Strategic Management for Government Agencies

An Institutional Approach for Developing and Transition Economics

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Strategic Management for Government Agencies

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Navin Girishankar
Migara De Silva

The World Bank
Washington, D.C.
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Foreword

During the past decade and a half, the World Bank, in partnership with member countries, has pursued reforms of state institutions and public administration in recognition of the changing role of the state in market-oriented economies. With the publication of the World Development Report 1997: The State in a Changing World, the World Bank clearly articulated the notion that “institutions matter” as a significant determinant of a country’s development prospects. This paper uses this institutional perspective to develop a framework for the strategic management of government agencies in developing and transition countries.

The paper argues that strategic change in government agencies is a process by which line managers continually seek to align core strategy, internal organizational design, and external environment. It first provides a working model of an efficient government agency that allows managers to identify areas of misalignment, which then become the basis for Bank-sponsored interventions. In helping managers realign government agencies, the paper recommends that the Bank employ three sets of instruments -- incentives, information-processing institutions, and coordination mechanisms. Finally, it illustrates how managers in client countries can systematically consolidate efficiency gains by mobilizing appropriate stakeholders, enforcing broad checks and balances to enhance transparency, and establishing system-wide change agents. Certain new aspects of institutional reform, namely information processing, are highlighted and will prove useful to Bank operations and policy research.

The paper should be of interest to all those concerned with the role of institutions in the development process, public management in developing countries, and the effectiveness of external development assistance in general.

Ruben Lamdany
Manager, Country Evaluations and Regional Relations
Operations Evaluation Department
Abstract

This paper presents a conceptual framework for the strategic management of government agencies in developing and transition economies. The framework, which integrates the New Institutional Economics, Management Theory, and Public Choice Theory, also models strategies for providing development assistance in the form of agency-level interventions for public sector management (PSM). In the past, PSM interventions such as civil service reforms and administrative restructuring, were largely linear policy actions that failed to stress the consolidation of desirable policy outcomes. However, in recent years, the Bank and its clients have started to realize that strategic change in government agencies is an iterative process, which requires an intervention phase as well as a consolidation phase.

For the intervention phase of Bank-supported projects, the paper first delineates a working model of an efficient government agency for which core strategy, internal organizational design and external environment are aligned or in equilibrium. The paper demonstrates how the objectives of PSM interventions are ideally based on assessments of "areas of misalignment" in government agencies. Misalignment of government agencies results from a variety of institutional factors inter alia special interests, information-processing institutions, and path dependencies. Increasingly, the Bank and client governments are demanding diagnostic tools that measure these variables.

In realigning government agencies, line managers and donors can use three types of instruments -- incentives, information-processing, and coordination mechanisms -- for achieving strategic change. However the sustainability of strategic change depends on a deliberate and distinct strategy of consolidating interventions in PSM in government agencies. A manager’s capacity to consolidate reforms depends on stakeholder support, checks and balances that enhance transparency and accountability, as well as system-wide technical support for agency-level change initiatives.

For policymakers, researchers, and operational staff, the ideas presented in the paper should spark an important debate on the ramifications of strategic management in the public sectors of developing and transitional economies. The ultimate value of the framework will be determined by the Bank’s ability to develop diagnostic tools and instruments that affect change on the ground. Furthermore, some new concepts introduced in the paper such as information processing institutions (IPIs) require substantive research on topics that the Bank and other donors must inevitably address in the years ahead.
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I. Introduction

After nearly fifteen years of experience with Bank-supported administrative and civil service reforms (CSRs), efficiency and effectiveness in the governments of client countries remain elusive goals. Yet, there is growing awareness on the part of the Bank and its clients that public sector management (PSM) interventions are necessarily iterative processes. PSM is comprised of a broad range of interventions from CSR to service delivery innovations. As it evolved rapidly across OECD and developing countries, PSM began to pose a major challenge to multilateral development banks (MDBs) and other interested parties. The challenge MDBs face is to develop a generalizable model for the development of state institutions that can be employed with a high degree of quality, conceptual rigor, and client-focus.

While deriving a general field theory for PSM may be unrealistic, defining a set of rigorous principles for the strategic management of public organizations in developing countries is both desirable and urgently required. In fact, on-going prescriptive and evaluative research by the Bank’s PSM unit, regional departments, the Economic Development Institute (EDI) and now, the Operations Evaluation Department (OED), has sought to glean lessons from past OECD experiences as well as Bank interventions in developing and transition economies. Well-known OECD experiences from New Zealand and Australia as well as bold developing country initiatives, namely those in Singapore, Hong Kong, and Uganda, have stimulated demand for further development of PSM interventions. Furthermore, cutting-edge knowledge from emerging fields such as the neo-institutional economics, transaction costs economics, and public choice theory are profoundly influencing the next generation of PSM policies. All these trends point to the need for more rigorous modeling and empirical analyses of strategic management in the public sectors of developing and transition economies. The World Development Report 1997: The State in a Changing World, which represents the most comprehensive policy document of its kind, has laid a foundation for future policy research across a wide variety of public sector issues as they relate to economic development. In this regard, a great deal of conceptual work remains to be done improving the outcomes of Bank-supported PSM interventions.

The main purpose of this Discussion Paper is to affect improvements in the microeconomic aspects of Bank-supported PSM in developing and transitional economies. Specifically, the paper proposes a model for the strategic management of government agencies in developing countries that explains the mechanisms of enhancing efficiency and effectiveness at the micro-level as well as necessary ingredients for catalyzing and consolidating these gains at the macro-level.

In recent years, the micro-level focus of some Bank interventions to improve public sector agencies (e.g., tax and customs administration) has increasingly been the subject of deserved critique. Among the many problems with an exclusively agency-focused PSM strategy is the lack of sustainability of efficiency gains. However, even
those interventions with a “systemic-focus” have produced mixed results both in terms of short term and long term improvements in the efficiency of state institutions. This suggests that systemic PSM interventions by themselves are not feasible alternatives to agency-based ones. Furthermore, institutional development of the State is a complex task that requires the harmonized application of micro and macro-level instruments. In other words, entrepreneurial managers in line agencies cannot realize and consolidate strategic change unless senior decisionmakers create an enabling environment at the systemic level.

Even as the Bank develops its strategic framework for comprehensive public sector reforms, it should continue innovations and improvements in its agency-focused strategies for several reasons. First, increased technical efficiency in a reformed agency or department represents an island of success that senior decision-makers can use to create demonstration effects for other public sector agencies. Second, the limited focus of such interventions gives decisionmakers greater room for experimentation with lower political risk than those associated with comprehensive reforms. Furthermore, experimentation affords public sector entrepreneurs within an agency the chance to learn strategic management by doing. Finally, in cases when the costs of systemic reform of the core public sector are overwhelming, agency-based interventions can help build the capacity and institutional knowledge in operational units (i.e., agencies) to manage systemic change when it does arrive.

With this in mind, Section II begins by defining the broad parameters of an evolving model for strategic management of public sector agencies in developing economies. Section III introduces the notion of strategic alignment popular among management theorists for the strategic management of public sector agencies. This includes a conceptual framework for aligning an appropriate core strategy, internal organization and external environment and identifying areas of misalignment within the agency in question. The section also highlights three sets of instruments -- incentives, information processing and coordination instruments -- that match realignment strategies as well as a methodology for setting a realistic implementation strategy based on the analysis of transaction costs. Section IV, on consolidation capacity, argues that agency-level gains in efficiency and effectiveness have to be supported at the systemic level in order to be sustained. We introduce a methodology that Bank staff and senior decisionmakers in client countries can use to discern their role in encouraging and sustaining incremental efficiency gains in public sector agencies. Finally, Section VII highlights areas for future PSM research that build on the ideas presented in the paper.
II. The Bank and Public Sector Management

Over the past fifteen years, a wide variety of Bank interventions attempted to improve the effectiveness and efficiency of the public sector. At various points in time and in different regions, these interventions have been rather loosely labeled as CSR, administrative restructuring, public sector adjustment, and so on. Despite their lack of consistent nomenclature or design framework, the Bank's use of new and more nuanced PSM policy instruments has grown steadily over the past fifteen years. First generation interventions, covering the 1981-86 period, focused primarily on realizing efficiency gains by cutting CS size and wage bill. By the 1987-1993 period, second generation interventions began to cover a broader range of micro and macro-level concerns such as organizational restructuring, training, recruitment, and pay reform. By 1993, the third generation of PSM support aimed to affect institutional change through legal and regulatory reform, anti-corruption and good governance strategies.

This expansion of Bank-supported PSM instruments is part of a larger trend in central and local governments around the world. In particular, Anglophone countries of the OECD -- most notably Australia, New Zealand, and to a lesser extent the UK and US -- have already made significant financial, technical and political investments in the New Public Management (NPM). The Bank has experimented with some NPM measures such as performance-based compensation in select client countries (Ghana), however, the feasibility of these measures require more thorough investigation. The rapid advance of new PSM instruments imported by the Bank to developing countries, while welcome, has not been matched by an equally rapid development of an analytically-sound strategic framework for PSM reform that is fashioned to the particular set of politico-institutional and economic realities in developing countries.

Demand for such a PSM framework is already in great demand as the Bank and other donors increasingly identify the development of state institutions as a vital component of their assistance strategies in developing countries. In fact, given the relatively poor performance record for Technical Assistance Loans (TALs) on public sector management (PSM), the Bank and other multilateral agencies cannot afford to delay in operationalizing a strategy rooted in cutting-edge theory and international best practices.

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practice. According to a recent review of TALs, the primary lending instrument for such interventions, an average of 52% of PSM TALs were rated unsatisfactory as compared to an average of 36% for TALs overall.\(^5\) If the Bank is to realize high returns to PSM activity, the design and implementation of these projects have to be significantly improved.

The first step in this direction is to arrive at some vision for the ideal life cycle of a PSM intervention (or any Bank intervention for that matter). In the past, policymakers of first generation PSM interventions such as CSRs assumed that linear policy actions with limited objectives would be sustained automatically, without a distinct strategy to consolidate reforms. The overriding objective of fiscal deficit reduction was probably partially responsible for the scant attention given to consolidating CSRs. In the face of repeated failures to limit the size of the public sector over time, policymakers became increasingly amenable to the notion that systemic reform of the public sector was more emphatically a question of changing the rules of the game than simply achieving fiscal savings. Changing and legitimating institutional arrangements that govern operational agencies of the public sector requires that decision-makers (i) design interventions and then (ii) actively consolidate the resultant efficiency gains.\(^6\) Whether at the agency-level or the systemic-level, development assistance to state institutions in client countries requires cyclical policy actions. A cyclical policy action is comprised of an intervention as well as a consolidation phase, both which are deliberately and strategically planned by public sector change agents.

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\(^6\) Girishankar, 1997.
effectiveness while negotiating an ever-changing environment.\textsuperscript{7} This paper attempts to provide the conceptual tools required to enhance strategic capacity. To this end, the paper defines a working model of a Pareto-optimal public sector agency; helps systematically identify areas in which strategic change is necessary; and finally, provides a methodology for building both agency-level and systemic capacity to consolidate efficiency gains.

Substantively, the framework for PSM intervention and consolidation is grounded in those schools of thought which have made a significant impact on the fields of organizational strategy, public sector reform and modern corporate strategy. These are the \textit{New Institutional Economics} (including \textit{Agency Theory} and \textit{Transaction Cost Analysis}), \textit{Managerial Economics}, and \textit{Public Choice Theory}. In supplementing this neo-institutionalist perspective, the framework also uses stakeholder analysis in order to help managers appreciate and capitalize on the politics of institutional change.\textsuperscript{8}

\textsuperscript{7}This definition of strategic capacity builds on that which is provided by Allen Schick in his assessment of New Zealand's reforms. Allen Schick, "The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change," Wellington, New Zealand: State Services Commission, 1996.

\textsuperscript{8}The discussion of the manager's role as a political actor in Section IV grew out of our discussion with Rogerio Pinto.
III. A Pareto-Efficient Public Sector Agency

Before decision-makers can determine how an agency should be reformed, they must first have some normative model that explains how organizations maximize efficiency and effectiveness. In this section, we describe a model for an efficiency-maximizing department that is supported by a series of analytically-sound arguments from different schools of thought.

Our model turns on the idea that an organization maximizes its operational efficiency when internal structures and systems are fashioned around its core strategy. This principle is widely accepted in corporate strategy and modern theories of firm behavior. Over the past two decades, this notion has been increasingly applied with success to non-profits as well as public sector organizations. Similarly, a working model of a Pareto-optimizing public sector organization is operationally meaningful in terms of increasing the strategic capacity of senior decision-makers to align mission and organizational design with a dynamic external environment. The notion of strategic alignment will be revisited after our discussion of the three layers of an efficient public sector agency -- namely (i) identifying a core strategy, (ii) institutional arrangements between principals and agents, and (iii) process design and the organization of work.

Issues of strategic capacity can be categorized as both substantive and institutional. Substantive considerations are primarily concerned with defining the content of PSM interventions or addressing the question of what interventions should entail. In so doing, substantive considerations can provide models for senior decisionmakers to rationally plan the strategic management of government agencies. However, the availability of substantive models for determining the scope of PSM interventions does not automatically render planning either rational or strategically sound. To the contrary, strategic management of CSR requires appropriate pre-existing institutional arrangements that provide incentives for decision-makers to use substantive models that are “consonant and supportive of achieving better [PSM] outcomes.” While the issue of pre-existing institutions is beyond the scope of this paper, Section IV does propose institutional arrangements during and after implementation that increase the probability of better outcomes.

Strategic Alignment

Alignment of the core strategy, internal organizational design, and external environment is required for a public sector organization to maximize both its operational efficiency as well as its effectiveness (see Figure 2). The strategic triangle, commonly used in management theory can help conceptualize this dynamic equilibrium. For this, we require a definition of core strategy, organizational design and external environment that is easily understood by policymakers and entrepreneurial managers.

Core strategy refers to the purpose or mission of a particular agency. The question of whether every agency has a clearly definable mission may be contentious in some core public sector organizations. However, for the vast majority of service delivery and even some policymaking bodies, the concept of a core strategy or even a relatively vague mission provides the basis for group cohesion, ethos among public servants, and a conceptual framework for strategic managers.

Organizational design is comprised of the processes and organizations of work that enable public servants to fulfill the core strategy of the agency or department in question. Finally, the external environment of a public sector agency is rather complex and should not be oversimplified. It includes the consumers of the organization’s direct outputs as well as the stakeholders within and outside the public sector who authorize the department’s existence and mandate. Such stakeholders could be interest groups, beneficiaries or consumers of an agency’s services, the legislative and executive branches, the head appointee of the ministry in which the department is housed, etc.
Managers should be able to achieve an equilibrium in the relationships between external environment and core strategy, core strategy and internal organizational design, and organizational design and external environment. Three conceptual building blocks -- a taxonomy of outputs, P-A arrangements, and organizations of work -- help managers do this for each of these relationships respectively.

- **External Environment and Core Strategy:** The taxonomy of public sector outputs helps managers derive an appropriate core strategy by clearly defining an output or a particular service. A prior question, of course, is the ability of department heads or even ministers to determine the needs of clientele for particular departments. Effectively assessing the needs of the citizenry depends, in part, on the representative quality of the regime. It also depends on the ability of bureaucrats or technocrats to gauge citizens’ preferences. For more immediate clients, such as other departments or agencies, stronger internal information systems and more effective intra-public sector coordination are necessary.

- **Core Strategy and Internal Organizational Design:** Managers should align the organizational design of their particular agencies with its core strategy by selecting appropriate institutional arrangements between principals and agents. In diagnosing problems in a particular agency, managers should first identify those inappropriate institutional arrangements that prevent internal structure and systems from being aligned with their mission. These concepts, as they apply to strategic change, will be described in greater depth in the following section.
Organizational Design and External Environment: When organizations continually design and adapt processes and organizations of work to evolving core strategies, they essentially align their internal administrative capacity with a constantly changing external environment. In fact, the permeability of different work organizations directly affects the ability of public sector organizations to respond to key stakeholders or adapt to technological and economic change. The internal features such as personnel and human resource systems, in turn, support the permeable design. For instance, lateral hiring of CS cohort with comparable managerial or technical skills will be more prevalent in permeable organizations as opposed to careerist, seniority-based hiring and promotion policies. The permeability of processes and organizations of work to external environments should be appropriate to the particular good or service provided by the department. Certain agencies, by design, are required to be more insulated, while others are better able to fulfill their mission by being more porous.

Box 1. The Building Blocks of a Pareto-Efficient Government Agency

(i) Taxonomy of Outputs
(ii) Efficient Institutional Arrangements between Principals and Agents
(iii) Designing Production Processes and the Organizations of Work

The notion of strategic alignment presented above provides a template for entrepreneurial managers. A more in-depth explanation of these building blocks of a Pareto-efficient public sector agency -- a taxonomy of outputs, P-A arrangements, and organizations of work -- is to follow.

A Taxonomy of Outputs: Linking External Environment to Core Strategy

One of the most effective ways of deriving an appropriate core strategy vis-à-vis a changing external environment is to delineate a taxonomy of outputs for a particular agency or department. In the contemporary lexicon of public sector management, outputs are considered the "direct product of an organization's activities in terms of goods and services." Therefore, the outputs of certain government agencies are inputs for others.

The Outputs vs. Outcomes Debate: In policy circles in the OECD as well as multilateral development banks, there is a growing debate about the relative value of the output-based management strategies in public sectors vis-à-vis an outcomes-based approach. According to conventional wisdom, New Zealand's "outputs-based" public management strategy has prioritized "technical efficiency" at the expense of "allocative efficiency."

12 OECD, p. 158.
Alternately, Australia has opted for enhancing allocative efficiency and effectiveness by installing a financial management and accounting regime that emphasizes outcomes. Rather than view these two examples as diametrical opposites, more recent scholarship suggests that they are merely different points on a continuum. So, the outcomes approach is a more nuanced form of outputs-based management.

Resolving this debate is not the purpose of this paper. However, it does have a direct bearing on our use of the "taxonomy of outputs" as a tool for aligning core strategy and external environment. Suffice to say, both efficiency and effectiveness have been and will continue to be the central objectives of Bank-supported administrative reforms in developing and transition economies. As the theoretical and operational developments in public management in OECD countries begin to impress themselves on developing countries, one issue is highlighted in particular, namely accountability. This requires that public sector managers, particularly senior managers, are held accountable for the performance of their respective departments.

In OECD countries, the push for greater accountability has been one part of a bargain between reform-minded elected officials and bureaucrats. In return for compliance to higher performance standards, managers are given greater autonomy in the day-to-day operations of their agencies. These include hiring, recruitment, purchase of inputs, etc. So in discussing the relative value of the outputs or outcomes approaches for governments in developing countries, we must answer the following question: Which system better enables governments to hold public sector managers accountable for meeting specific organizational objectives?

From this point of view, it is difficult to hold managers in developing countries responsible for outcomes of policies, which are significantly influenced by a number of exogenous factors that are themselves very difficult to measure. For instance, the influence of informal or indigenous institutions on policy outcomes in rural areas is difficult to determine and quantify. Therefore, the outputs-based management strategy appears to be the better method for steering public sector organizations in the Bank’s client countries, where efficiency is clearly a crying need.

As a final note, policymakers should be wary of underestimating the operational and cultural implications of using an output-oriented approach in countries that are still aspiring to the Weberian ideal of a traditional, input-based bureaucratic regime. Defining outputs in government agencies necessarily implies changes in performance appraisal, evaluation, budgeting, and even the nature and quality of government information. It is easy to see how information on government performance can profoundly change public discourse in developing countries. Specifically, greater awareness of government

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operations provides a pretext for beneficiaries to demand more customer-oriented service delivery. Stakeholder support for greater access and quality in service delivery could in turn fundamentally affect the legitimacy of the state. After all, the move towards specifying outputs in the public sectors of OECD countries emerged from growing public dissatisfaction with the quality and effectiveness of public services.  

**Defining Outputs:** Even if public sector reformers agreed to the desirability of enhancing accountability through output-based public management, they would be left with the difficult task of conceptualizing and operationalizing an outputs-based regime such as New Zealand’s. Traditionally, difficulties in defining the goods and services of government agencies have led to a variety of costing and monitoring problems. Public sector managers have to exert significant efforts trying to attribute different labor and capital costs to various outputs. Furthermore, under performance-based systems, managers will be increasingly pressured to measure the marginal contribution of a given worker in the production of a public good. These costing and monitoring issues are often even more unwieldy in core policymaking and coordination agencies than in service delivery agencies.

In addressing these definitional issues, some rapidly reforming governments in OECD countries, most notably New Zealand, have employed a set of powerful conceptual tools for identifying and classifying public sector outputs. The ultimate aim of using these tools is not only to establish incentives for the production and provision of these outputs but to maximize the intensity of those incentives for any particular output.

One of the most useful ways of defining outputs is to define according to high and low levels of contestability and specificity (see Figure 3). This approach to defining public sector outputs suggests that the analogy of the firm has been one of the major contributions of organizational or managerial economics to PSM. A very brief explanation of the implications of two schools of organizational economics -- Agency Theory and Transactions Cost Economics (TCE) -- will explain their respective

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18 Robert Laking, “An Approach to Public Management Reform,” PSM, World Bank, 1995, p. 12. Laking borrows this classification system from Israel (1987). Picciotto (1995) uses “excludability” and “subtractability” as criteria for classifying outputs. However, this formulation is essentially the same as the “contestability” and “specificity” criteria offered by Israel (1987). For purposes of our strategic CSR decision model, we use the contestability/specificity criteria for purposes of clarity.
contributions to public sector reform. Both schools of thought assume that all organizations -- economic, political and social -- are comprised of a series of explicit (legal) and implicit (informal) contractual arrangements between the factors of production, i.e., principals and agents. In a public sector department or agency, for instance principal-agent (P-A) contracts exist between elected officials and political appointees, political appointees and senior civil servants, civil servants and public servants, or even bureaucrats and temporary workers.19

Agents are contracted by principals to perform a particular function such as the production of a good or service in a firm or the provision of a particular public sector service. These functions ideally derive from the core strategy of the organization and are consistent with the principals of strategic alignment discussed earlier. The process of contracting agents is potentially rife with conflicts between principals and agents due to ex ante and ex post information asymmetry such as adverse selection and moral hazard respectively. Agency theorists and TC economists are concerned with minimizing the problems that principals face in hiring agents (ex ante P-A contracts) and then holding them accountable to the terms of the contract (ex post P-A contracts).

These problems primarily involve the dangers of opportunism due to asymmetric information before the signing of contracts and moral hazard during the implementation of the contract. In limiting these uncertainties, agency theorists have focused more narrowly on selecting and motivating particular agents while TCE thinkers have sought to identify the optimal governance structures that minimize the transactions costs of production and exchange within organizations.20 Put simply, TCE teaches that certain types of transactions, particularly those associated with lower levels of uncertainty and risk of opportunism, are undertaken most efficiently under contestable or market-based arrangements. Contestable contractual arrangements are possible here precisely because the production and provision of the service can be specified and monitored by the principal with relative ease. Other types of transactions, which are generally plagued with higher levels of uncertainty ex ante and ex post the negotiation of contracts, tend to require rules-based hierarchies given difficulties in specifying and monitoring performance.

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The ability to specify or define an output with precision in the general absence of barriers to entry for alternate providers (i.e., contestability) is the normative basis for the specificity-contestability matrix presented above. Highly contestable goods are generally those with lower barriers to entry and therefore, a diversity of potential suppliers competing with each other in any one or all of the sectors (public, private, non-profit). For instance, in the United States, legal representation is a highly contestable output because of the high number of practicing lawyers per capita. The growing number of "policy professionals" such as economists and other social scientists enables policy research and advice to become a highly contestable good. Specifiable outputs are those which can be readily defined. Such outputs are usually easily monitorable and defined clearly in unit terms such as the number of reports published or number of passengers transported by bus. They can also be defined by a clear objective such as collecting garbage or processing tax returns.
It is important to note that the determinants of specificity and contestability such as the ability to define outputs, barriers to entry, levels of uncertainty (i.e., general levels and those specific to a contract) are both exogenous as well as endogenous. To the extent that these are exogenous, they are part of the external environment illustrated in the strategic triangle (see Figure 2). In this way, the classification matrix for outputs strategically aligns a public sector department’s core strategy with its external environment.

By systematically ranking public sector outputs so as to place normative value on high specificity-high contestability goods (e.g., Type I as opposed to Type III or IV), public sector managers are better able to define what they want and in turn, agents will have a better idea of what is expected of them. Clarifying these terms before negotiating P-A contracts helps limit problems of ex ante information asymmetry or adverse selection. The next step then is to identify appropriate institutional arrangements or contracts between principals and agents that limit ex post information symmetry or moral hazard. Put simply, public sector principals want to limit the uncertainty that agents will not abrogate their end of the bargain.  

Efficient Institutional Arrangements between Principals and Agents

Departmental managers or any other public sector principals require institutional arrangements that best signal the success or failure of agents in carrying out the department’s core strategy, i.e., the production and provision of certain outputs. Institutional arrangements that are appropriately aligned with the core strategy are the building blocks of efficient organizational design. Given the varying levels of contestability and specificity, each type of output has a corresponding type of contractual arrangement that best signals institutional performance.

- **Type I** (high contestability - high specificity) outputs are most easily subjected to competition and “competition surrogates” in the production and provision of public goods. The market mechanism signals the failure of agents to perform at levels required by the contract. In addition, competitive contractual arrangements force public entities to face the threat of going out of existence. In order to survive, these public entities, like private firms, innovate processes, systems and structures to continually perform at higher levels of quality and efficiency.

- **Type II** (low contestability - high specificity) outputs require regular monitoring and auditing, which are made relatively easy because of the high specificity of these outputs.

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21 Israel, p. 48.

22 Ibid, p. 100.
• **Type III** (high contestability - low specificity) outputs, on the other hand, have specification problems which can be limited by institutional mechanisms such as professional norms and rigorous publicly-mandated standards.

• **Type IV** (low contestability - low specificity) outputs should be produced under institutional arrangements that account for both low specificity and low contestability. Generally, a CS requires bureaucratic, rules-based arrangements that arbitrarily define the output that an agent is to produce. In addition, the voice mechanisms for stakeholders help to signal the performance of agents. Stakeholders may also help policymakers define the outputs as “co-producers” of social sector goods and services (a special case of Type IV outputs).

**Designing Production Processes and the Organization of Work**

Traditional neoclassical theory assumes perfect information and no transaction costs; so a firm is essentially considered a production function.\(^{23}\) As a result, this school of thought says little about the processes that make up the internal structures and systems of a firm or a public sector organization. However, the ground realities of imperfect information, transaction costs, behavioral and general uncertainty, and opportunism clearly require an analytical tool with greater explanatory power. Therefore, a strategic framework for public sector reform in developing countries must necessarily build on the contributions of organizational theory and managerial economics.

Both organizational theory and managerial economics offer numerous insights into **process design** and the **organization of work** in government agencies. This third leg of the strategic triangle enables managers to appropriately organize work to the external environment. In other words, work processes are to be designed in ways that establish the most effective relationships with external stakeholders. For instance, competition or competition surrogates require that public sector organizations are open to and continually sharing information with the suppliers of a particular output. For Type IV non-social sector outputs such as intra-public sector regulation, relevant agencies should be insulated from special interests (and patrimonial influences) that would threaten to undermine the former’s credibility.

For purposes of clarity, we abstract two **stylized** types of process designs or organizations of work -- (i) vertical and (ii) horizontal. Our intention in using these stylized examples is not to produce a formulaic approach to public sector reform. However, a stylized approach will enable us to demonstrate how processes can be designed to maximize effectiveness and efficiency of an organization’s internal design.

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\(^{23}\) Williamson notes that “economizing [in neoclassical economics] takes the form of efficient choice of factor proportions, while issues relating to the organization of work mainly involve economizing on transaction costs. The latter rarely surfaces, much less are prominently featured, under the production function approach.” Oliver Williamson, “The Organization Of Work: A Comparative Institutional Assessment,” p. 293.
Vertical Processes and the Taylorist Work Organization: Many public sector organizations have traditionally undergone vertical processes in the provision of outputs. While some of these processes are no longer appropriate for certain outputs, there are many cases in which hierarchical arrangements are justified on grounds of efficiency and effectiveness. First, a description of such processes and their benefits is required.

In vertical or hierarchical production processes, a senior manager or chief executive generally relies on a pre-determined blueprint to specify the marginal contribution of junior staff or casual workers within a particular department. Each worker’s task is distinct and separated from those of other workers in the functioning of the department. The individual worker or public servant is expected to master a particular task and therefore perform the task more efficiently over time. In this way, a department reaps benefits in terms of uniformity of output and economies of scale that derive from what is essentially an assembly line approach. Variability or inconsistencies in processes and functions within a public sector department are mitigated by hierarchical arrangements that ensure adherence to blueprints.

It is also worth recognizing that what Taylorist approaches gain in terms of consistency, they lose in terms of adaptability and innovation because the “knowledge content” of each worker’s marginal contribution is limited to the isolated task they are performing. Process innovation is necessarily slower in vertical processes because a decision to change the blueprint can only be made by a senior manager, whom Frederick Winslow Taylor viewed as essentially an ‘engineer’. Information about production problems generally has to be relayed through layers of hierarchy from the front-line to the top of the department in question. At that point, a senior manager decides on an alternative blueprint, which he or she operationalizes through a new set of directives.

At any rate, the Taylorist work organization’s use of a hierarchical authority in defining and controlling processes as well as its deliberate restriction of permeability indicates its appropriateness for low specificity-low contestability outputs. Outputs that require predictability and uniformity in provision are non-social sector Type IV outputs such as budgeting, regulation, etc. For instance, budgeting is a core function that would benefit from hierarchical processes that are uniform, predictable, and consistent over

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24 Social choice theory and the “Sen Paradox” in particular, demonstrate that Pareto efficient outcomes are not possible when some groups or individuals have informational advantages vis-à-vis others. Put simply, the “Sen Paradox” shows that any organization that delegates decision-making authority to more than one subset of individuals will experience either incoherent behavior or inefficiency for some combination of individual preferences (Sen, 1970; 1976). For an application of this principle for Organizational Behavior, refer to Miller (1992).
time. Empirical evidence verifies that the most efficient budgeting systems in developing countries are usually subject to hierarchical and transparent systems of control.25

Box 2. Taylorism and the Progressive Movement in the United States

The modern hierarchical bureaucracy in the public sector, particularly in the US, was historically influenced by Taylor's ideas of "scientific management." According to scientific management, the ordinary work of an organization was to be studied on 'time and motion' principles so as to break down the work into easily learned tasks. The idea was successfully applied in the mass production economy of the early to middle twentieth century US, when Taylorist work organizations were able to "produce very long runs of identical or nearly identical items." 1

Borrowing the principles of Taylorism from the industrial sector, reformers of the Progressive Movement in the early twentieth century rapidly expanded public sector organizations -- from federal agencies to public schools -- in order to efficiently mass produce many different public sector goods and services for a rapidly expanding US population. It is important to note that the Progressives argued for Taylorism as a strategy that would insulate rational public sector managers from vested interests, politicization, and corruption. In other words, Taylorism in the public sector was a precursor of the modern theory of technocratic management, which argues for the effective reduction of a public sector organization's permeability to its external environment.


Horizontal Processes & the Networked Work Organization: A growing body of literature suggests that flatter production processes and networked organizations typically emerge in the context of an intensely competitive external environment. It is no coincidence that many "high performance work organizations" in globally-competitive high tech or manufacturing markets are made of flatter and more collegial production processes. The need to constantly incorporate best practices and to benchmark performance vis-à-vis market leaders requires that high performance organizations be permeable to outside people, ideas and clientele.26 Permeability itself affects internal organization as noted above. As opposed to vertical processes that stress predictability and uniformity of output, horizontal processes -- decentralized decision-making and managerial autonomy -- are designed to capitalize on the adaptability, flexibility, and the rapid rate of innovation that derive from a highly competitive external environment. Such arrangements demand greater accountability from managers, who in turn are forced to negotiate a continually changing external environment.


Another feature that distinguishes vertical and horizontal processes is the "knowledge content" of the marginal contribution of a given worker. As noted above, in hierarchical organizations, the knowledge content is limited by strictly defined, repetitive job tasks. Alternatively, in flatter processes and "networked" organizations, there is a greater emphasis on learning by doing. The interactive and learning aspects of work allows for variability (i.e., increases) in the knowledge content of a worker’s marginal contribution to the department’s functions over time. This is operationalized in a number of ways. Workers are organized in teams that collaborate, innovate, and share ideas as they produce a good or service. In other words, “rules of the game” provide incentives for workers to train each other and mentor younger workers.27 It does not end there. In more advanced networked organizations such as Volvo’s production facilities, each worker comes perform and therefore understand virtually every other job within the “production process.” Emerging information technologies increase such opportunities as they level the transaction costs of team work within a firm or a public sector agency.28 The benefits of collegial organizations of work are clear when rapid innovation is an inherent part of the organization’s success.

Table 1. Institutional Arrangements, Process Design, and Work Organization

<table>
<thead>
<tr>
<th>Output</th>
<th>Institutional Arrangements</th>
<th>Process Design and Work Organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type I</td>
<td>Competition</td>
<td>Horizontal (Networked)</td>
</tr>
<tr>
<td>Type II</td>
<td>Reporting and Audit</td>
<td>Horizontal/Vertical</td>
</tr>
<tr>
<td>Type III</td>
<td>Professionalization and Standardization</td>
<td>Horizontal/Vertical</td>
</tr>
<tr>
<td>Non-social sector</td>
<td>Bureaucratization,</td>
<td>Vertical (Taylorized)</td>
</tr>
<tr>
<td>Type IV</td>
<td>Reporting and Audit</td>
<td></td>
</tr>
<tr>
<td>Social sector</td>
<td>Stakeholder Management</td>
<td>Horizontal (Networked)</td>
</tr>
</tbody>
</table>

From the point of view of public sector reform, the lessons of networked, high performance work organizations in the private sector are invaluable. Just as the

27 Ibid.

28 Ibid, p. 52.
Progressives argued for the creative adoption of scientific management’s techniques by national, state and local governments in the early twentieth century, future-oriented reformers have ample reason to argue for a similar absorption of industry’s best organizational practices by state in late twentieth century. Clearly, all public sector organizations will not be able to simply replicate the organizational design of a globally competitive, high performance work organization. Nor should they attempt to do so especially if the institutional arrangements are not consistent with their particular core strategy and external environment. Having said that, it is important to note that ideas such as permeability (with all its implications for organizational design) have proven and will continue to prove beneficial for public sector organizations that are attempting to improve both efficiency and effectiveness. The evolution of the flatter, networked organizations in highly competitive environments suggests that their organizational design is well-suited to Type I outputs (high specificity-high contestability) that are most efficiently produced by using competition or competition surrogates.

There is, however, a twist to this story and that concerns certain Type IV outputs. Social sector goods are a special case of Type IV goods. While they suffer from low contestability and specificity, they paradoxically require a level of sensitivity to human development which hierarchical bureaucracies have often failed to provide. A much more permeable organization with necessarily interactive processes of production and provision affords the sensitivity that social-sector Type IV goods need. More porous institutional arrangements should facilitate participation and ownership by the beneficiaries or consumers of these outputs. For instance, in many developing countries, governments are increasingly planning and implementing educational, health, and environmental services in collaboration with rural NGOs and civic organizations. When hierarchical, rules-based arrangements fail to satisfactorily specify social sector outputs or signal the performance of the agents, “co-production” by external stakeholders and public servants has proven more effective. This requires public servants in social-sector agencies to evolve work organizations that utilize a network of co-producers in the planning, implementation and monitoring phases of output provision.

The Question of Culture: Clearly organizational design is not simply a question of redefining institutional arrangements or contracts between principals and agents. A more realistic framework should take note of the myriad informal institutional arrangements that support and inform questions of organizational design and reform. Professional ethos, conventions of loyalty, and the overall organizational culture make up the various institutional arrangements that govern various modes of provision such as competition, standardization or bureaucratization. Ideally, norms and informal rules should reinforce incentives provided by formal systems and structures. For instance, Taylorist organizations of work such as those associated with budgeting or regulation will evolve

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29 Our discussion of the “paradox of Type IV goods” grew out of a conversation with Arturo Israel, April 1997.

professional norms that emphasize loyalty to seniors and vertical lines of control because these cultural factors provide consistency to uniform, repetitive functions that engender regulation and budgeting with credibility and predictability. It is likely that civil servants in these regulatory bodies will take on the traditional, hierarchical roles to ensure consistency with the rest of the core public sector and establish vertical quality control process throughout the agency they manage.

Similarly, networked public sector agencies that produce social sector Type IV or Type I outputs will evolve norms that emphasize the modern managerial ethos that provides greater flexibility in return for increased productivity. Rather than relying on loyalty to hierarchy and senior civil servants, public employees are likely to consider themselves free-floating professionals with a set of transferable and marketable skills as well as a code of ethics that is applicable to a variety of settings. In other words, skilled public servants are likely to identify more strongly with the professional norms of technocrats (or in the case of the social sector, with a broad range of stakeholders) rather than a particular senior manager.

Networked organizations that are more permeable to their external environment experience their own set of stresses. They will have to devise additional mechanisms to ensure consistency and loyalty to the core strategy of the organization as they attract public servants who have already adjusted to a more flexible labor market for their skills. For instance, the increased incidence of competitive, lateral hiring in New Zealand has coincided with increases in the amount of time and resources allocated to inculcating newly-hired public employees with the expectations of their particular department and the government. Increasingly, formal arrangements such as Work Improvement Teams are being used to routinize collegial, networked interactions between public servants. Singapore was the first country to create public sector analogs to the private sector’s employee involvement organizations (EIOs). These public sector EIOs allow staff from varying levels to discuss problems of quality and then cooperatively devise strategies to improve the efficiency and effectiveness of their particular output or service. Other countries such as Malaysia, India, and Botswana have followed Singapore’s lead in employing institutional arrangements that formalize and reinforce the cultural implications of networked work organizations.

A related concern for reforming governments and more specifically their Ministries of Public Service is the need to socialize civil servants in ways that capitalize on this new drive towards accessibility to clients and openness to competition. Any civil service or public service ethos built around greater permeability will have to find new ways to inculcate some notion of the ethics of public office, the common good, or the national interest. In general, public sector reformers will have to be cognizant of the

31 Based on a discussion with Nick Manning, Economic Development Institute.

types of stresses, strains, and requirements that organizational redesign places on loyalty, norms, ethos and culture within their departments and agencies. The significance of institutional arrangements that fall under the rubric of organizational culture only increases when we deal with organizations that occupy the “mushy middle”, i.e., in between either the Taylorist or Networked extremes.

**Hybridized Processes and Work Organizations:** Public sector organizations in this “mushy middle” typically produce and deliver neither Type I nor Type IV outputs. According to the logic of this framework, the production and provision of Type II and III outputs are the ones most likely to be governed by hybrids of Taylorist and Networked work organizations.

We established that Type II or high specificity-low contestability goods are best produced using P-A arrangements such as reporting and auditing. Since they have no competitive arrangements that enhance efficiency or signal performance, Type II outputs are best produced using efficient vertical processes and Taylorist work organizations to generate economies of scale. In addition, Type II outputs such as the processing of tax returns generally need to be uniformly and consistently produced to ensure equity and impartiality to the citizen clientele. Hierarchical arrangements provide that uniformity, but their provision must be transparent in order to ensure proof of impartiality or equal treatment. Transparency is best realized by rigorous reporting and auditing to signal the performance of public servants who are producing Type II outputs. Managers can capitalize on the high specificity of these outputs to setting up effective audit and monitoring systems.

Type III or low specificity-high contestability outputs require a distinct organizational design. Their contestable nature avails Type III outputs such as policy advice to competitive or market-oriented P-A arrangements and therefore, flatter processes. To a great extent, the production of outputs and services such as policy advice or legal representation are more effective in collegial and collaborative work environments. This is particularly the case when the government is not only regulating the competition in the provision of the outputs, but is also a participant in that competition. Under these circumstances, a department’s own employees may bid for a contract and therefore, will be forced to outperform and underbid their private sector competitors (see the example of the Phoenix city municipality’s garbage collection function). New competitive pressures on public sector departments are akin to (albeit less intense) those faced by high performance work organizations. Innovation is required to increase the efficiency of production processes. Managers, faced with the threat of external competition, are likely to opt for flatter processes that reduce the time required to innovate front-line operations.

The key feature of the Type III is the difficulty in specifying, defining and evaluating their performance. For example, in the case of government consulting services or policy advice, which use flatter processes for production, managers will have a difficult time defining precisely what the service is and therefore, determining whether
the quality of policy advice was in fact satisfactory. In addressing this definitional problem, managers and policymakers should establish *publicly-mandated standards* for the content and performance or quality of outputs. Standards-setting and standards-enforcement functions within a public sector agency also plays a significant role in shaping the culture and ethos that affects the public servants in question. Similar to other forms of regulation, standardization generally requires a centralized, highly cohesive authority that can guarantee uniformity, predictability, and credibility in the standard-setting process. So the production of a Type III output such as policy advice is a case where flatter production processes for competitive service delivery (i.e., the use of consultants) are tempered by hierarchical systems of quality control such as policy coordination unit under the Prime Minister’s Office.

For certain Type III outputs, professionalization can serve as a partial replacement for hierarchical enforcement of publicly-mandated standards. For example, healthcare is highly professionalized with its own code of ethics, standard operating procedures, independent institutions for doctors, nurses, public health specialists, and medical technicians. The need for safety and public health standards will clearly exist, but is tempered by the enforcement of rules and professional standards germane to healthcare providers such as doctors, nurses, therapists, etc. The same is true for public legal representation, another Type III output, whose specification problem is limited in part by the historical development of the legal profession, which has its own set of norms, ethics, and conventions. Professionalized Type III outputs afford more room for networked or collegial work organizations to evolve because the traditional core public sector standards setting bodies play less of a hands-on role.

Production process and organizations of work are the means by which public sector organizations not only fulfill their functions but also align with their external environment. Work organizations determine the type of interaction (including the type of information exchanged) between citizen-clients and public employees of a particular agency. The appropriateness of organizational design shapes the quality of a government agency’s relationship with the primary beneficiaries of its services.

*The State After Outsourcing?* Having described a model for an efficiency-maximizing public sector department, it is worth making a larger analytical point. There is a prevalent notion that after a variety of public services have been outsourced, the remaining “irreducible core” state or public sector will be inherently hierarchical. Another popular view is that contracting out service delivery functions will essentially render the State obsolete. Both these views obscure a great deal of complexity. First, the model presented above does, however, speak to design questions within the core. A great diversity of non-hierarchical and hybridized arrangements could emerge over time within the public sector. Second, curtailing the State’s role in direct provision of goods and services does not render it irrelevant or even less relevant. Contestable arrangements

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33 Picciotto, p. 11.
such as bidding and tender require the State to play a more effective and active role in standardization and regulation. Both these functions, like all other aspects of strategic alignment, clearly require significant capacity. Research into short and long range policies to enhance this strategic or alignment capacity of entrepreneurs and senior managers in the public sector is currently being conducted by various members of the Bank’s own PSM consortium and should be developed as quickly as possible.
IV. Determining the Scope of Interventions

The model of an efficiency-maximizing public sector department presented above turns on the notion of strategic alignment. From this basic analytical viewpoint, the scope of PSM reforms will be significantly shaped by the areas of misalignment between a government agency's core strategy, internal organizational design, and external environment at any given point in time. The aim for Bank operational staff and line managers in client countries to (1) identify types of misalignment (i.e., inappropriate processes vis-à-vis core strategy) in an agency, (2) ascertain the reasons for the persistence of misalignment over time, and (3) chart out a realistic set of objectives for intervention.

Areas of Misalignment

Pinpointing the areas of misalignment is relatively self-explanatory and basically requires a strategic audit of a particular department's core strategy, organization design, and external environment. In fact, periodic strategic audits provide a means of identifying opportunities for achieving Pareto optimality in public sector agencies.

The function or purpose of a service delivery agency changes over time in response to evolving external conditions such as technological change, private sector development, fiscal crises, or different types of political pressure. Realigning core strategies with a changing external environment essentially speaks to the need to reclassify outputs within the specificity-contestability matrix discussed earlier. Our efficiency-maximizing model places normative value on high specificity-high contestability or Type I outputs (see Figure 4). So reformers can achieve Pareto optimal outcomes with regards to organizational mission by identifying opportunities to increase either specificity or contestability in ways that maximize the number of Type I outputs provided by the department in question.34

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*Figure 4. Changing Outputs*

<table>
<thead>
<tr>
<th>Type II</th>
<th>Type III</th>
<th>Type IV</th>
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</thead>
<tbody>
<tr>
<td>Increasing Contestability</td>
<td>Increasing Specificity</td>
<td>Increasing Specificity and Contestability</td>
</tr>
</tbody>
</table>

34 This introduces a measure of dynamism into Laking's and Israel's original formulation of output classification.
Take the example of Type II and IV outputs, which are difficult to subject to competition or competition surrogates. In the early 1980s, the city of Phoenix, Arizona embarked on several bold experiments in competitive service delivery of public goods. Garbage collection, a low contestability-high specificity (Type II) output, was historically provided by local city government. Phoenix city government’s monopoly over garbage collection proved to be both inefficient and expensive relative to other cities of the United States. The tax revolt of the late 1970s and early 1980s placed severe fiscal constraints on cities like Phoenix. These new pressures forced city planners to identify opportunities to increase efficiency in the delivery of services. In this context, they considered privatizing the collection of trash since private firms in the area had proven to be much more cost effective.\(^\text{35}\)

At the same time, city officials recognized that wholesale privatization could involve abdicating the local government’s mandate to maintain public standards for trash collection. So, they devised a plan by which public sector garbage collectors would participate in competitive bids with private companies for fixed term contracts. While it is important to recognize the impetus that fiscal crisis gave for introducing competition in garbage collection, the institutional capacity of the city was also a key factor in establishing these “new rules of the game.” For example, the city government required the capacity set new formal and informal rules for comparing competitive bids as well as granting or revoking contracts. Finally, the identification of inappropriate P-A arrangements governing service delivery as a source of misalignment between core strategy and organizational design was fundamental to the overall reform.

Over time, even some Type IV goods can be subjected to significant reclassification. In the United Kingdom and United States, public education has undergone clearer product definition and enhanced competition in service delivery. While public education still cannot be considered a Type I good, policy entrepreneurs in the US have been using a variety of methods to artificially stimulate a competitive service delivery system while maintaining high and common standards for learning. The “charter school” movement is one such experiment that has gained popularity in over 20 states (see Box 3).

Reformers in local school districts in the US are increasingly experimenting with “charter schools.” Under such an arrangement, any public entity such as a municipality can charter a public school organized by teachers, parents and other community members. According to the terms of these contracts, “charter schools” have to meet performance and content standards within a certain time period. Performance standards and content standards are meant to limit the specification problem in public education. For instance, the main component of performance standards is the average level of student achievement as measured by standardized examinations.

In addition, by allowing other public entities to charter public schools, this new system breaks the school board’s historical monopoly over public education. A chartered school district operates on the basis of open enrollment. So students are free to attend any public school and the “money follows the student” as per pupil expenditure. In this way, a measure of contestability is introduced as schools compete to attract increased numbers of students (and a larger budget) by performing at higher levels. Students and their parents are then attracted to the best performing schools. In turn, schools that do not meet performance standards lose their charters and turned out of the market. In this sense, public education moves closer to a Type I good. Its actual classification depends partially on the success of performance standards and the ability of charter schools to mimic a competitive market.¹


Causes of Misalignment

Misalignment, which is essentially a form of inefficiency, occurs when the taxonomy of outputs, P-A contracts, and organizations of work are not mutually reinforcing. In such cases, institutional arrangements may not be appropriate to the type of output an agency or department is sanctioned to provide.

Country experiences as well as a vast academic literature in public administration, public choice theory, management theory, and the various neo-institutionalist perspectives have provided a wealth of insight into the political economy of institutions and institutional reform. For the purposes of this paper, we have crystallized a list of key variables influencing the strategic capacity and alignment of public sector organizations such as agencies and departments (see Box 4).
Special and Vested Interests: The notion that vested interests within and outside the state can undermine the capacity of public sector institutions to maintain both efficiency and effectiveness is not novel. This has been a consistent argument in the study of political economy. However, in the last two decades in particular, the significant academic and political antecedents of Public Choice Theory have generated a revival of critiques of the bureaucratic state's tendency to create and perpetuate vested interests that hinder the evolution of efficient and effective systems of governance. Some Public Choice theorists have been particularly concerned with the role of self-interested bureaucrats -- vested interests within the state -- who may undermine the democratic character of the state over time.

This discussion is relevant to the public sector reform model because it notes the tendency of vested bureaucratic interests to either directly or indirectly resist strategic alignment initiatives such as outsourcing production of Type I outputs such as road maintenance. Resistance to alignment from within the public sector can be manifestations of the desire to protect turf, maintain patterns of formal and informal exchange, or reproduce advantageous power dynamics within or across agencies. Resistance to change from the outside can be equally formidable as special, highly vocal interests have a stake in maintaining certain policies and therefore, the implementing agencies for these policies. For instance, domestic producers of textiles may organize in favor of protectionist trade policies such as quantitative restrictions on imports. They would accordingly resist PSM interventions in customs and licensing agencies that would enhance efficiency and transparency. At any rate, the overall effect of successful resistance is the persistence of inefficient modes of production and provision for particular outputs. Potential gains in efficiency as well as effectiveness (such as the relevance of a particular output to beneficiaries) are foregone.

The academic literature on the bureaucratic politics is vast and beyond the scope of this paper. Suffice to say, this particular cause of misalignment should eventually be incorporated into the implementation strategy for PSM interventions. Often, co-optation of various bureaucratic interests in the short run is one of the only ways of achieving strategic change (see Section IV).
Information Processing: Major theoretical developments in the economics of institutions and information have increasingly compelled policymakers to devise strategies that strengthen state institutions by reducing transactions costs and improving the availability of relevant information to various stakeholders. Public sector entrepreneurs should be cognizant of the transactions costs associated with institutional change itself. The transactions costs of strategic institutional change, while difficult to measure, are influenced by the availability of relevant information for managers, workers, and other stakeholders.

According to North (1990), “the information that entrepreneurs receive and the way they process the information” shapes the perceptions of potential entrepreneurs in private and public sector organizations. These perceptions in turn shape entrepreneurs’ decisions to affect changes in the “existing institutional framework.” From this vantage point, we argue that policymakers should consider the notion of information-processing as an important determinant of entrepreneurs’ ability to identify the need and opportunity for change.

For purposes of both theory and policy, we make a deliberate distinction between information processing institutions and organizations (IPIs & IPOs). This distinction, which at first may seem overly semantic, is based on the NIE view that institutions constitute “rules of the game.” Institutions provide incentives for the evolution of structures or socio-economic groupings, namely organizations, that enforce (and potentially change) these rules. If IPIs are the formal and informal ways in which information is processed, then IPOs are the processors of the information. Identifying IPIs and strengthening IPOs can help stakeholders (i.e., citizens, elected officials, senior bureaucrats, and entrepreneurial line managers) measure the performance of public sector agencies.

In designing interventions to support IPOs, members of a reforming government’s aid consortium should be cognizant of (i) the types of information available to public sector employees and their clients and (ii) the ways in which information is processed. Ex ante assessments of IPIs & IPOs should eventually become standardized components of the institutional environmental assessments (IEAs) proposed in the Bank’s Africa

36 North, p. 8.

37 We derived the notion of information-processing from Professor Douglass North’s analysis, in Institutions, Institutional Change, and Economic Performance, of entrepreneurs’ mental models as factors influencing institutional change. After further discussions with Professor North, we defined information processing institutions and information processing organizations as potential tools for policymakers in both OECD and developing countries.

38 For a more in-depth discussion on the importance of accountability and transparency in consolidating reforms, please refer to Section IV.
In addition, the Bank and other donors should consider developing systemic *information processing strategies* as part of institutional reform agendas. These information processing strategies should essentially focus on limiting information asymmetries between principals and agents.

### Box 5. Information Processing Institutions and Organizations

<table>
<thead>
<tr>
<th>Information Processing Institutions (IPIs)</th>
<th>Information Processing Organizations (IPOs)</th>
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<tbody>
<tr>
<td>• Informal Learning</td>
<td>• Mentoring Arrangements</td>
</tr>
<tr>
<td>• Interactive Learning</td>
<td>• Team-based Tasking of Work</td>
</tr>
<tr>
<td>• Monitoring and Evaluation</td>
<td>• Auditing and Evaluative Bodies</td>
</tr>
<tr>
<td>• Publication of Performance Results</td>
<td>• National Performance Review Agencies</td>
</tr>
<tr>
<td>• Demand-driven Analysis of Policy and Government Operations</td>
<td>• Think-tanks, Research Institutes</td>
</tr>
<tr>
<td>• Client and Consumer Feedback</td>
<td>• Watchdog NGOs and Private Firms</td>
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</tbody>
</table>

**Informal Institutions:** Historically, development policy has assumed that formal institutions have a greater impact on organizational performance than informal rules. Implicit in this argument is the view that changes in formal rules directly shape changes in informal rules. While theoretical and empirical work on formal rules of committee formation in Congress supports this notion, the relationship between formal and informal rules is not unidirectional. Informal norms within government agencies in developing countries often provide more powerful incentives or disincentives to performance than do formal rules.

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40 In Section IV, we introduce the idea of designing interventions that enable the development of *information processing markets (IPMs)* that produce and analyze information regarding public policy and the performance of public sector agencies. This notion is relevant to accountability and transparency enhancing measures. The historical development of IPMs and their role in improving the quality of governance in OECD countries warrants further investigation and research.

This is especially true of many post-colonial public administrations around the world where the official Weberian rules of bureaucracy coexist with informal patrimonial relations. For instance, tender and bidding procedures for service delivery contracts may be governed by formal rules intended to maximize cost efficiency and product quality. Nevertheless, public sector officials managing the bidding process may favor NGOs or private firms that are owned by members of their own clan, caste or extended family with little regard for efficiency and cost criteria. Therefore, in identifying the causes of a public sector department’s misalignment, decision-makers should conduct a patrimonial profile of the institutional environment in question.42

**Mental or Conceptual Constructs:** NIE recognize the power of ideas in influencing the actions of entrepreneurs change agents. As noted earlier, entrepreneurs within government agencies influence the “rules of the game only after they identify appropriate windows of opportunity. North (1990) argues that mental constructs or mental models strongly shape entrepreneurs’ abilities to identify windows of opportunity and reform institutions to enhance efficiency and performance. In fact, North attributes the failure to capitalize on opportunities for institutional change to the skewed perceptions or inappropriate mental models of potential change agents.43 One of the most important aspects of development policy is shaping the ways key stakeholders think, i.e., influencing the ways in which they learn and acquire knowledge. Ideally, MDBs should introduce ways of learning or processing information that positively influence the evolutionary path of institutions take over time.

The mental or conceptual constructs of senior public managers and civil servants can be discerned by observing public statements, interviewing high-level policymakers and civil servants, reading political platforms, and finally through policy dialogue with the Bank and other multilateral agencies. Effective ways of influencing the mental models and conceptual constructs of potential reformer in client governments include non-lending activities such as economic and sector work (ESW), intense training sessions in policy analysis, presentation of rigorous cross-country analyses to senior policymakers in the reforming governments, joint research projects with indigenous research institutes, as well as effective articulation of ideas via the popular press and media. Ultimately, conceptual models for public sector reform should be continually updated and vigorously incorporated in the Bank’s lending and non-lending services.

**Path Dependencies:** Finally, path dependencies are the consequences of small events or chance circumstances that shape a particular historical process. Certain path dependencies increase the transaction costs of organizational change.44 For example, the

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42 Pinto, p. 19.


44 North, p. 93-4.
colonial regimes fostered professional ethos among civil servants that stressed the importance of maintaining law and order while maximizing the efficiency of labor and resource extraction. This ethos was reflected in colonial civil servants' relations with the citizenry. Suffice to say, notion of a "customer orientation" in the delivery of services was alien. In post-colonial societies, the path dependencies of state-society relations do restrict the emergence of a public service ethos based on demand-driven principles of modern public management. In any case, historical analyses of public sectors explain in part the reason why misalignment of public sector organizations are reproduced over time. In addition, reformers who are cognizant of path dependencies are likely to develop more complete and realistic reform strategies.

Setting Reform Pace: Accounting For The Transaction Costs Of Change

A key aspect of any public sector reform is setting an appropriate pace for realignment. Even if we assumed that areas of misalignment were correctly identified and the scope of reforms determined, a department may not have the institutional capacity to absorb change. To a great extent, an organization's capacity to absorb change is determined by the transactions costs associated with that particular institutional or organizational change. Reformers, who propose to reclassify outputs or redesign organizations of work, should account for these costs in determining realistic reform pace. The notion of permeability, discussed earlier, provides some insights into how reformers can predict the ability of their agencies or departments to internalize the transactions costs of change.

At one end of the spectrum, the high degree of permeability typical of "high performance work organizations," fosters a change-friendly ethos in networked work organizations that support the provision of Type I outputs. Such organizations have effectively institutionalized the lower levels of transactions costs associated with change. Consequently, open or permeable public sector organizations like New Zealand's can sustain a higher reform pace within a relatively shorter period of time.

At the other end, low permeability, associated with Taylorist work organizations for Type IV, non-social sector outputs, generates an ethos that prioritizes uniformity and conservatism. Interaction outside these pre-determined lines of vertical control carry very high transaction costs (see Table 2). When reformers do attempt to change such hierarchical departments within a short period of time, they tend to face significant implicit and explicit resistance. Policymakers are then forced to adopt a more gradualist approach to reform.


46 Tapscott, 1996.
Table 2. Setting Reform Pace & Accounting for Transaction Costs of Change

<table>
<thead>
<tr>
<th>Process Design &amp; the Organization of Work</th>
<th>Transaction Costs of Process Change</th>
<th>Pace of Reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Horizontal (Networked)</td>
<td>Low</td>
<td>Rapid</td>
</tr>
<tr>
<td>Horizontal/Vertical</td>
<td>Low/High</td>
<td>Rapid/Gradual</td>
</tr>
<tr>
<td>Horizontal/Vertical</td>
<td>Low/High</td>
<td>Rapid/Gradual</td>
</tr>
<tr>
<td>Vertical (Taylorized)</td>
<td>High</td>
<td>Slow</td>
</tr>
</tbody>
</table>

Instruments for Realigning Public Sector Organizations

Up to this point, the discussion has focused on developing a set of concepts and a common language that the Bank and other parties can use in planning the reform of public sector agencies and departments. However, the conceptual antecedents of institutional reform have little utility without a range of instruments with which reforms can operationalize reform agendas. Listed below are three types of instruments that entrepreneurs can use to strategically align the public sector organizations that they manage. A more detailed explanation of existing instruments has already been provided in a variety of World Bank publications on pay and employment reform as well as civil service reform. The purpose here is to simply provide an outline of the instruments that managers should employ to operationalize the framework that is the subject of this paper. Since the objective of this paper is largely conceptual, it will not attempt to operationalize the strategic management model in any detail.

Table 3 provides a general outline of the types of instruments needed to operationalize the strategic management model. This outline reflects the influence of the NIE perspective (and therefore, our model), which emphasizes limiting information asymmetries and increasing the intensity of appropriate incentives. Both sets of instruments should be appropriately shaped to support the institutional imperatives of either Taylorist or Networked organizations. Information and incentive instruments, while necessary, are not sufficient to ensure efficiency and effectiveness. In other words, the new managerialist reforms that are sweeping over public sectors across the world, and particularly in the OECD, must still be engendered with a "public" quality. Coordination

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47 A variety of the public sector specialists within the Bank have contributed to a growing body of knowledge on the various instruments that reformers should employ to provide incentives of performance. Notable contributions include work by Lindauer, Nunberg, Schiavo-Campos, and Stevens.
between line managers and central authorities is essential government change processes are to be in line with publicly-mandated standards and objectives.

**Table 3. Reform Instruments: Incentives, Information, and Coordination**

<table>
<thead>
<tr>
<th>Instruments</th>
<th>Creating Taylorized Organizations</th>
<th>Creating Networked Organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wages</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Incentives</td>
<td>Wages</td>
<td>Wages reflecting private sector rates</td>
</tr>
<tr>
<td></td>
<td>* Decompressed wages</td>
<td></td>
</tr>
<tr>
<td></td>
<td>* Rigid job classification</td>
<td>* Flexible job classification</td>
</tr>
<tr>
<td>Recruitment</td>
<td>* Careerist hiring systems</td>
<td>* Greater reliance on consultants and outsourcing</td>
</tr>
<tr>
<td></td>
<td>* Meritocratic entrance exams for civil and public servants</td>
<td>* Lateral hiring</td>
</tr>
<tr>
<td>Culture</td>
<td>* Vigorous socialization of civil servants and public employees to build internal cohesion</td>
<td>* Less stress on socialization; greater emphasis on codes and ethics for mobile “public policy professionals”</td>
</tr>
<tr>
<td></td>
<td>* Ethos dependent on loyalty to hierarchy</td>
<td>* Ethos more dependent on professionalism rather than loyalty</td>
</tr>
<tr>
<td></td>
<td>* Vertical lines of control</td>
<td>* Work improvement teams</td>
</tr>
<tr>
<td>Information</td>
<td>* Internal auditing and reporting</td>
<td>* Consumer surveys</td>
</tr>
<tr>
<td>Processing</td>
<td>* Publication of results</td>
<td>* Greater scrutiny by external IPOs</td>
</tr>
<tr>
<td></td>
<td>* Evaluation by internal bodies</td>
<td>* Decentralized, market-oriented dissemination of information about policy and government performance</td>
</tr>
<tr>
<td></td>
<td>* Centralized dissemination of relevant information</td>
<td></td>
</tr>
<tr>
<td>Coordination</td>
<td>* Rules enforced by centralized ministries through senior civil servants</td>
<td>* Reliance on reporting, regularly scheduled meetings between line managers and secretaries</td>
</tr>
</tbody>
</table>
V. Building the Capacity to Consolidate Interventions

We began with the notion that PSM operations should ideally undergo a cyclical process of intervention and then consolidation. In Section III, we provided a conceptual framework for determining the scope of these interventions. Here we propose a framework for enhancing government capacity to consolidate the efficiency gains from these interventions. This “consolidation” methodology identifies both institutional checks and balances as well as stakeholder relationships that make the strategic management of public agencies possible and sustainable.

In one sense, a government’s capacity to consolidate efficiency gains in line agencies is a function of ex ante commitment to the development of state institutions. Virtually all Bank interventions across sectors are concerned with strengthening state institutions. Only in the early and mid-1990s did the Bank fully recognize that “imperfect commitment” to policy objectives was a major factor in the poor implementation record of development projects.\(^4\) Unfortunately, this realization has been late in coming to agency-level and systemic PSM interventions where issues of “borrower commitment” are arguably most important. Evidence of the complexity of PSM-related Technical Assistance Loans (TALs) in combination with less emphasis on building client ownership have contributed to the highest “projects-at-risk” ratios among TALs overall.\(^4\) Implicitly, a governments’ ability to implement and internalize PSM innovations depends on its early ownership of the objectives of Bank-supported interventions.

Ownership of micro-level PSM interventions requires that client governments understand the political dynamics of strategic change in public organizations. In other words, it demands that the objectives of PSM interventions be clearly linked to political, economic, and bureaucratic interests. PSM experts have increasingly recommended mechanisms that make “adherence” to the new rules of the game (i.e., the rules of strategic management in public organizations) binding.\(^5\) Client governments, and specifically line managers in executing agencies of Bank operations, continue to face a nagging question: how do reformers make the efficiency gains of PSM interventions stick? A variety of answers -- from fostering “strong political will” to using “participatory project identification” -- have emerged over the years. Ultimately, both agency-based and systemic PSM interventions should be designed after a thorough analysis of interests, stakeholders, and political processes.

For this purpose, we have developed a simple three-step process of raising the expectations of stakeholders that PSM interventions will be vigorously implemented. These are (i) identifying opponents, allies, and agents of strategic change interventions,


\(^5\) Ed Campos and Sanjay Pradhan, 1996.
(ii) enhancing transparency to support interventions, and (iii) choosing a systemic change agent to further agency-level change processes across the public sector (see Table 5).

**Box 6. Consolidation Capacity: Building a Ladder of Expectations**

| Step 1. Identifying Opponents, Allies, and Agents of Strategic Change |
| Step 2. Enhancing Transparency to Support Reform |
| Step 3. Designating A System-wide Change Agent |

**Step 1. Identifying Opponents, Allies, and Agents of Strategic Change**

It is widely recognized in the new political economy literature that poorly-timed announcements of policy reforms or any institutional change often enable vested interests to rapidly mobilize in opposition even when the proposed change would result in Pareto efficient outcomes. Similarly, the failure to build ownership of institutional change during the project design stage can also spark the coalition formation among groups that felt excluded or alienated from the reform process. Both ideas can be easily applied to the case of an entrepreneurial manager in a government agency. Whether at a systemic or agency-level, entrepreneurs face the same dilemma of eliciting stakeholder participation in the project cycle for PSM operations without being stymied by opponents of change processes.

For PSM interventions, vested interests such as public sector unions are closer to policymaking bodies and therefore can mobilize with greater speed. Even without formal announcements of PSM reforms, public sector employees are privy to a wide variety of informal flows of information. It is safe for entrepreneurial managers to assume significant opposition from interests within the agency as well as other government workers who fear the spread of “strategic change” fever to other agencies of the public sector. Likely opponents should clearly be identified behind closed doors so as not to alert the opposition. If resources are available, it would be useful for entrepreneurial managers and their ministerial-level allies to model the various scenarios that could result from the politics of strategic change. Even when sophisticated simulation models are

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51 Eggertson, 1990.
52 A clear example of this second scenario was the evolution of the Clinton Administration’s proposed health care reforms of 1994.
not available to line managers, a basic *ex ante* assessment of political support and opposition should prove invaluable.

Entrepreneurial managers and senior-level decisionmakers supporting the overall direction of Bank-supported institutional reform should identify allies, change agents, and opponents. *Allies* are primarily those stakeholders within the bureaucracy who would benefit from a restructured or redesigned department or ministry. Such stakeholders could include younger public servants who would benefit from new performance-based compensation systems such as gainsharing rather than traditional seniority-based policies. Allies could also be identified within coalitions *outside* the bureaucracy who are currently lobbying for reforms across the public sector or in particular agencies. For instance, during the tax revolts of the 1970s and 1980s in the US, broad-based coalitions agitated for significant tax cuts at the national, state, and local levels. These stakeholders were increasingly concerned about the efficiency rather than the absolute levels of public expenditures. In developing countries, growing numbers of middle-class taxpayers, concerned about the efficiency of government spending and the quality of public services, could potentially form similar coalitions. Special interest groups may also form powerful coalitions in opposition to proposed changes in the structure of government agencies if they feel it would affect policy outcomes. For instance, environmental groups may agitate against downsizing measures directed at the US Environmental Protection Agency.

For change-conscious managers, it may be worth taking this stakeholder analysis a step further. To borrow a favorite metaphor of New Zealand’s new public management leaders, Bank-supported interventions can be seen as a series of principal-agent relationships or contracts. On the one hand, senior government officials are the *principals* of a particular type of change process, which their *agents*, i.e., line managers, carry out at the micro-level. Likewise, the objectives of these PSM interventions such as the type of restructuring or numbers of employees to be retrenched can be considered the terms of the contract between reformers and their line managers.

Within government agencies, senior managers are themselves *principals*, who “employ” a series of agents to plan, orchestrate, and consolidate strategic change. This accounts for the popularity of consultants in both private and public sector restructuring efforts. They can be hired to carry out a very specific set of objectives without conflicts of interest. They are agents with one principal, i.e., the senior manager. They can push change agendas in ways that deflect the political costs from the *principals* of these initiatives. This borrows the idea of “*efficient nuclei*” (introduced by Schiavo-Campo), in which a core group of change agents introduce new rules of the game within a public organization as opposed to “enclavists,” who bypass existing institutions. It is advisable that managers ensure that these *change agents* within their agencies are technically-sound and therefore considered objective. Hiring technocrats or specialists for these change adviser roles is advisable in order to depoliticize the change process as much as possible.

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Allies clearly play an important role, which is best left independent of technocratic change agents, who will leave once the process has been completed and institutionalized. Later in our discussion, we expand the "efficient nuclei" idea to an intra-public sector market for efficient nuclei with the power to demonstrate new rules of performance-orientation.

Step 2. Enhancing Transparency with Effective Information Processing

As managers make preparations for strategic change with the support of ministerial-level reformers, they should consider establishing checks and balances (inside and outside a particular agency and bureaucracy at large) that will monitor and reinforce change processes. In the Section III, we argued that IPIs and IPOs influence entrepreneurs' ability to identify opportunities for institutional change. In so doing, IPIs and IPOs have a significant effect on the probability that an institutional framework will evolve towards the Pareto optimal ideal defined earlier.

Our concept of information-processing stands to gain much from the new institutionalist literature on voting. With his "impossibility theorem" (1951), Kenneth Arrow proved that the outcomes of majority-rule voting did not depend so much on the preference of voters as it did on the sequence of votes. More recent work on "structured-induced equilibrium" by Shepsle and Weingast (1981) concludes that the institutional structure of rule-making bodies in Congress limit both the number of alternatives subject to voting as well as the number of voters. The outcomes of voting are determined by the agenda of voting or the universe of choices open to voting, which are in turn circumscribed by those in power.56

Similarly, the developmental outcomes of collecting, processing and disseminating information about a particular government agency are partially determined by the institutional structures governing information processing. To borrow a metaphor from Shepsle and Weingast (1981), IPOs are the "gatekeepers" or agenda setters for the politics of government performance, which have numerous direct and indirect effects on policymaking, service delivery, and governance functions of the state. For instance, the perceived performance of a particular agencies could affect the budgetary allocations it receives in the future. Given these high stakes, IPOs are contested and even politicized arenas where various stakeholders vie to shape the rules of information-processing and therefore, the path of institutional development in government agencies.

In most OECD countries, for instance, political interest groups invest significant resources in shaping the ways in which the media covers issues that have a direct affect on their interests. The well-known roles of "spin-doctors" during political campaigns or press secretaries during an administration's tenure in the US are some of the more overt examples of how stakeholders try to influence IPIs. Less obvious IPIs are those that report on the performance of government agencies and measure the outcomes of policy.

56 Eggertson, p. 67.
These institutions often have a more direct influence on stakeholder perceptions and institutional development than the media. The ways in which audit and oversight bodies, evaluations bodies, and even research institutes process information have major implications for budgetary allocations across sectors as well as within agencies. For instance, the types of indicators used to monitor the performance of law enforcement agencies affect the incentives of prosecutors and federal officers and therefore the public’s perception of the quality of the services they provide.

Despite its present popularity, transparent information in and of itself is not necessarily compatible with sound technocratic decisionmaking and successful PSM interventions. For instance, ill-timed “information leaks” about PSM interventions to the media could jeopardize negotiations between reformers and public sector unions over the terms of restructuring proposals. Alternatively, influential think-tanks could solidify support for interventions by publishing reports, which project that long term efficiency gains of strategic change outweigh the short term costs of administrative restructuring (i.e., severance payments for retrenched workers).

In building government capacity to consolidate PSM interventions, development policy should aim to amplify IPIs that encourage managers to pursue strategic change within public sector organizations. In other words, the processing and dissemination of information about strategic change in government agencies should limit the ability of opponents to frame issues narrowly and form coalitions against efficiency-enhancing reforms. In taking a longer term view, MDBs and client governments should aim to generate a virtuous cycle in which IPIs such as monitoring mechanisms first enable managers to identify opportunities for strategic alignment. Strategic alignment enhances the performance of agencies, which is then evaluated and reported by other IPIs (e.g., evaluation units, operational auditors) to a series of stakeholders including senior bureaucrats, Cabinet ministers, the executive, and the general public.

It is crucial that reformers employ a viable framework to systematically shape how information is made available and processed during a PSM intervention cycle. For this purpose, there are two ways of enhancing transparency or processing information that also broaden and deepen political support for change. **Public reporting** and **evaluation** of interventions potentially enhance an agency’s ability to legitimate and consolidate strategic change initiatives.

**Public Reporting:** Public reporting, when institutionalized, legitimates strategic change processes among various stakeholders within and outside the public sector. It also increases scrutiny of strategic change by a particular manager. Furthermore, publicly reporting aspects of the negotiation between change-friendly managers and their employees familiarizes stakeholders (especially the public) with the key issues and obstacles facing those directly involved. In the process, change-friendly stakeholders’ come to expect that change is imminent.
In that sense, publicly reporting the ways in which reforms were designed as well as the status of on-going PSM reforms is a partial outgrowth of public choice theory and its critique of the bureaucratic state. According to many Public Choice theorists, the tendency of bureaucrats to centralize power in the hands of the state threatens the democratic character of the regime. There is a continuous tension between the special interests of bureaucracy and those of the citizenry. The political economy of administrative reform is concerned about the danger that bureaucrats themselves become vested interests that directly or indirectly resist strategic alignment or the attainment of Pareto-efficient outcomes within public sector organizations.

Entrepreneurial managers often have tremendous difficulties overcoming bureaucratic resistance to change efforts precisely because resistance is not easily identified. Even the most astute manager is not able to comprehend all the complexities of bureaucratic politics. One of the main constraints on managers' ability to understand and direct strategic change is the lack of necessary information about the actions of employees, who are supposed to undergo it. Entrepreneurial managers face a classic problem of information asymmetry vis-à-vis the employees of their respective agencies. On a systemic level, senior bureaucrats, multi-lateral donors, elected officials, and citizens find themselves in a series of principal-agent relationships governing the strategic change of government agencies. All these principal-agent relationships are hampered by the dangers of information asymmetry and moral hazard. Specifically, each group of principals that is closer to the actual change process within an agency enjoys an advantage in terms of access to information regarding the agency’s workers ability align core strategy, internal organizational design, and external environment. If we were to assume that public employees were rational, self-interested beings, then this condition of asymmetric information opens the door for different forms of abuse including the use of change processes to re-establish patrimonial relationships or increase particular units' share of budgetary allocations, etc. Public reporting is designed to create veto points outside a particular agency that limit employees' ability to forge inefficient institutional arrangements over the provision of public goods and services.

Many strategic change processes or PSM interventions involve downsizing bloated agencies. In such cases, public reporting clearly explain the criteria used to decide on numbers of public servants to be retrenched. Stakeholders should also know whether the process of determining these criteria was consultative or unilateral. As mentioned earlier, this type of public reporting generates scrutiny. More importantly, it creates veto points as citizens or clients of an agency begin are better able to form a judgment about the performance of their “agents,” i.e., public employees. Among other things, public reporting raises expectations that agencies will operate more efficiently and effectively. Managers’ failure to meet these rising expectations generates opposition in

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its own right and therefore, raises the transactions costs of not implementing public sector reforms.

**Box 7. Does Agency Theory Help Us Clarify the Types of Information We Need?**

A PSM intervention can be seen as a contract between a public sector manager and a series of change agents within and outside the department. These change agents could be new hires, management consultants, as well as employees of the executive agency responsible for all interventions. Information about the four following issues can be made available, but as noted earlier, revealing such politically-sensitive information may undermine technocratic decisionmaking.

- Principals and agents of PSM interventions
- P-A relations during the granting of intervention “contracts”
- Terms of the intervention “contract”
- P-A relations during and after the implementation of interventions

Consider a strategy for enhancing the transparency of retrenchment policies. First, Principals and Agents of the retrenchment should be clearly identified within a particular department. Revealing the identities of principals and agents to the broader public may lead to political instability. If there were broad support of retrenchment policies, publicity would be a more viable option. Official legislation, press releases, and media coverage are some ways of enhancing the identification process.

Second, *during the granting of “contracts”* concerning PSM interventions, the criteria and methods used for downsizing should be open to the scrutiny of stakeholders. For instance, are realistic budgetary and macroeconomic assumptions used to determine downsizing targets in the CS? Is the process of determining and announcing layoffs consultative or unilateral? After the establishment of a CSR contract, the actual terms of the intervention such as the quantitative targets of a retrenchment or the projected levels of severance should be available to all interested parties within the CS and to the media (under stable regimes).

Finally, information about *the implementation of PSM interventions* should be collected, scrutinized, processed, and disseminated through monitoring and evaluation. Timely feedback from monitoring and evaluation of CSR implementation enables decision-makers to either curtail measures that are likely to fail or continue with vigorous implementation of interventions that show signs of success.

**Evaluation:** Evaluation also limits a line manager’s vulnerability to *adverse selection* before choosing an agent or *moral hazard* after choosing one within his or her own department or agency. Any entrepreneurial manager within a public sector department is likely to face myriad obstacles in implementing interventions such as direct and indirect resistance or others that have been discussed earlier. These challenges, particularly resistance to change or co-optation of PSM interventions, are likely to be more intense and overt in developing countries, where alternatives to public sector employment are few and far between. In order to correct these forms of information asymmetry and hold their employees accountable to intervention objectives, *managers should use evaluation*
within an agency as a way to monitor the progress of change processes. This use of intra-agency evaluation techniques is well-established in governments where managers have a significant degree of autonomy as in the case of Australia. PSM interventions sponsored by the Bank should encourage periodic evaluations by a body outside the agency in question.

For an entrepreneurial manager, evaluation of PSM interventions provides an opportunity for monitoring strategic change as well as catalyzing institutional learning. In addition to manager, senior government officials, and multilateral donors can use evaluation results to identify higher return instruments for affecting strategic change in government agencies. There are many ways to evaluate change processes with government agencies. In the short run, staff surveys, focus groups, and reviews can easily be conducted by the change advisors of the manager. Over time, desirable strategic change should register in increased output efficiency of an agency as well as improved performance of operational units, teams, and individual employees. It is worth noting that emerging information technologies are offering managers new ways for monitoring and evaluating a variety of processes within and across government agencies.

While it takes time for information technologies to be used at the agency-level in many developing countries, there is much room for experimentation. In some cases, elected officials are important allies in encouraging the use of technology to affect change in state institutions. Most of the times, it is as simple as letting public employees know that there are a pair of eyes watching the way they work and how well they perform. For instance, the Chief Minister of Andhra Pradesh has pioneered combined the use of modern telecommunication technology with weekly surprise spot-checks to basically raise the costs for government workers of poor performance or non-performance. With a cellular phone and laptop computer in his possession, Naidu accesses appropriate websites and electronic mailboxes to monitor the implementation progress on development projects across the state. Troubled projects are met with speedy inspections by the chief minister himself. The speed and unpredictability of these inspections has government workers at the very least concerned about the consequences of poor performance.

The Bank itself has gradually focused on the importance of evaluation capacity in borrower governments. OED and Regional departments have begun developing capacity building initiatives for evaluation and monitoring. Focusing these efforts in a central agency such as the Directorates of Aid Coordination under the Ministry of Finance allows borrowing governments to develop information-processing capability in the center. This can then be transmitted and developed on demand-driven basis across agencies to help line managers that demonstrate the leadership to affect strategic change.


**Facing the Reality of Constrained Capacity:** To this point, our discussion of transparency assumes a great deal in terms of a government’s institutional capacity as well as political legitimacy. In countries where Weberian bureaucracies are relatively established, the use of public reporting as well as monitoring and evaluation is viable. In other countries, however, the fragility of formal state institutions (i.e., the public administration, the legislature, and judiciary) raise the stakes of transparency and accountability measures, often rendering PSM interventions politically unpalatable. In such cases, it is simply not feasible to recommend that a government agency employ measures such as transparency enhancement that could threaten the state’s legitimacy.

From a purely technical point of view, transparency measures implemented without adequate institutional capacity and political capital could easily backfire. As a result, reforming agencies could suffer serious setbacks, rendering them as ineffective as they were before PSM interventions were implemented. For instance, in some countries of the LAC region, government agencies have introduced a variety of interventions designed to increase output efficiency and transparency. However, the public outcries in response to reports of corruption generated severe pressures for bureaucrats and public employees. To insulate themselves from these pressures, bureaucrats devised a variety of control mechanisms which became so cumbersome that they undermined the initial objectives of the PSM interventions.60 Such experiences only highlight the need for greater research into the relationship between information-processing and stakeholder support for Bank-supported interventions in general.

Arguably, recommendations to enhance the transparency of state institutions within Bank literature have been primarily exhortative rather than technocratic. This raises the question of incentives for enhancing transparency in developing countries in which the state have been historically insulated from the exercise of voice and exit by formal and informal norms. In these settings, line managers and bureaucrats face strong disincentives against making either operational inefficiencies or corrupt practices transparent. Adverse reactions for clients and citizens could potentially undermine bureaucrats’ status, tenure in public bureaucracies, and more fundamentally, the prevalent rules of the game of service delivery. Rather than simply exhorting public administrations to make operations more transparent, the Bank should approach the lack of transparency of state institutions as a problem of government’s monopoly over information.

**Changing the Way We Think About Transparency:** Much of the literature on transparency assumes that the government is the monopoly provider of relevant information about the performance of state institutions and is mired in a perpetual “conflict of interest” dilemma mentioned above. An alternative approach is to view

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information processing as a service that can be subjected to (and often is already subject to) some form of competition. Ultimately, this approach aims to develop information processing markets (IPMs) in which competitors aim to provide the most timely and accurate information about the performance of state institutions to a diverse clientele, comprised interest groups, professional associations, the private sector, and civil society. IPMs are made up of competing IPOs or firms, most of which operate both inside and outside the public sector.

**Box 8. Bank-supported Information-Processing Market Development**

Catalyzing the development of IPOs would provide an important avenue for building an economy's capacity to limit problems of information asymmetry such as moral hazard in the functioning of government agencies.

The Bank should offer start-up grants (subject to a competitive bidding) to develop IPOs inside and outside the state. The Institutional Development Facility (IDF) Grants could be modified to provide start-up costs to identify and fund IPOs. Technical assistance in the use of information technology, investigative reporting, applied research, and building public opinion could also build the capacity of these nascent organizations. From a political economy perspective, owners and employees of IPOs would have a tangible stake in providing timely and relevant information about operations in government agencies for interested clients. This opens the door for coalition formation between those who run IPOs and those agitating for strategic change of government agencies.

Eventually, the Bank should consider using ESW and adaptable lending instruments for the development of information-processing sectors in developing economies. Sectors such as these would operate like transaction sectors, which are made of firms that sell transaction services to private and public sector buyers.¹


From audit bodies and special commissions to NGOs, professional associations, and think tanks, IPOs investigate, analyze and report on public sector activities. The growth of Internet-based US “firms” can be seen as an example of rapid IPM development. These firms process and deliver information on the performance of government institutions, good governing practices, and emerging policy issues in healthcare, education, social security, worker training, and the environment.⁶¹ The scope for IPM development in developing and transition countries is arguably large given the

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high demand for information about government policies and performance. For instance, private sector growth in these countries is partially dependent on the transparency of regulatory policies and processes. The positive externalities of developing an information-processing sector in the Bank’s client countries promise to be extensive as both public and private sector managers require access to large amounts of information about both the state and market for effective decision-making.\textsuperscript{62}

**Step 3. Choosing a System-wide Change Agent**

The third and final step in building a government's capacity to consolidate strategic change initiatives is to complement agency-based PSM interventions with a system-wide agent to catalyze, monitor, and identify opportunities for strategic change. To conceptualize, implement, and consolidate strategic change from scratch on an agency-basis without investing in central strategic capacity would be short-sighted and inefficient. Furthermore, it does not establish any mechanism by which lessons learned from one agency's change process are recorded and applied to other agencies. As a result, institutional learning from the numerous interventions of donors is never collected or consolidated. The Government's base of knowledge about its own institutions is never built, and is consistently dissipated.

*The objective of the Bank’s PSM work should be to affect change on an agency-basis while simultaneously building central or systemic capacity to affect strategic change where and when it is necessary.* The most direct way of building government’s “central strategic intelligence” about institutional reform is to designate or create a high profile central unit such as the Aid Coordination Unit in the Ministry of Finance or a unit under the Council of Ministers in Eastern European transition countries. As the nerve center of the government for reforming state institutions, this system-wide change agent (SCA) will have the ability to support specific interventions in particular agencies, identify the opportunities for change in other agencies, and finally, serve entrepreneurial line managers who request strategic advice. Armed with the conceptual framework discussed in Section III and specific knowledge of its agencies, the SCA has the potential of providing the “transformative nuclei” to agencies that are undergoing change processes. These nuclei or individual change agents would then return to the SCA, document lessons learned, and build on existing body of PSM knowledge within the government.

While few governments in developing countries have gone as far as establishing an *in-house management consulting facility*, the idea is not so far-fetched. For instance, establishing a SCA under the General Secretary of the Council of Ministers is being discussed in Albania, where the Government lacks any central strategic planning

capacity. Such a measure serves a dual purpose by (i) creating high profile stakeholders, who are change-friendly technocrats, and (ii) building a government’s own technocratic foundations for modern PSM. While creating stakeholders in the SCA that support change processes in line agencies is politically savvy, forming a new bureaucratic interest alone cannot serve any substantive purpose unless it is constituted to deliver sound technocratic advice to entrepreneurial managers.

In that sense, it is useful to think of the SCA as a central, in-house management and strategic consulting unit. Its role include (i) identifying opportunities for reform, (ii) servicing the needs of entrepreneurial managers, and finally, (iii) providing coordination and oversight for PSM interventions overall.

- **Identifying Opportunities for Reform:** Since their “clients” are essentially reform minded senior managers across the public sector, it is logical that the SCA should devote some efforts to identifying agencies, departments, and other governmental bodies that are potential candidates for reform and strategic realignment. A variety of methods could be employed to keep abreast of the needs of various departmental managers. The SCA should be provided the mandate to perform diagnostic work such as strategic audits, manpower audits, and functional reviews of various agencies and departments on a regular basis. This diagnostic work would provide the basis for building a central reservoir of knowledge on the mission, organizational design, and external environments that various agencies face. This vision for the SCA essentially means that it would replace international donors in providing strategic and conceptual support for agency-based strategic change.

- **Serving the Needs of Entrepreneurial Managers:** After receiving the well-publicized findings of the SCA’s diagnostic work, line managers should contract the SCA to conduct more intensive strategic audits and even send “transformative nuclei” to take a “hands-on” approach to strategic change. Eventually, purchaser-provider arrangements between managers and the government’s SCA would provide impetus for the evolution of an internal market for strategic services. The “cost” of SCA’s consulting services should be met on a matching basis. Even when managers are not inclined to do so, the SCA can generate significant pressure for them to adopt efficiency-enhancing change initiatives by periodic publicizing the results of strategic audits of line agencies.

- **Providing Coordination and Oversight for PSM Reforms:** The third type of service that a SCA provides is system-wide coordination and oversight. In other words, it harmonizes micro-level or agency-level change initiatives with system-wide priorities for enhancing efficiency and effectiveness of state institutions. This is done in two ways. First, reporting directly to the executive, the SCA provides up-to-date

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information about the operations of government agencies. It is also able to provide strategic advice about opportunities for system-wide comprehensive PSM reform. The executive can then consider the operational efficiency of government agencies as an important variable in policymaking. Second, as the central liaison for coordinating external assistance on PSM interventions, the SCA will be able to direct external resources to agencies that are either strategically important or likely deliver the highest return to the development dollar. Finally, the SCA serves as an able counterpart to the many donors attempting to fund PSM interventions, often in a supply-driven manner.

Box 9. The Bank’s Role in Building Effective System-wide Change Agents

Clearly, the three-fold role of the SCA outlined above requires a significant investment of resources, time, and technical expertise in building a modern, in-house consulting group to service the needs of public sector entrepreneurs. Whether renovating existing units under the executive or the Ministry of Finance, the Bank can use lending instruments such as TALs or IDF grants to effectively create a “fiercely meritocratic” body of technocrats. These technocrats should be multi-faceted with state-of-the-art training in public management or related fields, experience in government or private sector organizations, and most importantly, willing to take on the often-times unpopular role of change agents.¹


An effective SCA must be technically sound and “fiercely meritocratic.” To make this a reality, the Bank should recommend an aggressive recruitment policy that attracts and develops the best possible in-house experts in public management, public expenditure policy, organizational behavior, institutional economics, and business administration. Clearly, both monetary as well as non-monetary incentives are required to attract staff to jobs that may actually be unpopular in the eyes of most other public servants. A rigorous socialization process for new recruits is absolutely necessary to generate an esprit de corps and loyalty to the SCA mission of strategic change. In most cases, the SCA may have to recruit civil servants and other public servants internally. Such strategies have been discussed in the Bank’s policy dialogue with clients in the past. For instance, in Laos, a reformist government initiated a specialized personnel policy for public servants, who would be specifically used as “CS developers.”²


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VI. Conclusion and Directions for the Future

This paper represents an attempt to develop a neo-institutional framework for modeling the strategic management of government agencies in developing and transition economies. This conceptual framework offers entrepreneurial managers, senior decision-makers, and MDBs working in developing and transition economies the following tools:

- **A Dynamic Model Of A Pareto-Efficient Public Sector Organization**: This model turns on the notion that public sector agencies must strategically align mission, organizational design, and external environment in order to achieve Pareto efficient outcomes for government operations.

- **A Methodology For Setting A Reform Agenda**: By identifying areas and causes of misalignment, managers are able to pinpoint areas that require PSM interventions. In this regard, the framework recommends a variety of institutional assessment tools, which could greatly enrich the quality and scope of the Bank’s lending as well as its economic and sector work (ESW).

- **A Framework for Consolidating Reforms**: Finally, the paper offers a three-step model for developing a government’s capacity to consolidate strategic change. The framework for consolidation notably recognizes the role of stakeholders and the need for checks and balances in sustaining strategic change. By introducing the idea of information-processing, we provide some new ways of conceptualizing oft-cited governance themes such as transparency and accountability. In addition, some of the insights such as information-processing could be readily applied to institutional problems in other sectors.

The primary contribution of the paper is to further develop the Bank’s conceptual knowledge of how efficient government line agencies operate. However, the conceptual framework presented in this paper will realize its full value only after it is tested empirically and then operationalized in Bank lending and non-lending services.

**Testing and Operationalizing the Conceptual Framework**

In the short run, operationalizing this neo-institutional framework is a two-step process. First, the framework should drive a new generation of Bank-sponsored empirical research on government agencies across client countries. Such empirical work should analyze random and purposive samples using the methodology presented in Section III. Case studies would document the existing relationships between mission, organizational design, and external environment in order to identify areas of misalignment. Second, the findings from this diagnostic work, particularly common areas of misalignment in government agencies (and their causes), should provide a basis for Bank PSM strategy for agency-focused PSM interventions. Lending and non-lending services should be designed in accordance with the insights of institutional diagnoses and assessments.
The Bank is currently developing and consolidating its knowledge and expertise in institutional assessment through the Institutional Assessment Thematic Group. Among other things, the thematic group’s work synthesizes the contributions of PSM, participation, social development, and sector policy experts. This knowledge base is designed to serve task managers and other operational staff with best practices for institutional assessment and development. New diagnostic tools developed from our conceptual framework such as strategic audits would support the work of the thematic group in this regard. In turn, the tools could be rapidly disseminated to task managers through the thematic group’s knowledge management system (KMS).

**New Frontiers of Institutional Development**

One of the most important concepts presented here is the notion of information-processing institutions and organizations. While IPIs and IPOs are subject to agenda control like rule-making bodies in legislatures, they are nevertheless crucial mechanisms for enhancing transparency of government processes such as service delivery, budgeting, and regulation. Furthermore, IPIs and IPOs provide a means for enhancing transparency by supporting the development of competitive information-processing markets (IPMs).

These topics comprise largely uncharted territory for policy researchers. The advent of the information revolution has greatly enhanced the role of firms whose primary product or service is processed information. While there has been some research on the “transaction” sector in US history (North & Wallis; 1986), researchers have generally failed to investigate the role of IPIs and IPOs in promoting or supporting economic development. Initial observations suggest that the information revolution is fast transforming the ways in which citizens, businesses, and government interact developed countries. Such changes will only highlight the rudimentary state of research in this area. Insights into the economic value of IPMs could significantly influence Bank operations in countries that suffer from a serious dearth of information either about government or private sector activity. From the point of view of catalyzing rapid economic development, the Bank’s researchers should thoroughly investigate the potential role of international donors to support growth of the “information-processing sector” in developing and transitional economies, where the demand for timely and accurate information about the policies and performance of government is arguably highest.

For policymakers, researchers, and operational staff, the ideas presented in the paper should spark an important debate on the ramifications of strategic management in the public sectors of developing and transitional economies. The ultimate value of the framework will be determined by the Bank’s ability to develop diagnostic tools and instruments that affect real change on the ground. Furthermore, some new concepts introduced in the paper such as information processing institutions require substantive research on topics that the Bank and other donors must inevitably address in the years ahead.
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