Institutional Adjustment and Adjusting to Institutions

Robert Klitgaard
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Foreword

This paper applies institutional economics to development practice. Experience shows that the qualitative insights of the new economics of information can yield practical guidance for addressing such classic problems as:

- markets that seem not to work well for poor people;
- government agencies that seem corrupt, inefficient, and overcentralized;
- how to “take account” of indigenous institutions in development interventions.

Drawing on experience as well as theory, the author outlines frameworks for analyzing institutions, both governmental and market, as a prelude to improving their functioning.

The heart of the paper deals with the crisis in public sector incentives. It recognizes that attempts to craft once-for-all reforms—though often prescribed—usually fail, because their complexity and finality threaten too many vested interests. The paper offers a selective, experimental or “learning by doing” approach in which government officials define performance measures and set goals, and plan cooperatively how to meet them. Experiments that are limited in time and scope, and in which people with vested interests can help design the ways to measure success, give reforms a chance.

The paper also outlines a framework for taking indigenous institutions into account in development efforts. Adjusting to indigenous institutions will have many different forms; sometimes it is appropriate, sometimes not. But systematic attention to them in program and project design, through frameworks such as the one proposed in this paper, will generate practical ideas we might not otherwise reach.

Robert Picciotto
Director General
Operations Evaluation
Abstract

Institutional economics can make a positive contribution when applied to such classic development problems as markets that regularly fail the poor, corrupt and inefficient government agencies, and how to take account of indigenous institutions. Well-functioning markets often depend on well-functioning states. In order to improve how well government institutions are functioning, one must understand the reasons for poor performance—corruption, poor incentives, and, often, overcentralization. The paper proposes an approach for overcoming constraints to incentive reforms and provides a model economic framework for resolving the incentive problem. It recommends a therapeutic approach for addressing the issue of corruption. The paper also advocates that development institutions not only adjust government agencies, but adjust to them. This means giving the institutions resources and respect, empowering stakeholders, and working with them. Outside institutions can sometimes help government officials address sensitive issues and make credible commitments. The World Bank can play a catalytic role in this regard. The paper suggests that the aid relationship is itself in need of adjustment, and that international development institutions may themselves benefit from the types of measures being proposed.
1. Applying Institutional Economics to Development Problems

Six years ago at the Annual World Bank Conference on Development Economics, Brian Van Arkadie lamented the disconnected approach to the study of institutions in development and the lack of practical lessons and applications. John Nellis commented that the subject, though "profoundly important," "lacks an analytical method, a conceptual framework capable of rendering it coherent" and said the "next and most crucial step . . . is to specify precise operational methods and tools by which to improve performance in institutions." Today, looking over a different intellectual landscape, one may be more optimistic.

No doubt the field, or fields, are still diffuse. On one side we have theoretical economists such as Bengt Holmstrom, Paul Milgrom, John Roberts, and Jean Tirole, some of whom—such as Pranab Bardhan and Joseph Stiglitz—work on development. In various ways they are revolutionizing the theory of the firm, industrial organization, and the study of market institutions by systematically inserting problems of imperfect and asymmetrically held information. Their tools are mathematical, but many of them produce models that offer fresh, qualitative explanations for phenomena that are hard to explain using elementary microeconomics—for example, share-cropping arrangements, wages in firms that are below workers' marginal products early in their careers and above their marginal products later on, and a variety of institutional mechanisms that trade off risk and incentives. On the other hand, quantitative testing has been limited, since key parameters of the models are difficult to define and measure.

Another brand of institutional economics includes empirical studies of market structures and the way economic organizations work. Here political scientists and business administration experts have made contributions that are not generically different from the kinds of studies that might be made of political or social institutions. That history and management idiosyncrasy matter is a common thread running through these studies.

A third group includes critics of economic theory who use institutions as a means to attack prevailing paradigms. "Institutional economists," writes Warren J. Samuels, "also conduct protests against both the established market economy and the established body of orthodox theory which they see as too closely tied to existing institutional arrangements."

Finally, there are people interested in what might be called indigenous economic institutions ranging from local systems of property rights and exchange through to cultural norms and conventions understood in part as solutions to economic problems of risk-sharing, communication, and credible commitment.

Given this diversity—and these four categories fail to encompass the richness of the work, for example, of Douglass North, Elinor Ostrom, and Oliver Williamson, and of the many superb institutional economists who work at the Bank, such as Ed Campos, Brian Levy, Mary Shirley, among others—it is not surprising that institutional economists may find themselves at odds. And this may also explain why development practitioners still judge that the subject has little to offer of practical use.

In what follows, I summarize briefly some of my own forays into institutional economics, which have as their objective the improvement of policy analysis and management in developing countries. Drawing on the contributions of others, particularly the economists of the first camp mentioned above, I
have tried to show that the qualitative insights of the new economics of information can yield practical leverage when applied to classic problems such as:

- markets that seem systematically not to work well for poor people, including even highly competitive markets, such as those for agricultural products but also credit, labor, and land;

- government agencies that seem mired in inefficiency and corruption, with tendencies toward overcentralization; and

- how to "take account" of indigenous institutions.

Notes


2. Comment on "The Role of Institutions in Development," pp. 177, 179.


2. Market Institutions

Markets in developing countries can be liberalized in the sense of freeing prices and yet not work well for poor people. Conventional economics teaches that there are various reasons why competitive markets may not yield Pareto optimal results, such as decreasing cost industries and monopoly, externalities, public goods. The economics of information adds others, such as adverse selection, moral hazard, and incomplete contracting. These last problems will be especially severe when information is scarce, difficult to process, and asymmetrically held; where property rights are unclear; and where legal systems do a poor job of defining and enforcing commercially relevant rules, such as loan repayment and contracts—in other words, under conditions that characterize many developing countries, especially in rural areas.

Indigenous societies develop their own institutions to address problems of adverse selection, moral hazard, incomplete contracts, and the rest. Economists have analyzed sharecropping as a rational solution to the need to balance incentives and risk in a principal-agent relationship. The prevalence of sharing arrangements, indeed the relative strength of extended family and of clan, can be partially understood as a response to environments of great risk. Rural people in Africa may “save” in the form of cattle so as not to be subjected to harassment for not sharing a more divisible resource such as grain or money. Rotating savings and credit associations may reflect a similar need to save in a way that one is credibly able to refuse kin and clan who wish to borrow.

Economic development can be understood as supplementing or even replacing these traditional institutions and practices with more modern institutions for dealing with risk, imperfect information, credible commitment, and contract enforcement. (Below I will discuss how indigenous institutions can participate in and even facilitate economic modernization.) In this perspective, one emphasizes the importance for “making markets work” of better legal systems and the uncorrupted and efficient administration of justice. One stresses such informational aspects as better weights and measures and, more generally, better institutions for gauging, certifying, processing, and diffusing information about the quality of products, people, risks, and services.

Are there success stories we can learn from? And are there usable frameworks that might help us in practice analyze market institutions and suggest ways to improve them? The answers are yes and yes. Several examples and an analytical framework can be found in my book, Adjusting to Reality. Two general points deserve emphasis. The first is that well-functioning markets often depend on well-functioning states. For example, property rights and contract laws must be well specified and enforced—so must rules about the repayment of debts. Since information has aspects of a public good, states play a central role in helping markets overcome problems of information asymmetry. The second point is that states are often ineffective in playing their roles of enforcer and information enhancer. Indeed, the private sector, especially in developing countries, is less constrained by states that intervene than by states that intervene ineffectively, corruptly, or not at all. And so our attention turns to the question, what can be done to make the institutions of government—and more generally nonmarket institutions—work better?

Note

3. Nonmarket Institutions

"Better states" does not only mean states that spend modestly or states that respect rights. Nor does it only mean states that adopt sensible macroeconomic policies. "Better" also means overcoming chronic problems of poor incentives, systematic corruption, and overcentralization. Problems with public agencies should not be seen as the simple result of evil or megalomaniac politicians nor of public servants who lack administrative skills. An approach more in the economic spirit says that government agencies and their employees are reacting rationally to the circumstances they inhabit.

Part of the problem is the nature of the outputs and production processes in the public sector. In many cases "products" are hard to measure and, if they have aspects of public goods, hard to charge a price for. Production technologies—that is, the way that inputs combine to produce public goods—are difficult to specify. For these and other reasons, it will often be more difficult to improve internal structures of information and incentives in public agencies compared with private agencies. Institutional economics predicts "weak" incentive systems, long-term employment contracts or understandings, merit systems based on credentials but not performance, and a "process culture."

But improvement is possible. Both the new theory of the firm and contemporary examples suggest that once the problems are identified and addressed, improvements (be they first-best or second-best) can be devised. These will in turn be subject to gaming, ratchet effects, influence activities, and other phenomena; but these aspects, too, can be creatively and productively addressed.

I have picked an issue that I believe is of central importance and also susceptible to new approaches by organizations such as the World Bank. It concerns the crisis in public sector incentives. Some "success stories" are outlined in Adjusting to Reality. In the first appendix to this paper, I provide a qualitative outline of a model of the incentives problem, which goes beyond the framework of Adjusting to Reality. For now, consider an example of current interest, one that is not yet a success story: public sector incentives in The Gambia.

The Incentives Problem: The Case of The Gambia

As an enclave surrounded by Senegal, The Gambia is in many ways atypical. But many of the problems I learned about during a recent visit are generic.

Low pay. A January 1994 government document notes that in 1992-93 government "salaries in real terms were still well below their 1984 levels .... In addition, official public service salaries for high positions are also extremely low when compared with those in the parastatals and the private sector." A systematic study of salaries is planned for 1994-95. But even in the absence of comprehensive data about relative wages and the brain drain out of public service, virtually every document I saw and every interviewee made the point that salaries were too low to attract and retain qualified professionals in many key areas of government. In the just-completed May 1994 high-level meetings between the government and the Bank, it was estimated that government salaries have fallen by 40 percent in real terms over the past decade.
An example is the Accountant General's (AG) domain. Currently, two members of the AG's approximately 175 central staff have a professional credential in accounting; three are away on training. None of the approximately 175 accountants in the various ministries and departments, which report to the AG, has a professional qualification.

Poor pay helps explain these problems. Even at the technician level, employees can earn 100 percent more in the parastatals and 200 to 500 percent more in the private sector, plus perks. “The biggest headache is pay,” lamented the Accountant General. “The government pays for the training and then when people come back, they go off to greener pastures.”

Weak pay-performance linkages. It is becoming widely recognized in The Gambia as in many other countries that there is something economically undesirable about pay that remains the same whether one achieves much or little.

How should one deal with the problems of low pay and weak linkages between pay and performance? The prevailing and mistaken approach in The Gambia seems to have three components. First, any reform should involve massive changes across the entire civil service. Second, such reforms require comprehensive studies and blueprints. Third, because such studies are technically complicated, they must be undertaken by expensive foreign technical assistants. (Is it cynical to note that this prevailing approach is pushed by a number of foreign technical assistants?)

The number of studies planned and underway in The Gambia is remarkable. For example, in the Ministry of Finance's efforts to reform taxes, many recent meetings have had as a principal outcome the definition of a long string of studies to be carried out by foreign experts. Government documents in preparation for the World Bank's sectoral adjustment loan—documents themselves drafted in large part by foreign technical assistants—foresee many other new studies.

The phenomenon of studies is not confined to economic matters. In the course of a conversation with the Solicitor General, she told me that a large sector study of the legal system was to be undertaken with support from the US Agency for International Development. I noted that I had read a review of the justice system that was done a few years ago. Was it possible that the Solicitor General and her colleagues already knew what was wrong with the legal system, without any new studies, and that they could in effect do a sector review themselves, working weekends for a month?

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<th>TABLE 3.1: TWO APPROACHES TO INCENTIVE REFORMS</th>
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<td><strong>Prevalent Approach</strong></td>
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Box 3.1: Designing an Experiment with Incentives: Outline for a Model Memorandum

1. Quantitative summary of the current unsatisfactory situation. Because of X, Y, Z shortcomings (resources, incentives, capabilities), we are currently able to process only A% of the cases we should, and of those, only B% are processed adequately. As a result, the government and citizens forgo α, β, γ benefits and incur λ, φ, θ costs.

2. Examples. Here are three recent examples of things we were unable to do that clearly led to forgone benefits or additional social costs.

3. Measures of success. After considering our objectives and our organization’s key tasks, here are the measures of performance along which we believe it is fair that we be assessed. Some are quantitative indicators of the tasks we perform and the results we obtain. Others are qualitative ratings, constrained by a curve so that not everyone can be rated “top one-third.” Still others may be based on the detailed evaluation of a sample of particular cases.

4. Proposition. If we had x, y, z (additional resources, incentives, capabilities), we will in K time-period be able to achieve (even if qualitatively) the following measurable benefits and reductions in costs: 1, 2, 3, 4, and so on. We are willing to make such-and-such of the incentives conditional on the attainment of so-and-so performance targets, which will be monitored in the following transparent ways: i, ii, iii, iv, and so on.

She shook her head and smiled. “You’re right. We could do a study quickly that would identify six areas that need fixing. But that’s a problem here; it’s always more studies and more studies. Most of the aid received goes for studies, and then the studies say what we already know.”

Policy research of course does have its place. It is the reflex of calling for a comprehensive study that deserves noting and criticizing. In contexts like The Gambia’s, this approach generally takes too long, costs too much (especially the salaries of the foreigners who do the studies), runs into political roadblocks because of its “grand reform” nature, and, in the case of the civil service, probably cannot engender enough savings to make a big enough difference to civil service pay to matter.

The different approach recommended here is selective and experimental. It is at once humbler and bolder than the current approach. It is humbler because it recognizes that comprehensive studies are limited in their ability to blueprint change. It is bolder because it calls for learning from experiments, even from their negative lessons. It hopes to shock the entire civil service system into change by experimenting with indicators of performance and pay. It would involve Gambians centrally in the design and evaluation of the experiments, as opposed to their usually peripheral involvement in grand studies.

Specifically, the government would select a few key functions, such as revenue raising, auditing, and the justice system. In each area, the government would challenge Gambian officials to define qualitative and quantitative performance measures. These could include:

- quantitative measures of (a) activities undertaken and (b) results achieved;
- contests designed by employees;
- estimates of the quality of a sample of activities by peer groups, outsiders, or clients, on the proviso that ratings also include “grades on a curve” so that not every person and activity is deemed “excellent”;
- staff morale and turnover; and
- statistical controls that “adjust” measures of performance by the relative difficulty of the target group one is working with (for example, for tax collectors, which region, type of economic activity, type of tax, and so on, all of which affect the amount earned).

These ideas would be broached in participatory seminars. Then experiments would make rewards of various types contingent on the achievement of
performance targets. The rewards should include pay, but also can mean training, travel, professional recognition, reassignment, promotion, better working conditions, more independence, and so forth. Some of the incentives could be for individuals, but many would be for teams (offices, bureaus, even entire ministries).

As an example, Teneng Jaitah of the Ministry of Finance and I worked with several groups of Gambian officials on the outline shown in Box 3.1. Each agency is challenged to work through this outline, as a kind of preface to experiments with incentive reforms.

**Overcoming Constraints on Incentive Reforms**

The current approach to incentive reforms rightly feels constrained by budget exigencies and pressures from foreign donors to reduce the overall public wage bill. The approach recommended here must also countenance these realities. But it has several decisive advantages.

First, it proposes experiments, not wholesale reforms. Experiments are less expensive. Some technical assistance (TA) money now used for studies could instead fund learning-by-doing with better performance measures and new incentive schemes.

Second, because it is selective, this approach can begin with sectors where the experiments are likely to be self-financing, such as revenue-raising. Cost savings can be documented rather readily in certain areas, such as tendering, public works, and legal costs. In other areas, such as auditing, accounting, and investigating, the immediate benefits may be less financially tangible but essential to a campaign to improve government management in general.

Third, this approach can be built into a broader new strategy for institutional adjustment:

- Improve incentives. Link incentives to information about the attainment of agreed-upon objectives.

- Enhance information and evaluation. Put it in the hands of clients, legislators, and those with official oversight (regulators, auditors, judges, and so on).

- Promote competition and countervailing forces—including civil society, the media, the legislature and the courts, and political parties—and procedures that allow these different interests and voices to make a difference in policy and management.

- Launch a systematic campaign against corruption.

- Harden the budget constraint. One possibility is to reduce foreign assistance. Another is to make aid contingent on progress in institutional adjustment.

This approach contrasts with traditional approaches to institutional development, which are based on the premise that what is needed is more: more training, more personnel and equipment, more coordination, more studies and central planning, and more TA. My argument is that without improvements in information and incentives—and more broadly, without institutional adjustment—the usual approaches can be expected to fail in the difficult environments now facing many developing countries.

Do we have analytical frameworks to guide us, and success stories to give us ideas? Again, I believe the answers are yes and yes, although there is still much to learn. Adjusting to Reality² presents details on the incentives problem (see also the appendices, below) and ideas about economic approaches to two other chronic problems of non-market institutions: corruption and determining the right level of centralization and integration of public agencies.

**Notes**

1. For example, a recent government document estimates that salaries in Inland Revenue are about half as great as those for similarly qualified people in the private sector. The average monthly wage of a customs officer is so low that it is "extremely difficult for staff to manage on their monthly wages. This may well be a factor behind the widely publicized allegations of bribery and corruption within the Customs and Excise Department." ("The Gambia, Administrative Reform Program," January 1994, draft, pp. 27, 30.)

2. Especially chapters 6-10. Also relevant is Robert Klitgaard, Controlling Corruption (Berkeley and Los Angeles: University of California Press, 1988). Both books include case studies of success as well as analytical frameworks.
4. Indigenous Institutions

Recently, my research has turned to a third area that involves institutional economics, although other disciplines quickly enter. How can one understand and “take into account” what might be called indigenous institutions in economic and political development?

Concern for indigenous institutions is increasing, and we have seen in recent years remarkable examples of relevant research. For example:

- The rigorous documentation of the high correlation between the density of civic institutions to the quality of government in Italy.¹

- The combination of qualitative and quantitative methods to show that the “fit” between traditional institutions and modern structures distinguishes “successful” and “unsuccessful” Native American reservations.²

- New studies of successful African management which emphasize the roles of indigenous institutions.³

- Studies suggesting that indigenous institutions are crucial to the success of many rural credit programs.⁴

- One of the first applications of the cross-cultural information about local institutions from an anthropological data bank to a practical problem of development policy.⁵

Two sorts of economic insights are relevant. First is the idea that, in the absence of formal legal systems and well-developed markets, people solve problems of incomplete contracts, adverse selection and moral hazard, and risk-sharing through a variety of indigenous institutions.

These may include organizations we can see and study, such as rotating savings and credit associations or age groups or water-users associations, as well as other “institutions” that are less tangible, such as rules of enforcement of repayment and agreement, norms for aiding people in distress (when negative risks become realities), and even belief patterns.⁶ The economics of information helps (or should help) anthropologists get beyond their debate over whether primitive economies can be understood as having markets, and instead analyze many institutions in terms of risk-sharing, overcoming problems of imperfect information, and the like.⁷

Second, economics can help us to see that indigenous institutions are part of a complicated system of relationships, wherein the institutions are themselves a function of such things as the socioeconomic setting and conditions, the particular paths of local history, and public policies, and at the same time those institutions change with some lag and themselves condition the “production function” for development.

(1) Indigenous institutions = f (socioeconomic setting, history, policies, . . .)

(2) Development outcomes = g (socioeconomic setting, history, policies, indigenous institutions, . . .)

(3) Utility function for development outcomes = h (socioeconomic setting, history, indigenous institutions, . . .)

The third equation states that the utility function for various kinds and levels of so-called development may also vary as a function of indigenous institutions, among other variables. Thus, indig-
enous institutions enter in many ways: shaping what is desired, interacting with policies to mediate outcomes, and themselves undergoing change in the development process. An analytical approach derived from economics may help formulate useful questions for sociologists, anthropologists, and others. What do these equations look like in fact? What sorts of interactions are there among policies and indigenous institutions? How do such institutions change—and how might local peoples resist those changes or accelerate them, if they so desire?

**Guidelines for Adjusting to Institutions**

How might indigenous African institutions be “taken into account” in the improvement of governments, markets, and management? The Bank’s ongoing research under the label “Africa’s Management in the 90s” is exploring this question through a series of fascinating studies. As we have seen, indigenous institutions can among other things respond to market and nonmarket failures of various kinds. Their effects are not simple, however. They contain their own dynamics of meaning and perhaps also of inefficiency and market power. Thus, they potentially have both benefits and costs, and both should be “taken into account.”

But what exactly do the words in quotes mean? I discern very different answers to this question—what might be called different “texts” in the sense of literary criticism, namely something akin to intellectual reflexes or templates. Let me distinguish, artificially but I hope recognizably, four such texts.

1. **Give them resources.** To some, taking indigenous institutions into account means giving them resources and agreeing to go along with whatever they come up with. If one asks why such institutions should not simply be left alone, the answer is that they have legitimacy but lack “capacity.” A danger here is a kind of “traditional fundamentalism,” and what many Africans apparently perceive as inefficiency and unfairness in many local institutions, even when “legitimate.” For example, some possible costs of relying on indigenous institutions come to the fore when a gender perspective is taken.

2. **Give them respect.** To some observers, both donors and governments systematically bypass what is local and unique, seeming thereby to devalue it. And to overcome this phenomenon, “taking us into account” means “consult us, talk with us, listen to us.” To many intellectuals, the needed “respect” has a different connotation: the recognition of the “symbolic motor,” or the autonomy of meaning from material causality, that culture provides and indigenous institutions embody. Not coincidentally, this text can also be a cri du cœur from noneconomists and nongovernment organizations vis-à-vis economists, quantitative approaches, and large formal institutions.

3. **Enable them.** An insight of this text is that institutions, even traditional ones freighted with meaning as well as functions, are not exogenous or static. They respond to, among other things, conditions of risk and opportunity, and to both market and nonmarket failures. They will be optimally enabled—in some cases strengthened, in others perhaps replaced—by creating a well-functioning democracy, the rule of law, incentive-driven and output-oriented government bureaucracies, and vigorous competitive markets with ample information. In other words, after structural adjustment, democratic reform, and “institutional adjustment,” indigenous institutions will be optimally “taken into account” via correct incentives for the public and private sector to do so. Therefore, says this text, we don’t have to figure out how to take them into account; we just have to create a system with lots of information and correct incentives so that local actors will themselves do so.

4. **Connect with them, reconcile with them.** Dia’s work hypothesizes that at the core of Africa’s development problems is a “disconnect” between modern and traditional institutions. The corollary is that a “reconciliation” of these institutions is the answer. Two features of these propositions as a text seem important.

One is akin to “I’m okay and you’re okay.” Both indigenous and modern institutions have something to offer; they must be reconciled, merged, creating something new. As a consequence, to those relying on this text it is uncomfortable to ask whether for some tasks and in some settings the problem is too much merging of traditional practices into modern institutions, or that in other circumstances merging may lead to co-optation and even demise.
Another feature is the robust mysticism of merger: “Don’t just give them resources, don’t just talk, and don’t just enable—somehow we’ve got to get together and both become something new.” Exactly what this means, the adherent admits, is unclear, but it is deeply felt: this text tends to combine exhortation and frustrating vagueness.

The reader will recognize that these four texts go well beyond issues of indigenous institutions and development. Indeed, I suspect that one’s choice among these prototypical texts is influenced by such things as one’s academic discipline, “personality type,” and “culture,” perhaps as much as by the evidence on the specific subject under discussion, such as indigenous institutions and development.

But the point here is not the origins of these “texts” or even their validity, rather that we need a response that is akin to literary criticism. It is worthwhile to recognize that multiple texts exist, to analyze them and deconstruct them—especially our own texts. We must be ready to hear these differing responses and to double check our own reactions to make sure they are not simply texts. How might we push such discussions beyond texts?

One goal of development is to replace inefficient methods of production (technologies in the amplest sense) with more efficient ones. Since productivity is often higher in other parts of the world than in many underdeveloped regions, it would seem easy to “develop” simply by borrowing better production technologies. But we have learned that borrowing is often not successful because (among other things):

- Resources are insufficient (capital, human capital).
- Incentives are skewed (public sector, private sector).
- Property rights are weak.
- Monopoly power is seized for private ends and not public purposes, in part because countervailing institutions are weak or absent.

Responding to these problems, development strategies have moved from the simple increase of physical and human capital to the adjustment of economic policies to governance to institutional adjustment. Now we raise a further issue, “Might taking indigenous institutions into account also be part of the strategy?”

Imagine a matrix. There are many kinds of development problems, in which different kinds of indigenous institutions may under different kinds of sociocultural conditions play differentially useful roles—while for other kinds of problems in other sociocultural settings the same institutions may have little or no useful role. We need to unpack this matrix of problem, sociocultural context, and institutions.

Here are some ideas for doing so:

**Market Failures**

Take credit markets as an example. They exhibit predictable problems of information, economies of scale, and enforcement. Indigenous institutions may help overcome these problems. For instance, they may have better information on the riskiness of specific potential clients and more efficient screening techniques. They may provide a low-cost and credible way of pooling transaction costs and risks, taking advantage of economies of scale. They may possess both techniques of enforcement and (if carefully designed) appropriate incentives for applying them.

This is only one example. The general heading for project designers and policy makers is this: What are the market failures we see? How might indigenous institutions provide the information, economies of scale, enforcement, incentives, and so on, that could help mollify those failures? What new problems would using such institutions entail (for example, their managerial inefficiency and their own implicit market power) and how might these be ameliorated (for example, management training, accounting systems, oversight, and so on)?

**Bureaucratic Failures**

Typically it is difficult to measure outputs in public agencies and therefore difficult to create appropriate incentives within the bureaucracy. Controls, discipline, professionalism, and exhortation attempt to substitute for links between pay and performance. But they are imperfect substitutes, and monopoly plus discretion minus accountability is also a recipe for corruption. In many countries, bureaucracies underperform and even become predatory, perhaps especially in countries with low
levels of human resources, weak countervailing institutions, and legacies of colonialism and dirigiste economics.

How might indigenous institutions play a role in overcoming these failures? The policy analytical task is to examine the sources of the failure one-by-one. Might indigenous institutions be utilized to provide better information on the outputs of government agencies? How? Might they provide incentives to government agents? Might they be efficient mechanisms for the delivery of public services, perhaps because they "internalize" some of the costs of predatory behavior and therefore have better incentives to deliver the goods? Might they be used to provide "competition" in service delivery? Working through such questions might generate a host of ideas that otherwise would not have occurred to us.

Once again, we must also anticipate the problems that using such institutions might entail—co-optation, inefficiency, the creation of market power, and others—and consider ways to ameliorate or prevent these problems in advance.

The Rule of Law

The administration of justice is often an obstacle to economic as well as political development. How might traditional institutions help remedy some of the failures of the current system? As in the previous headings, we would analyze various dimensions of information and incentives. We would add further headings. Can traditional means of dispute resolution be exploited to replace or supplement more formal mechanisms?

Again, the costs and risks of using indigenous institutions would be analyzed as well. What sorts of training and accountability might render these "informal" mechanisms more efficient and less subject to monopoly-creation and arbitrariness? Would these "improvements" themselves threaten the indigenous institution in any way?

Governance

How might indigenous institutions help improve representation, openness, transparency, and legitimacy? Consider a Bolivian initiative—the use of local organizations not only to define needs and in some cases deliver local public services but also (in concert with this) to create a new, parallel set of councils from local to regional to national levels: councils of indigenous institutions. The possibilities and the pitfalls of such initiatives, in terms of inefficiencies and possible monopoly power, must be anticipated. The idea once again would be to create a kind of checklist or framework for policy analysis, which would then be applied to specific situations.

These headings are I hope suggestive but they are certainly not exhaustive. They try to exemplify three points.

First, to understand where indigenous institutions might have a role to play we need to analyze the specific sector or problem at hand, its market and nonmarket failures. Second, we need a framework or model for analyzing these market or nonmarket failures. The one I have been using is economic; there may well be other useful approaches. Third, in this analytical effort it will of course be essential to have local knowledge and involve local experts in indigenous institutions. Through this process one would analyze the benefits and costs of various ways of taking indigenous institutions into account.

Adjusting to local institutions would likely have many forms, depending on the problem, the institutions, and the sociocultural setting. Sometimes indigenous institutions would be important and sometimes unimportant. Sometimes the result might be to avoid indigenous institutions altogether. The point is that by working systematically in project and policy design through frameworks like these, we might be able to go beyond "texts" and generate practical ideas for taking indigenous institutions into account—ideas that through our customary modes of policy analysis might otherwise never surface.

Notes


3. For example, the many studies described in Africa Technical Department, Indigenous Management Practices: Lessons for Africa's Management in the '90s, Work Program and Methodology (Washington, D.C.: The World Bank, May 1993);

4. For a World Bank reference among many examples, see Jacob Yaron, "What Makes Rural Financial Institutions Successful?" *The World Bank Research Observer*, Vol. 9, No. 1 (January 1994), who explains that "One key to success appears to be the introduction of a social mechanism that lowers transaction costs, while supplying effective peer pressure for screening loan applicants and collecting loans" (p. 68).


6. Many authors have noted that "institutions" means both "organizations" and "norms, beliefs, even patterns of conventional behavior." I lament the confusion but have not discovered an antidote.


5. Institutional Adjustment and Adjusting to Institutions

Institutional adjustment means improving the institutions that facilitate the achievement of our aims; adjusting to institutions means taking existing institutions into account without changing them. Which should we do, under what circumstances? (Let us take “we” in the most generous possible sense to include especially people themselves as they decide to resist or accelerate various brands of “development.”)

Long ago Albert O. Hirschman warned that no matter which choice we undertake we will be criticized for it. If we are what he calls “trait takers” we decide to work with the institutions we find. We will later be criticized for perpetuating inefficient, hierarchical, sexist, urban-biased institutions—even if our efforts succeed. If we are “trait makers,” trying to alter underlying institutions, we will be criticized as naive, imperialistic, culturally biased social engineers—even if our goals are met.¹

And this is one reason why dealing with institutions—adjusting them, or adjusting to them—is precarious. It is compounded by the fact that we seem to know relatively little about how to do either.

True, when thinking about institutional adjustment, there are appealing analogies to structural adjustment. In the case of structural adjustment, we worried about “getting prices right” for private sector agents. Now we worry about “getting incentives right” for public sector agents. There we tried to create open and transparent markets. Now we try to create open and transparent governments. There we worried about property rights and privatization in order to decentralize economic decision-making efficiently. Now we worry about empowering stakeholders and optimally decentralizing public services. There we worried about economic competition. Now we worry about administrative and political competition.

There are, however, important differences that affect the process of designing adjustment strategies in the two domains. I will exaggerate to make a point.

Devising a structural adjustment program centers on a few crucial decisions at the top: devaluation, setting prices free, lowering tariffs and removing quantitative restrictions, deregulating, and cutting spending. A few people can make and dictate these decisions in a relatively short time. In Turkey, for example, fewer than ten technocrats under Turgut Özal knew the content of reforms before they were announced.² If the political leadership wants it done, it is done. (Aside to readers who are political leaders: I did say I was exaggerating.)

In contrast, institutional adjustment requires extensive tailoring to specific circumstances, and it will require ownership not only by top leaders but by the rank-and-file officials who will implement institutional reforms. Thus, in most cases institutional adjustment will require extensive consultation, participation, and joint learning. Process is crucial.

This difference implies, I believe, a greater emphasis on experimentation. The word experiment may carry unwanted connotations, but it captures an important element of successful institutional adjustment. A lesson from many past efforts at administrative reform is that attempts to craft once-and-for-all, systemwide changes fail. For one thing, the very complexity and finality of such reforms offer too many chances for vested interests
to resist. Experiments limited in time and extent, in which the vested interests can help design the ways to measure success, give reforms a chance.

Most institutional reforms will need to learn as they go. Blueprints are simply too difficult. Framing adjustment efforts as "experiments" emphasizes the learning. It also suggests measurement after a specified period of time, which is also welcome.

There are exceptions to these generalizations. Sometimes, in order to be credible and effective, change must be systemwide and sudden, without the announced prospect of changing again after an experimental period.

But with regard to institutional adjustment, my experience is that it is wise to begin in carefully defined sectors with efforts that may be criticized for being "too simple," but from which lessons can soon be drawn and improvements made. Doing too many sectors with too complicated a system is theoretically preferable but practically perilous.

But aren't these institutional issues too sensitive and too contextual for the World Bank to consider? Do the Bank's comparative advantages include such things as local knowledge, politics and history and culture, and projects with large requirements for participation and partnership in the sense I have been describing?

These questions raise serious issues. But in some cases I believe the World Bank's entrance into institutional adjustment can be catalytic. Sometimes outside assistance can help legitimate sensitive issues, help leaders make credible commitments. Incidentally, with regard to institutional adjustment the dividing line between "willing" and "unwilling" leaders is not as clear as journalistic accounts may make it appear. For example, in my experience many leaders are, so to speak, schizophrenic about corruption. They may sincerely loathe it and wish to eradicate it, while at the same time participating in it or allowing it to occur. It is also true that in my workshops on corruption, after some time people are remarkably frank about the corruption that exists, how it works, and how it might be prevented—even when these analyses belie an incriminatingly intimate knowledge.

I do not have time to describe these several-day-long workshops here, but I do want to cite certain lessons of more general applicability to institutional adjustment and hints for a catalytic role for outsiders. Sensitive subjects like corruption, and more broadly institutional adjustment, may require a therapeutic approach. First the subject of corruption is demystified through the analysis by participants of case studies from other countries—and case studies of successful campaigns to reduce corruption. Then analytical frameworks are supplied that help participants realize that corruption is not (just or primarily) a problem of evil people, but one of sick institutions. A heuristic formula is: corruption equals monopoly plus discretion minus accountability. To members of corrupt organizations this insight often proves therapeutic.

As in good therapy, the participants then move to self-diagnosis and self-prescription, looking at corruption in their own ministry or country, its causes, and its possible remedies. The facilitator assists in several ways: by asking questions, helping combine seemingly different phenomena or separate seemingly similar ones, by pushing when the group avoids work or escapes into relativism or cynicism. Out of such an experience emerge both a deeper understanding of general phenomena and specific manifestations of corruption, and a plan of action to begin to fight them.

This plan may require assistance, and this is where external actors can help. Beyond money and ideas, outsiders can help in surprising ways by "imposing" conditions and deadlines that fortify local decisionmaking and self-discipline. An aura of international respectability—"part of a worldwide program to fight the universal plague of corruption, not just here in [country x]"—may help nervous actors coalesce around reform.

As part of a strategy of institutional development, the World Bank and other agencies may be able to "lever" such workshops. A project that follows such an event—or several such events at different levels of the public and private sectors—may use the workshop's recommendations, co-opt key actors as managers and monitors, and via carrots and sticks improve the chances that the adjustment process will succeed.

Healing the Aid Relationship

The therapeutic metaphor may be carried one step further—the need to adjust the institution of international aid itself. The relationship between
donor and recipient, between lender and borrower, has its own rules of the game. They, too, may benefit from economic analysis. Some of the failures of aid to foster institutional development can be analyzed using institutional economics. Consider three incentive problems in the aid relationship.

First, technical assistance personnel are usually not paid for training successors or developing capacity, but for completing a certain technical job (or simply for being in situ for a contractually specified length of time).

Second, staff members of donor institutions often lack appropriate incentives. Their compensation and promotion depends hardly at all on the eventual success of “their” projects, but instead on shorter run measures of “craft” quality and even the amounts of money or number of projects moved through the donor bureaucracy. If officials are forced to operate through narrow-gauged projects, it can inhibit their ability to tackle cross-cutting institutional issues such as information and incentives.

Third, lending agencies do not optimally share the risks that their conditional aid entails. In principle, the amount they are repaid should depend in part on the success of their conditionality, given that the recipient follows it. Currently, the risks are disproportionately borne by recipients.

These three incentive problems help explain some of the chronic problems of the aid relationship. All three will be difficult to remedy. Like some of the problems analyzed above, their amelioration may require an experimental attitude, the participation of staff and clients in pilot efforts, and an openness to learn with other donors and with recipients.

So, the economic perspective suggests that aid resembles a transaction involving risk-sharing and appropriate incentives. But aid is more than a transaction: it is a relationship, a partnership (as the Bank’s Katherine Marshall among others has emphasized). The aid relationship is itself an institution in need of adjustment. Beyond economics, might other metaphors lead us to the right kinds of institutional reforms in this domain? Thomas Bucaille has usefully noted that aid is, or should be, a pedagogical relationship in the best sense of that dangerous word.4 Understanding our individually and mutually inappropriate incentives requires learning together, new processes of together analyzing and experimenting with our incentive structures.

Let us go even further. I mentioned above that sensitive subjects like institutional adjustment may require a therapeutic approach. At the end of Childhood and Society, Erik Erikson concludes that the therapist has to become a partner and transcend certain historical roles. Listen and see if his words do not also ring true for the aid giver, the foreign adviser, the expatriate activist.

“In a more enlightened world,” Erikson wrote in 1950, comparing the situation to that in Freud’s time, “and under much more complicated historical conditions the analyst must face once more the whole problem of judicious partnership which expresses the spirit of analytic work more creatively than does apathetic tolerance or autocratic guidance. The various identities which at first lent themselves to a fusion with the new identity of the analyst—identities based on talmudic argument, on messianic zeal, on punitive orthodoxy, on faddist sensationalism, on professional and social ambition—all these identities and their cultural origins must now become part of the analyst’s analysis, so that he may be able to discard archaic rituals of control and learn to identify with the lasting value of his job of enlightenment. Only thus can he set free in himself and in his patient that remnant of judicious indignation without which a cure is but a straw in the changeable wind of history.”5

Notes

Appendix 1: Some Economics of Incentive Schemes

This appendix tries to convey the essence of an economic approach to the incentive problem, using a variation of the principal-agent model. A central idea is that since the agent’s performance is only imperfectly measured, paying a wage based on what the principal can observe creates a risk for the agent. Because of risk-aversion, the agent would prefer a fixed wage that does not depend on performance. But the principal dislikes fixed wages, because then the agent has no economic incentive for higher performance. The optimal wage agreement strikes a balance between risk-sharing and incentives. Usually this combines a fixed payment that does not depend on a measure of performance with a variable payment that does.

The appendix then tries to derive, schematically, some policy implications of this approach.

The Model

Suppose you are the principal and I am your agent. Your profits are a function of my efforts: Profit = P(e). But my efforts are costly to me: Cost = C(e). Ideally, you would pay me a wage equal to the value of my marginal product. But you don’t know my effort e, at least not perfectly. You can observe an indicator of my effort, which is

\[ z = e + x, \]

where x is a random variable representing the measurement error.

You can also observe a variable y, which is not correlated to e but is correlated to x. For example, suppose z is sales of the product for this month. It is some function of my effort but also depends on industry demand y. You might take y into account to enable a more precise estimate of my effort.

The wage you pay me can be analyzed as having two parts, one fixed and one dependent on your assessment of my effort:

\[ w = \alpha + \beta (e + x + y) \]

\( \beta \) is a measure of the incentive intensity of our wage contract. When it is zero, you pay me a fixed wage \( \alpha \). The parameter y measures how much weight you give to y in relation to z.

What contract would be socially optimal (for the two of us?) Assume expected values of x and y are normed to zero (for convenience), and assume no wealth effects. My certain equivalent is equal to expected income—cost of effort—a risk premium for the income risk I bear because \((x + y)\) is a random variable. Milgrom and Roberts (1992: 247) show that the risk premium turns out to be approximated by \(1/2r \beta^2 \text{Var}(x + y)\). Your certain equivalent as a risk-neutral employer is the expected profit—expected wage.

Both of our certain equivalents depend on the four variables \( \alpha, e, \beta, \) and \( \gamma \). By the assumption of “no wealth effects,” an efficient contract will maximize the sum of the certain equivalents. But there is also an incentive constraint, which says that I as your agent will set my effort level such that the marginal benefit = marginal cost. So an employment contract is efficient if and only if the choices \( \alpha, e, \beta, \) and \( \gamma \) maximize the total certain equivalent among all “incentive compatible” contracts where \( \beta - C'(e) = 0 \). The solution generally has some fixed pay and some variable pay that is a function of the two measures z and y.
TABLE A1: Conditions Favoring and Not Favoring Pay-Performance Links

<table>
<thead>
<tr>
<th>Aspect of Incentive</th>
<th>Favorable to Intense Incentives</th>
<th>Unfavorable to Intense Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>P'(e)= marginal social benefits of more effort by agent</td>
<td>Additional efforts by public servants lead to big gains in effectiveness</td>
<td>Because of other constraints, additional efforts by public servants yield no gains in effectiveness</td>
</tr>
<tr>
<td>r = agent's risk-aversion</td>
<td>Employees are almost risk-neutral, perhaps because plentiful opportunities exist and they are already well-off</td>
<td>Employees are very risk-averse, perhaps because poor</td>
</tr>
<tr>
<td>Var(x+γy) = how accurately agent’s effort measured</td>
<td>Effort and results are easy to measure</td>
<td>Effort and results are almost impossible to measure</td>
</tr>
<tr>
<td>C''(e) = responsiveness of agent’s effort to incentives</td>
<td>Effort is very responsive to incentives (for example, high discretion)</td>
<td>Effort is not responsive to incentives (for example, fixed-pace activity)</td>
</tr>
</tbody>
</table>

From this model we can derive the incentive intensity principle. The strength of incentives should be an increasing function of the marginal returns to the task, the accuracy with which performance is measured, the responsiveness of the agent’s effort to incentives, and the agent’s risk-tolerance.

\[ \beta = \frac{P'(e)}{1 + r[\text{Var}(x+\gamma y)]C''(e)} \]

where C''(e) is the slope of the marginal effort curve. This formula is computed by maximizing the total certain equivalent of principal and agent with respect to e.\(^1\)

The incentive intensity principle suggests that under some conditions it is optimal to have “highly intense” incentives, but under other conditions a flat wage is the right choice. Table A1 shows some of the extreme conditions favoring and not favoring performance-based pay.

In many public bureaucracies, especially in developing countries, the conditions seem to resemble those in the right-hand column of Table A1. Of particular importance is the difficulty of measuring performance—in the model, reducing Var(x+γy). In part this is due to the nature of the goods being produced in the public sector.\(^2\) In part it is due to the primitive technologies and insufficient funds available for evaluation in many poor countries.

The incentive intensity principle suggests that under some unfavorable conditions, intense incentives will not yield efficient bureaucracies. Under those conditions, trying to raise \( \beta \) would have meager and indeed perhaps negative effects.

But there is a third point. The four parameters of the incentive intensity principle are not necessarily immutable. In particular, notice that when the measurement of performance improves, a wage package can be constructed that both enhances incentives and reduces risk.\(^3\) This is why better information is at the heart of institutional reform.

Coping with Problems with Incentive Reforms

Box A1 summarizes some of the difficulties facing performance-based incentives. Beyond the categories suggested by the incentive intensity principle, it adds considerations of incentive dynamics, political economy, and layers of hierarchy.

In particular, agents and principals may take dynamic steps that undermine incentives and information. Consider agents first:
Agents distort activities toward those things easily measured at the cost of those things not easily measured.

Agents engage in influence activities: distorting information, influencing evaluators of information, not revealing useful private information.

If relative rankings of agents are used, agents may avoid useful teamwork or even sabotage others.

Agents may avoid job transfers or the learning of new skills, for fear of losing bonuses attached to existing arrangements and competencies.

Agents may act collectively to transmogrify performance bonuses into higher base pay.

Principals may also take steps that undermine the system:

Ratchet effects: after learning more about the production function, principals move the goal posts, leaving agents worse off than before.

Intermediate layers of the bureaucracy may simply lack incentives to undertake performance appraisal. The appraisals are often limited to employee inputs, qualifications, or endowments, rather than to the much more difficult idea of contribution to value-added.

In performance ratings, intermediate layers of the hierarchy collude with or extract rents from lower levels, undermining the system (and in extreme models leaving underlings no better off than before).

Such issues have been analyzed in the literature, and the complexities of reality soon overwhelm available economic models. In particular, when dynamics are included, the incentive intensity principal no longer can be assured to hold.* Without a host of special assumptions, we cannot pretend to "compute" the optimal incentive intensity any longer, even in theory.

Nonetheless, the very categories suggested by theory as undermining performance incentives provide a framework for considering how in practice these problems might be mitigated. Box A1 contains some examples. And, building on the incentive intensity principle, the framework for policy analysis in Box A2 suggests ways to make incentive reforms more likely to succeed.

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**Box A1: Summary of Some Conditions Affecting the Desirability of Performance-Based Incentives**

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>P'(e)</td>
<td>Marginal social benefits of more effort by agent</td>
</tr>
<tr>
<td>r</td>
<td>Agent's risk-aversion</td>
</tr>
<tr>
<td>Var(x + yy)</td>
<td>How accurately agent's effort can be measured</td>
</tr>
<tr>
<td>C''(e)</td>
<td>Responsiveness of agent's effort to incentives</td>
</tr>
</tbody>
</table>

Additional complications:

1. How to afford incentive schemes (use non-monetary incentives as well; use samples; borrow measurement techniques when possible; involve agents and clients in performance appraisal; use partial fees-for-service; watch out for bonuses that become standard).

2. Extraneous factors determine P'(e) (control for them statistically; use tournaments, contests, relative rankings, but these create side-effects).

3. Teamwork (may need group incentives, but then free-rider problems; collusion).

4. Dynamics and political economy (skewing agents toward the measurable to the detriment of the less measurable; "influence activities," including dissimulation, gaming, sabotage, and corruption; ratchet effect; creating disincentives for transfers, learning new skills, and so on; answers include a richer informational environment and processes that build transparency and credibility).

5. Layers of bureaucracy (evaluators may not have correct incentives).
Box A2: A (Partial) Framework for Policy Analysis

1. Strengthen the link between employee effort and the agency's value-added.
   - Make sure everyone understands what the value-added is and how it is being sought. What are the "key tasks" of the organization? What does it take to perform them better?
   - Incentive reforms require the participation of employees themselves in the specification of each agency's objectives, performance measures, and incentives. This helps educate everyone on the links between effort and value-added.
   - Help employees improve the quality of their efforts (training, feedback on achievements).
   - Sometimes \( p'(e) \) is close to zero for any individual but is large for groups of employees. In such cases team incentives are more feasible and desirable than individual incentives. (Free-rider problems may then emerge, which demand another iteration of solutions.)

2. Reduce the risk-aversion of employees.
   - Raise the level of the pay.
   - Help remove employees' uncertainties about pay-for-performance by running transparent experiments where employees (and clients) help to design quantitative and qualitative measures of performance, appropriate incentive schedules, and ways to evaluate the experiment's results in a relatively short time.
   - Make credible commitments about the evolution of pay-performance formulas over time, to avoid the "ratchet effect." Again, a process is often important. For example, if employees, management, and clients help appraise progress and set new incentive schemes, along with a guarantee to return to status quo ante under agreed-upon conditions, this may engender the confidence to enable an experiment with incentive pay to begin.
   - Avoid incentive master plans for all agencies and all time. Learn by doing. Make sure affected parties take part in the evaluation of the incentive experiments.
   - Facilitate employee self-selection. Introducing performance-based pay can be expected to lead workers with lower risk-aversion to prefer public sector jobs.

3. Reduce the variance of measures of performance.
   - Include information from clients.
   - Empower clients. Seek analogies to market power or joint management. Experiment with user charges and analogies to them such as in-kind contributions, sharing them with employees.
   - Quantitative and qualitative outcome measures can be used. So can peer ratings, as long as ratings

The problems raised by dynamic considerations and the political economy of incentive reforms do not yield ready solutions. Probably, however, part of the answer concerns the processes through which (1) performance measures are designed and (2) incentives are constructed and tested and reassessed. These changes in process can be understood, I believe, as a rational response to the possible dynamic and political economy problems with performance-based incentives.

Implications

We have seen that the desirability and design of pay-for-performance schemes depend in predictable ways on aspects of the task environment. Given the task environments found in many public bureaucracies in developing countries, performance pay will fail, and consequently low levels of performance and high levels of corruption will be chronic because, our models say, they are "rational" responses to a miserable organizational environment. For organizations to work better, this environment must change.

The last point opens new horizons for thinking about institutional development. From the perspective of a given manager or minister in a given system, reforming incentives may be impossible. Not only do civil service rules not permit it, but the manager may not have the authority or the resources to generate the measures of performance on which an effective incentive system depends. What is needed is analogous to structural adjustment: a change in the rules of the game, a new enabling environment. A key feature of the needed reform is better information about what government agencies do and what results they achieve.
are forced to be "on a curve" (that is, not everyone can be rated "excellent").

- Extraneous variables can be taken into account in the design of incentive schemes (the y in the incentive intensity principle could try to measure such extraneous variables, which are given weight g). Examples are controlling for students' social backgrounds in estimates of school contributions to learning, and in the Philippines Bureau of Internal Revenue controlling for the tax base of a local district in estimating the efficiency of the district office in raising revenues. Also, an incentive scheme may employ measures of relative performance, analogous to tournaments, which help "control for" the extraneous variables that affect everyone's performance up or down.

4. Reduce the costs to employees of additional effort.

- Begin with the easiest cases. In particular, try reforms in areas where performance is relatively easy to measure objectively and where the revenues raised or costs saved can make the experiment self-financing.
- Through training and better equipment, shift the cost-of-effort curve.

5. Reduce the costs of providing incentives.

- Incentives include money but also other things, which may be less expensive: promotions, training, travel, special assignments, transfers, awards, favorable recognition, and simple praise. Even information about how well one is doing turns out to function as an incentive.
- Remember the principle of the sample: incentives can be based on samples of performance. Especially in an experiment, there is no need for the comprehensive measurement of each and every outcome of each and every action.
- Cultivate political support, particularly from unions and foreign donors. The idea of an experiment reduces their worries and involves them in design and evaluation.
- Challenge technical assistance (TA) by foreigners. For example, learn by doing rather than attempting comprehensive studies that often end up being inconclusive or unsatisfactory. For example, use TA funds to finance experiments where local experts and even government officials carry out the required "studies" based on the participatory diagnosis of what is already known about problems and possible solutions.
- Privatize creatively. This can mean experimenting with hybrids of public and private sectors working together to provide services. Information about performance may incidentally be enhanced.

The task is daunting, precisely because public agencies take on the provision of the kinds of goods that private markets will not optimally supply. But it is not impossible, as is testified by an exciting array of efforts around the world.

Notes


2. James Q. Wilson distinguishes four types of public organizations, depending on the measurability of what might be called their efforts and their outputs. In "production" organizations, both efforts and outputs can be measured; here, the prospects for performance-based incentives are strong. At the other extreme, "coping" organizations, in which neither efforts nor outputs can be gauged, are weak candidates for incentive pay. (Indeed, Wilson says, "In coping organizations effective management is almost impossible" [p. 175].) As prospects for performance pay, the two other corners of the table are in-between.

<table>
<thead>
<tr>
<th>Can measure effort</th>
<th>Cannot measure effort</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Can measure outcomes</strong></td>
<td>Production (e.g., internal revenue, social security, post office, FBI)</td>
</tr>
<tr>
<td><strong>Cannot measure outcomes</strong></td>
<td>Procedural (e.g., armed forces in peacetime)</td>
</tr>
</tbody>
</table>


3. Milgrom and Roberts show that there is an associated monitoring intensity principle. More resources should be spent on monitoring when it is desirable to give strong incentives. Measuring performance carefully and providing intense incentives are complements. It is also possible that policy changes exogenous to any particular manager improve...
the ability to gather, process, and interpret information about performance. If so, incentive intensity will increase, and so will the welfare of agents and the performance of the organization.

4. Laffont and Tirole note that optimal linear incentive schemes “were no longer so once dynamics, political economy, or multi-principal conditions were thrown in” (p. 663).
Appendix 2: Summary Advice on Incentive Reforms

The following points represent what might be called hints or lessons from the incentive reforms I have studied.

- Incentive reforms require the participation of employees themselves in the specification of each agency's objectives, performance measures, and incentives.

- In designing performance measures, it is helpful to define "key tasks"—in other words, to analyze the organization's "production function" carefully.

- Quantitative and qualitative outcome measures can be used. So can peer ratings, as long as ratings are forced to be "on a curve" (that is, not everyone can be rated "excellent").

- Include information from clients.

- Empower clients. Seek analogies to market power or joint management. In pursuing such reforms, continually think "information and incentives."

- Experiment with user charges and analogies to them such as in-kind contributions, sharing them with employees.

- Team incentives are often more feasible and desirable than individual incentives.

- Incentives include money but also other things: promotions, training, travel, special assignments, transfers, awards, favorable recognition, and simple praise. Even information about how well one is doing turns out to function as an incentive.

- Avoid incentive master plans for all agencies and all time. Learn by doing. Make sure affected parties take part in the evaluation of the incentive experiments.

- Begin with the easiest cases. In particular, try reforms in areas where performance is relatively easy to measure objectively and where the revenues raised or costs saved can make the experiment self-financing.

- Remember the principle of the sample: incentives can be based on samples of performance. Especially in an experiment, there is no need for the comprehensive measurement of each and every outcome of each and every action.

- Cultivate political support, particularly from unions and foreign donors. The idea of an experiment reduces their worries and involves them in design and evaluation.

- Challenge technical assistance by foreigners. For example, learn by doing rather than attempting comprehensive studies that often end up being inconclusive or unsatisfactory. For example, use TA funds to finance experiments where local experts and even government officials carry out the required "studies" based on the participatory diagnosis of what is already known about problems and possible solutions.

- Privatize creatively. This can mean experimenting with hybrids of public and private sectors working together to provide services.
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