity can be developed and various local governments can be assigned differential powers by taking into account the above mentioned factors as was done in Pakistan in the past and more systematically being done in Indonesia by rating each local government.
- *A major separation of spending and taxing decisions leads to lack of accountability in the public sector.* In Mexico, South Africa and Pakistan, federal revenue sharing transfers finance up to 99 percent of expenditures in some provinces. This de-linking of taxing and spending responsibilities have led to accountability problems at the provincial levels. In the event of such de-linking, role of conditional (conditional on standards of services and

access to such services and not on expenditures) block transfers and evaluation is worth examining to enhance accountability.

- *Intergovernmental transfers in developing countries undermine fiscal discipline and accountability while building transfer dependencies that cause a slow economic strangulation of fiscally disadvantaged regions.* Properly designed intergovernmental transfers on the other hand can enhance competition for the supply of public goods, fiscal harmonisation, sub-national government accountability and regional equity. Substantial theoretical and empirical guidance on the design of these transfers is readily available. The design of these transfers must be simple, transparent and consistent with their objectives. The experience of Indonesia offers important insights in grant design. For example, Indonesia's education and health grants use simple and objectively quantifiable indicators in allocation of funds and conditions for the continued eligibility of these grants emphasise objective standards so as to have access to these services. Indonesian grants for public sector wages on the other hand, represent an example of not so thoughtful a design as it introduces incentives for higher public employment at sub-national levels.
- *The role of fiscal transfers in enhancing competition for the supply of public goods should not be overlooked.* For example, transfers for basic health and primary education could be made available to both public and not-for-profit private sector on equal basis using as criteria, the demographics of the population served, school age population and student enrolments etc. This would promote competition and innovation as both public and private institutions would compete for public funding. Chile permits Catholic schools' access to public education financing. Canadian provinces allow individual residents to choose among public and private schools for the receipt of their property tax dollars. Such an option has introduced strong incentives for public and private schools to improve their performances and be competitive. Such financing options are especially attractive for providing greater access to public services in rural areas.
- *Fiscal rules accompanied by "gate keeper" intergovernmental councils/committees provide a useful framework for fiscal discipline and fiscal policy coordination.* In this context, one can draw upon industrial countries' experiences with 'golden rules', Maastricht type guidelines and 'common budget directives' to develop country specific guidelines. To ensure voluntary compliance with the guidelines, appropriate institutional framework must be developed. Transparency of the budgetary processes and institutions, accountability to electorate and general availability of comparative data on fiscal positions of all levels of government further strengthens fiscal discipline.

- *The integrity and independence of the financial sector contributes to fiscal prudence in the public sector.* To ensure such an integrity and independence, ownership and preferential access to the financial sector should not be available to any level of government. In such an environment capital markets and bond rating agencies would provide an effective fiscal policy discipline.
- *To ensure fiscal discipline, governments at all levels must be made to face financial consequences of their decisions.* This is possible if the central government does not backstop state and local debt and the central bank does not act as a lender of last resort to the central government.
- *Societal norms and consensus on roles of various levels of governments and limits to their authorities are vital for the success of decentralised decision-making.* In the absence of such norms and consensus, direct central controls do not work and intergovernmental gaming leads to dysfunctional constitutions.
- *Tax decentralisation is a pre-requisite for sub-national credit market access.* In countries with highly centralised tax bases, unrestrained credit market access by sub-national governments poses a risk for macro stabilisation policies of the national government as the private sector anticipates a higher level government bailout in the event of default and does not discount the risks of such lending properly.
- *Higher level institutional assistance may be needed for financing local capital projects.* This assistance can take the form of establishing municipal finance corporations run on commercial principles to lower the cost of borrowing by using the superior credit rating of the higher level government and municipal rating agencies to determine credit worthiness.
- *An internal common market is best preserved by constitutional guarantees.* National governments in developing countries have typically failed in this role.
- *Finally, contrary to a common misconception, a developing country institutional environment calls for a greater degree of decentralisation and more rapid implementation of ROME than needed for an industrialised country.* For an efficient working of a centralised bureaucracy, advanced information gathering and transmittal networks, an efficient and dedicated civil service, and well developed institutions of citizen participation and accountability are needed. This is possible in the setting of an industrialised country environment. A more primitive public sector environment is more suited to a decentralised form of governance with focus on bottom up accountability for results. This is because information requirements and transaction costs are minimised by moving the decision-making closer to people who are affected by those decisions. Closeness also serves to enhance better participation, preference matching for public services, transparency and greater accountability.

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## Comments

### *1.*

I very much agree with Mr Shah's proposition that the state has become too small for the big things and too big for the small things. Let us take the first half of the proposition "too small for the big things". Certain types of action should now be performed by global institutions. But these global institutions are not here, perhaps not yet. We have liberalised trade, we have freedom of trade in goods and services and free capital and technology flows, but we have not created the global institutions to deal with the fallout of these problems. Some people here have talked about the lag of morality behind institutions. I think the problem is much more one of the lag of institutions behind technology and behind the liberalisation of trade and capital flows. I would like to illustrate the need for global institutions by one example. We are now playing negative sum games in which everyone loses. Japan, with a large current account surplus, now invests largely in the capital richest countries of the world, in the United States and Europe, at the risk of devaluation and inflation. We have large unemployment and underutilised industrial capacity in the OECD countries, particularly of Europe, which is a clear waste. And we have underutilised, unskilled, and semi-skilled manpower in the developing world. Now if we could recycle the Japanese current account surpluses to the capital-hungry countries of the developing world instead of to the capital-richest countries of Europe and America, that would be in everybody's interest. It would be in everyone's interest to have a global institution, a global investment trust, which would carry multilateral government guarantees of the surpluses against devaluation and perhaps inflation. It would be of interest to the Japanese who would have safe investment because they would be guaranteed. It would be in the interest of the European countries, which now suffer from large-scale unemployment, because most of this money would be spent on the exports of the OECD countries and it would remove the balance-of-payments constraint on their expansion and their full employment policies. It would clearly be in the interest of the developing countries, like Pakistan, which are greatly in need of capital and which would benefit from this additional capital. And it would be in the interest of the world, which could resume higher growth without being worried by running into balance-of-payments difficulties.

Three types of surplus, now wasted, would be brought together in the interest of world expansion; the current account surpluses of Japan, the surplus industrial capacity and skilled manpower of the rich countries, and the surplus underutilised manpower of the developing countries. I could go on talking about similar institutions such as the need for a global central bank which would provide liquidity for global trade or a global environmental protection agency which would coordinate efforts to look after the global environment. Again we are now playing a negative

sum game because we do not have global institutions to look after issues like global warming, the pollution of the air and oceans, or biodiversity. A global institution for migration of people, for commodity price stabilisation, for coordination of large-scale investments, for global health problems, would all be desirable. I could go on. And I do not mean more international bureaucrats with glass-plated buildings and coifed secretaries, but rules and norms. Some of the functions could be taken on by existing institutions. So much about the first half of what Mr Shah quite rightly regrets: that we do not have global institutions to correct for the fact that the nation state has become too small for large thing.

Now let us look at the other half. There are a lot of interesting remarks in the paper on the need for decentralisation with which I agree. But there are also points where I would disagree. I detect an excessively romantic, excessively glamorous idea of the decentralisation of government.

May I remind you that here in Pakistan, in the 1960s, you had a form of decentralisation to what were then called Basic Democracies. But this did not give more power to oppressed poor peasants, but to the big local landlords who continued to grind the faces of the poor, even more than they had before. What one would need is a combination of central government action with empowerment of the poor. The poor in Pakistan would then have had countervailing power against the local élites, who otherwise took over the decentralised government. If in the USA you were concerned with the fate of the poor blacks in Mississippi, you would not delegate power to the state of Mississippi. You would go in for central legislation and a powerful Supreme Court and at the same time empower the poor blacks of Mississippi.

Another difficulty about decentralisation is that it can lead to greater regional inequalities. Again, central action is needed to correct for these. Rather than cry “decentralise!” we should ask which decisions should be taken at which level and in which sequence. If you intend to decentralise, you should not confine it to local government but also decentralise by mobilising the civil society. NGOs can contribute to more popular participation.

On globalisation, an additional point needs to be made. What has happened is not full globalisation, but partial globalisation of the rich and powerful in the developing countries. This globalisation, this very partial global integration of the élites, has led to national disintegration. The élites in countries like Pakistan or Bangladesh or India have their medical and surgical treatment in the clinics of the rich countries of the world. They send their children to the schools and universities in the rich countries. They spend their holidays and do their shopping in the rich countries. They invest their money in the stock exchanges of the rich countries. Interest in capacity-building for local, domestic social services, for local schools in, say, Pakistan, or for local health services lags; these get neglected in the process. In this way, international (partial) integration leads to national disintegration.

Another point of concern is the “brain drain”, the emigration of professional, educated manpower to the rich countries. Pakistan suffers a lot from such brain drain. But more important and neglected is another aspect. In order to prevent even more skilled manpower from emigrating, you have to pay them something not too much out of line of what they would get abroad. At the same time, the frontiers abroad are closed to the unskilled workers who are in surplus supply. As a result, egalitarian incomes policies in countries like Bangladesh or Pakistan become impossible. Once again, partial global integration (of the élites) leads to national disintegration.

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## 2.\*

Paul Streeten in his incisive comments made important points with respect to the danger of strengthening the power of local landlords through decentralisation and also the prospects of increased regional disparities resulting from devolution of power to the regional level. When you look beyond the excitement of current globalisation, it is clear that perhaps the greatest, the most intense form of globalisation that the world has known is the one that started when the Industrial Revolution matured and you had a globalised process of capital accumulation within the context of colonialism. In the period from 1817 to 1940, there was the greatest export of capital from Europe to the rest of the world, and equally the greatest transfer of profits from the developing world to the developed world in that period. There was probably an unprecedented restructuring of the economies of many of the developing countries as they converted from self-sufficient producers to exporters of raw-materials. There was also the restructuring of society and culture. So when one is talking about globalisation, I think one needs to exercise a certain caution and not present it as a completely new phenomenon.

However, having said that, clearly, globalisation in the contemporary period has a number of rather interesting features which distinguish it from the earlier period, and which also ask for a new kind of global and local action. It is obvious that the magnitude of capital transfers has become very large and the speed of such transfers has become extremely fast. Similar is the speed of transfer of new kinds of product, which often does not have any weight and does not occupy any space—the electronic products, very high-value knowledge-intensive products which may cross the country very quickly.

Then, there is the role that skilled person power can play in changing the destinies of the countries, and the way this skilled manpower enters the highly mobile, almost abstract new commodities, things like software.

Now, one of the major consequence of these particular features in the contemporary world is that globalisation has tremendously increased the influence of certain countries. At the same time, it has damaged a large number of people in the developing world, as we witness the phenomenon of mass poverty in the 20th century. It has marginalised 50 percent of the world population that lives in the large poor

\*The above comments are the edited version of an oral presentation by the commentator as transcribed from an audio recording of the session.

countries. It is really the global institutions and the structure of global economic system that I am concerned about. When one is talking about building new institutions at the national level, one needs to point out that new institutions perhaps also need to be built at the multinational level to come to grips with national phenomena. In this regard, two obvious issues arise. One is the phenomenon of debt servicing. Debt servicing perhaps has become more important now than at any other time in the history of the global economy. Debt servicing has become a major mechanism of transferring both financial and real resources from the developing to the developed world. I say "real" in the sense that is illustrated by the following example. Take sub-Saharan Africa and large parts of Pakistan and India. When these countries are induced to increase their foreign exchange earnings through the export of agricultural raw materials, they forcibly use their very fragile soils more intensively. And when it has been done over time, it has rendered large areas of the developing world's soil infertile. For example, in sub-Saharan Africa, we find the impact of famine as a result of overuse and depletion of soil affecting some 35 million people. We have a similar acute condition in Pakistan today, where you have declining input productivities in agriculture, and declining use of major crops, both of which phenomena are rooted in the loss of nutrients in the topsoil. So this phenomenon of globalisation, which, while it is being celebrated, also has a down side, and we really need to think of building multilateral institutions which could reverse these transfers of both financial and real resources. At the moment, the major multilateral institutions that we have in place are designed to do exactly the opposite. They are designed to transfer resources out of these poor countries rather than bring them back in.

Paul Streeten's proposal is an extremely timely one that we need to build perhaps new global environmental protection agencies, and divert the Japanese balance-of-payments surplus to the developing world; certainly. The other point that is interesting in Dr [Anwar] Shah's paper is that national governments focus much more on skill development and on enhancing the skills of the labour force. In a world where most value-added products are consumed in the advanced industrial world, this development would really amount to transferring scarce capital resources partly through brain drain and partly through provision of this knowledge as inputs into products which are consumed in the West. So, it would become a mechanism of transferring scarce capital resources from the developing to the developed world unless you create institutions within the national economy through which the secondary multiplier effects of skill development and skill use could accrue to the developing world. Nadeem-ul-Haq has done some work in this field, on how the phenomenon of brain drain can actually play the role of capital transfers in growing inequalities between these countries. We need to focus on this, and on building institutions through which developing countries can enjoy the secondary multiplier effects of skill development

within their own economies and for their own people.

Another issue that I think requires a comment on Dr [Anwar] Shah's otherwise extremely fertile and provocative paper is the idea that liberalisation is sort-of negatively correlated with welfare expenditures in a broad sense of the term. The point is: Is there an institutional basis for this negative correlation at the global level? If you look at the history of the advice which the World Bank and the IMF have rendered over the years through their conditionality programmes, it is very clear that they requested many developing countries to reduce the budget deficit through the reduction of public expenditure. Historically, these programmes have not been accompanied by proposals on how to accelerate the GDP growth. They may be coming to it now, late in the day, but historically the real emphasis has been on the reduction of public expenditure. Now, given the power structure in many of the developing countries, a proposal for reducing public expenditure really transpires into reducing development expenditure; because, given the sources of power of the élites in these countries, there has been a reluctance to reduce non-productive expenditure on their own bureaucracy, military, and so on. So they ended up reducing development expenditure. If we look at Pakistan, for example, our development expenditure as a percentage of the GDP has declined from something like above-7 percent in the 1970s, to less than 7 percent in the 1980s. It is less than 3 percent now. As economists, we often under-estimate the impact of this reduction on employment and poverty. Historically, the public sector, regardless of being inefficient and incompetent, has been a major source of employment generation. We need to talk about changing the structure of power in these developing countries in such a way that they can reduce the budget deficit through the reduction of non-productive rather than productive expenditure. And this brings me to perhaps what I think is the essential absence in the paper—the issue of power. When we talk of things like Result-oriented Management and Evaluation systems, and look at them in terms of a set of ideas, or as a concept, it is an extremely attractive proposition. But when one is looking at implementation, you come face to face with the power structure, i.e., point to it for exactly the opposite service considerations from the ones which Dr Shah proposed in Rome (Result-oriented Management and Evaluation). If you look at the past experience of Pakistan, and many other developing countries like India, Sri Lanka and Bangladesh, our system is predicated on channelling state funds to rent-seekers, and this is done through a notion of power which is predicated on creating patron-client relations. The basis of patron-client relations is the basis of establishing and maintaining power. So, to propose that you set up something like a Result-oriented Management System, under these circumstances, is to threaten the world power to produce and reproduce in these countries. That is why the whole issue of power structure needs to be looked at. I shall not go into the two aspects of decentralisation which Prof. [Paul] Streeten dealt with so well. But I would like to conclude with this table which Dr [Anwar] Shah has produced,

which shows a strong correlation of governance quality indices and decentralisation. He is using this evidence to bring forth the argument that you should have decentralisation in the abstract, completely ignoring the power aspect of it. I would like to see the sample on the basis of which the correlation has been drawn. If Dr Shah had selected a sample of countries where there was a symmetric local power structure and decentralisation occurred, my suspicion is that the correlation in such countries would move the other way.

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