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# Incentives and Human Resource Management in the Design of Public Sector Reform

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## THE 'DEVELOPMENT APPROACH' TO GOVERNANCE

We, in Pakistan, should be very happy that the global development community has finally accepted the centrality of public sector reform (also known as improved governance) in the quest for improved living standards in poor countries. Development economics is a subject that is based on the interpretation and observation of some Western academics and Western donor-based agencies. We should have some sympathy for these leaders of development thought and policy for they have struggled with integrating the prevailing theme (fad) in Western thought and philanthropy with learning about the societies and economies that they were supposed to be prescribing for. Using the principle of "ends justifying the means", they defend their reliance on the current "fad" as well as on the only clearly visible, organised and powerful actor—the government, no matter how inefficient—they would.

The result is that this approach led to a long era of government-led development, which centralised policy- and decision-making, initiated planning, and created a wide range of public-sector institutions. The role of the government was thus extended into areas that were conceptually indefensible. In this manner, the public servant grew into her new much more lustrous and looser robes. A bloated, over-centralised, and a private sector inhibiting government was created to be the observation and implementation outpost of the development word. This was the first step in the transformation of the public sector in the direction of misgovernance.

The large, growing and domineering public sector while inhibiting growth and development was hungry for resources. Reacting to the bloated public sector and the distortions that were thereby created, the distant leaders of policy and thought developed the "Washington Consensus." The new buzzwords were "remove distortions", "get the prices right", "fiscal consolidation", to be followed by "privatisation and internalisation." Disjointed efforts at dismantling the earlier

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planning structures and SOEs developed a fragmented public sector. Fiscal consolidation was achieved through sporadic efforts at expenditure reduction and revenue raising. Since reducing public sector employment was politically risky, expenditure-reduction measures often relied on nominal wage freezes, which eventually translated into real wage cuts. The public sector reacted to these strategic attacks on its recently expanded mandate in three ways:

- First, by slowing down reform in critical areas so that it's grip on resources could be maintained;
- Second, by seeking alternative means to make up for the real wage cut that the public sector employees was experiencing. Thus, "perks" —Legalised and non-transparent means of non-wage resource extraction—became a major form of civil-servant emoluments while the tolerance towards corruption significantly increased.
- Third, the more skilled, the less corrupt, as well as those seeking a more reform-oriented approach opted out of first the public sector and later, as opportunities shrank domestically, out of the country.

The result was a bloated and fragmented public sector, which had rapidly lost skills and also developed a tolerance for corruption and inefficiency. It is not surprising that in this milieu growth and investment slowed down sharply and perceptions of country risk increased sharply. What is surprising is the continued oblivion of all the main development thinkers and agencies of the West to the crying need to understand and prepare a strategy for a sound public sector reform.

Development indicators measuring social and economic health have all remained fairly stubborn in the face of changing fads of development thinking and donor advice and funding. This frustration has lately led to interest in the catchall term—"governance". However, despite the adoption of the new term, reports and discussion on this subject either remains shallow or continues to define governance in traditional terms. The development thinker is still trying to obtain indicators of poverty, education and health to name a few. The problems facing the people in many of these countries may be different. For example, a review of writings of the intelligentsia in countries such as Pakistan reveals that important problems that are leading to low levels of productivity and high perceptions of country risk are:

- poorly managed urban sprawls;
- rising crime rates;
- poor infrastructure;
- an extremely low quality of service provided by the public sector; and
- a distant centralised, overburdened, overbearing and predatory state.

Ignoring this, the development-thinker has gone from saying that civil service reform is not important or something that can take place at a later stage of development to the stage of a belated recognition but then regarding it purely as a process or budgetary phenomenon. Hence their emphasis on downsizing, departmental closedowns, further centralisation of hiring and firing. You only have to review all the public sector work on developing countries to verify my claim.[1] Interestingly enough, through this process of learning and erosion of public sector efficiency, there has been no element of remorse or "mea culpa" from the development economist. Adroitly, they are able to pass the blame entirely on to the poor countries. But then poverty is a curse and the poor can do no good including think for themselves!

Unfortunately while the development economist was learning, the intelligentsia of a country was being increasingly marginalised. The systems in developing countries were being rapidly corroded. Their role was being totally denied in the development thinking and practice and by those who controlled resources or were in a position of influence. In the thinking of the development theorist, reform was viewed as an exercise in retrenchment, accounting, and a set of laws and processes that can easily be defined through the long arm of the international consultant. Domestic human capital of the concerned country appears to play a limited role in this scheme of things. Sure there is a reference to weak incentives and the lack of domestic skills in the public sector, but the thrust of the argument remains that their reform can be entirely designed and driven by external thinking and human capital.

Fortunately for the poor countries, the transformation of the former communist countries has drawn better economists into looking at issues of economic development and growth. We are, therefore, on the verge of some exciting new findings on public sector reform in developing countries using the *principal-agent* and *asymmetric information* paradigms.

In this paper, I shall draw upon these developments in economic theory and country experience to show that a well-designed public sector reform must rely upon quality human capital of domestic origin, whether such human capital be available either at home or overseas. Without the partnership of such human capital, neither can the reform be properly conceived nor can it be durably implemented!

## LEARNING FROM INCENTIVE AND ORGANISATION THEORY

Much research has been conducted in the theory of *incentives in organisations* in the realm of neoclassical economics and this can be used to understand civil

[1]See for example, the World Bank OED reports and the work by the public sector reform experts in the Bank. There is some passing reference to the need for human resource management as well as possible wage compression. However, the emphasis is entirely on capacity building, transparency and accountability building a better legal framework, all of which are basically euphemisms for more technical assistance. Domestic human capital and incentives for the use of it are not of interest.

service reform. Basically these theoretical developments are based on two important paradigms:

- The fundamental point of departure for understanding any human behaviour is the recognition of ***selfishness*** that is inherent in all human actions. This viewpoint is fundamentally opposed to the commonly held view that derived from the 19th century liberal view, which saw the government as a benevolent protector of the poor. The *public servant,* as the name implies, was considered to be *selfless*, kind and caring, devoid of the need for worldly goods and desires. Such angels would work for the common weal with no caring for family and the future! Clearly this view is incompatible with the paradigm of selfishness.
- ***Information is costly*** to collect and that people may have different amounts of information available to them, which they will use to their advantage. This means that all exchange must now take into account the information asymmetries and the cost of obtaining information. Public sector regulatory intervention is often required where informational asymmetries prevent the market from working. However, this also gives selfish public servants an opportunity!
- This world of selfish individuals possessing asymmetric information leads to certain understandable forms of behaviour and certain approaches to analysing such behaviour have been developed.
- **Moral Hazard** *(hidden action)* when one party has the incentive to shift the risk onto another uninformed party.
- **Adverse Selection** *(Hidden Information)* when one party has more information about a market transaction.
- To deal with these issues, an analysis of contractual relationships, known as ***Agency Theory*** has been developed. An agency relationship is defined through an explicit or implicit contract in which one or more persons (the principal(s)) engage another person (the agent) to take actions on behalf of the principal(s). The contract involves *delegation* of some decision-making authority to the agent. Agency problems that emanate from conflicts of interests, which arise out of selfish behaviour in the presence of incomplete information, are common or endemic to most economic relationships.

  Agency analysis has been used extensively to analyse how workers, managers, directors or investors respond to various incentives. Self interested economic agents can be motivated in roughly three ways:
- **formal incentives** such as piece rate wages, bonuses, stock options and relative performance evaluation are based on verifiable **measures of performance**;

- foremen, fellow employees, bosses or boards of directors **monitor** work inputs; and
- **career concerns** inside and outside the firm may encourage a forward-looking employee to exert more effort.

The longest peacetime expansion in the US history owes a lot to these new developments in economic theory. Stock options, participation in the benefits of new discoveries in both monetary and non-monetary terms, and other clever contracting mechanisms have been designed to align incentives of managers and shareholders. They have led to an increase in the profitability of the US firms. Such incentive-based schemes drawn from the agency literature have also found their way into performance-based governance schemes. Examples of such schemes can now be found in countries such as New Zealand and the UK. As always, it takes a while for development theorists to catch up with serious economics since they are too busy following a diffuse agenda and patronising the poor. Consequently, agency theory has only recently begun to be used to understand public sector reform in developing countries.

## THE NEED FOR PROFESSIONALISATION AND DECENTRALISATION

We live in a specialised world and there are limitations on the mental capacity of the human mind. The costs of producing and transferring knowledge prevent any single individual or a small body of experts to monopolise any form of decision-making or expertise [Jensen and Meckling (1992)]. If knowledge valuable to a particular decision is to be used in making that decision there must be a system for partitioning out decision rights to individuals who already have the relevant knowledge and abilities or who can acquire or produce them at the lowest cost. Clearly, competent *professionals* who have incurred the costs of acquiring such knowledge as well as shown the inclination (and hence the comparative advantage) for it should be given the responsibility of taking such decisions.

Because all individuals in a firm are self-interested, simply delegating decision rights to them and dictating the objective function that each is to maximise is not sufficient to accomplish the objective. A control system that ties the individual’s interest more closely to that of the organisation is required. The control system specifies:[2, 3]

[2]This control problem is solved in a capitalist economy by a system of alienable property rights. The inalienability of rights within an organisation means control problems must be solved by alternative means.

[3]Specification of the performance measurement and evaluation system *merely* states the objective function. If the reality is different, self-interested individuals discover and understand the performance measures and evaluation system on which their rewards and punishments depend. Thus if the prevailing culture suggests that rewards lie in bribery and corruption which will not be checked, no amount of codification of good rules and procedures and exhortations for honesty will stop them from taking the more profitable route.

- the performance measurement and evaluation system for each subdivision of the firm and each decision agent *(monitoring)*;
- the *reward and punishment system* that relates individual's rewards to their performance.
- **Job Mobility** with better career possibilities inside and outside the firm encourages a forward-looking employee to exert more.
- There is neither guaranteed employment nor a guarantee of a promotion with seniority or age. Promotion is strictly on performance and subject to external competition. At any level, an outsider can and will be brought in if such an appointment will help increase profits.

The complexity of modern society and the specialisation required forces even firms to seek a *decentralised form of management*. Determining the optimal level of decentralisation requires balancing the costs of bad decisions owing to poor information and those owing to inconsistent objectives. In the extreme case of a completely centralised organisation the costs owing to poor information are high while the agency costs owing to inconsistent objectives are zero. The costs owing to poor information fall as the decision rights are delegated down to lower levels in the organisation. Assuming the usual convexities and continuity arguments, the optimal degree of decentralisation can be found to occur where the right is collocated with the specific knowledge relevant to the decision.[4]

Decentralisation often results in two widely used divisional performance measurement rules known as *cost centers and profit centers*. Cost centers are subdivisions that are directed to minimise the total cost of providing a specified quantity of service. Profit centers are more independent than cost centers; their budgets are more likely to be variable than those of cost centers. In general these centers place fewer knowledge demands on the CEO. The key point to note is that such centers are often given considerable autonomy within an expectation of performance.

## THE "MULTINATIONAL" HAS LEARNT!

Learning from "the theory of organisations" as outlined above, the multinationals, especially the American companies have built large and powerful global conglomerates. The empires are built on talent or the use of professionals, regardless of their origin. We all know of the contribution of the Pakistani talent to the development of global blue chip companies such as AST Computers, NEXGEN, Advanced Micro Devices, Citibank, American Home Products, Saudi American Bank, Bank of America, Ethan Allen to name a few. In each of these companies

[4]The optimal degree of decentralisation depends on factors like the size of the organisation, information technology (including computers, communications, and travel), the rate of change in the environment, government regulation, and the control technology.

Pakistanis have played a pivotal role. The multinational management has followed exactly the principles of incentive and organisation theory:

- They have created an atmosphere of professional meritocracy, by hiring the best professionals that they could find regardless of creed and offering them a lucrative and prestigious career.
- Allowing these professionals a large degree of autonomy within a decentralised environment.
- They have held these professionals to high standards. Performance is closely monitored.
  - Good performance is generously rewarded through bonuses that in a short span of time make millionaires out of talented individuals;
  - Bad performance is sharply penalised through instantaneous job loss as well as fervent prosecution of malfeasant behaviour; and
  - Career advancement is purely talent-based. Talent and not age or seniority is the only criterion for advancement.

It is interesting to note that through the application of these sound managerial principles that are firmly grounded in economic theory, corporations such as Citibank, Hoechst etc are able to pull record profits in distant locations. They do so through their decentralised system of management and often relying purely on local talent. In many of these countries governments are unable to draw upon this local talent because of their outmoded managerial and pay structures!

## RETHINKING PUBLIC SECTOR REFORM STRATEGY

Development thinking continues to rely on the government to meet the challenges of progress. An important question that needs to be asked is "whether the government in its current oversized and corrupt form capable of leading any development activity?" Or is it likely that assigning new roles to the government will lead only to the rapid development of further means of seeking rents?

As noted above, governments have clearly grown excessively and have developed a penchant for control and power. At the same time, if international ratings such as Transparency International, Business International Index and the ICRG are to be believed, maladministration and corruption have also increased. Meanwhile, human resource management in the government clearly leads to a poorly motivated public sector that does not attract quality human capital (see Box 1).

**Box 1**

**Human resource management in Public Sectors in Developing Countries**

The public sector has traditionally been viewed merely as a transfer mechanism. The available evidence on wage, employment and human capital policies in the public sector wages suggests the following stylised facts:

1. Poor public sector incentives for attracting talent**:**
   - Public wages have declined in real terms over time in many developing countries
   - Declines in real wages have been larger in poor countries
   - At the senior levels, the private sector wage is much higher than the public sector wage, while the opposite is true at the lower levels.
   - There is considerable **wage compression**: Wages at upper levels of public administration have often been reduced by more than those at the lower levels.
   - The wage declines have been accompanied by an increase in perks and other non-wage benefits that are not only harder to monitor but provided at a higher cost than the value or benefit that the recipient derives.
   - Corruption and maladministration increases with declining real wages.
2. Stabilisation programmes affect fiscal adjustments often through declines in real wages in the public sector.
3. Civil services in poor countries are typically hierarchical, unified, closed and non-meritocratic structures
4. Donor-led CSR efforts thus far have not yielded any success

See Haque and Aziz 1999 for details

Attempts at reform must develop the view of an *efficient* government—one that in the most direct, clear and simple manner seeks to achieve a small number of well-defined social objectives. The design of government must attempt to incorporate *dynamic efficiency* by trying to continuously improve its productivity by means of periodic public reviews of the functioning of the government activities.

Clearly, any reform will have to conduct an audit of current government activities and institutions with a view to clarifying the need and objectives of all institutions. It should aim to eliminate the waste especially by closing down useless tasks and non-performing institutions. It should aim to bring government back to governing and not taking over the economy or the private sector.

Reviewing the theory of organisations suggests some important principles of improving productivity in the government.

- An important change that needs to be made is that of reviewing the recruitment and use of human capital in the key area of governance. This would mean a careful market-based review of cash remuneration. For without that, productivity in government will not be increased, nor will the civil servant be motivated to carry through the reform. The current system of remunerating government servants results in strong incentives to corruption as individuals with less education and increased proclivity to be corrupt opt for such service.
- A smaller government more efficient and professionally staffed government should seek talent from everywhere. Like all other markets, the market for government jobs should also be subjected to external competition. Recruitment should be continuously conducted at all levels and not dependant on one exam only. As much as possible cross flow between management from the private sector to the public sector should be encouraged. Mobility should be strongly encouraged.
- Career concerns are an important source of incentives for productivity and good behaviour. Automatic promotions based on service period or seniority with no evaluation of productivity should be abandoned. Clear, well publicised productivity guidelines, which are easily monitorable, should be established for public positions.
- Emphasis should be placed on the development of institutional autonomy and hard budget constraints. Decentralised decision-making and autonomous cost and profit centers are among the important factors contributing to the strength of the corporate world and should be adopted in the government too.

## BUILDING CAPACITY: HUMAN CAPITAL FLIGHT VS. TECHNICAL ASSISTANCE

While public sectors have been oriented towards wage compression, and economies have been growing slowly, the optimal response of those with skills, was to migrate. We have a fair amount of evidence on brain drain suggesting that there may be a talent pool that poor countries could draw from [see Table 3 and Haque and Aziz (1999)]. Given the relatively short supply of skills in these countries, even non-spectacular numbers appear to have consequences for institutional capacity. Haque and Kim (1995) show that there is an output and income loss with the migration of skills.

A standard approach to dealing with the issue of loss or lack of scarce skills is the provision of technical assistance. International agencies and bilateral donors such as United States Agency for International Development use this approach extensively. Skills that are scarce in a developing economy are provided by short-term expatriate advisers, typically at compensation levels higher than those prevailing in international markets.[5] This is to compensate for undertaking the hardship of moving from metropolitan centers. The high cost of technical assistance is justified since it is expected that institutional development will be encouraged as the human capital input of technical assistance can galvanise a modern system in a short span of time. Once the system has been set in motion, the local human capital can maintain it at the low salary structure prevalent domestically.

Most countries that utilise technical assistance experience a substantial amount of brain drain. For equity and other considerations, the technical assistance model prevents the migrants from a country to return as part of technical assistance. Any person who has been a part of the brain drain can only return home at the low domestic salary and not at the technical assistance level of emoluments. The UN has actually mandated a salary structure in their offices that are situated in developing countries. Bear in mind that the UN local office jobs in many of these countries are among the more coveted. The structure of the professional policymaking/social science labour market is as follows: the lowest paid jobs are in the public sector; locally the UN jobs are preferred; and should the person be willing to move, headquarters jobs are desirable. It is not surprising then that the public sector lacks skills. What is surprising is that the question of the costs and benefits of the alternative channels of brain drain repatriation and technical assistance for institutional development in developing countries, which should be of obvious interest, are seldom studied.

Suppose, as is usually the case, that skilled workers have already migrated. In this case, the comparison needs to be made between attracting an expatriate and a resident of the higher income country. However, Haque and Khan (1997) have shown that for the same compensation, technical assistance programmes will attract higher skilled migrants than experts from a higher income country.[6] Consequently, technical assistance cannot be a substitute for the approach being proposed here—a comprehensive reform of the civil service that fully utilises domestic talent.[7]

## REFORM OF THE PAKISTAN CIVIL SERVICE

Reportedly, misadministration and corruption in Pakistan are high. Given the current level of wastage, we have a management problem and not a resource problem. It is widely believed that the current system is elitist without being professional. Learning from organisation theory, the following can be suggested:

[5]Typically, technical assistance is made available in areas of public sector responsibility such as institutional weaknesses. In such areas, the public sector rigidly maintains an uncompetitive wage structure [see Haque and Sahay (1996) and Haque and Kim (1995)]. Frequently, policy intervention of donors, especially for short term stabilisation, results in a reduction of public sector wages [See Kraay and Van Rijckeghem (1995)].

[6]For proofs of proposition 6 and 7, see Haque and Khan (1998) and Haque and Aziz (1999).

[7]A piecemeal approach to reform based on technical assistance can, in certain cases, lead to unbalanced development and less than durable solutions. For example, the “enclave” approach has been used for quick results.

- *Pay-scales Must be Attractive Enough to Compete for Quality*. The current system of remunerating government servants results in (a) strong incentives to corruption and (b) in the induction of individuals with less education and more incentives to be corrupt in to the service.[8] Salary scales must be set to attract the required human capital to be attracted to public service. This means, departing from the notions of dedicated public service and moving towards a system of market-based salaries within government.[9] As in many countries, such a policy would also mean *decompression of pay scales* and hence the tolerance of greater inequality in government.
- *Performance-based Remuneration Must be Transparent and in Cash.* The bulk of the civil servant's salary should be only in cash. The government should not be in the business of managing houses and cars. These perks are often abused and consequently, impose a heavier a burden on the budget than salaries alone would. Unfortunately, no study has been done of the cost to the taxpayer of maintaining these perks. Nevertheless, we can easily assume that cars are maintained by the government at greater expense and have a shorter life than those in the private sector.
- *Greater Mobility and Openness to External Competition:* The current closed shop system should be closed down and replaced by a new system that relies on open recruitment of the best people from all over given the spread of Pakistanis in the world. Recruitment should be continuously conducted at all levels and not dependant on one exam only. As much as possible cross flow between private management from the private sector to the public sector should be encouraged. Conflict of interest issues will arise but they will be no worse than today where the system is rife with corruption. Selection of good professionals through open and transparent means: Open recruitment should be conducted at all levels from among all available competent professionals and not just those in the government. Such appointments should be subject to some form of scrutiny of the public. For example parliament or parliamentary committees could confirm senior positions like secretaries after open hearings and expert witnesses.
- *Develop Performance-based, and not Seniority-based, Careers:* Automatic promotions based on service seniority with no evaluation of productivity should be abandoned. Clear, well-publicised productivity guidelines, which are easily monitorable, should be established for public positions. Periodic public reporting on progress and performance indicators should be mandatory. Individual and departmental responsibility could also be enforced with some citizen's or the

[8]It is now widely rumored that the high scorers on the civil service are now opting for Customs Service as opposed to the traditional District Management Group or the Foreign Service.

[9]The current low salaries are creating a virtual acceptance of corruption. What is worse, once corruption acquires acceptability, candidates with better educational background and consequently less prone to corruption are less likely to offer themselves for government service.

elected representative's collaboration. For example senior bureaucrats could present annual reports of their department activities to parliament or parliamentary committees allowing media coverage for public information.[10]

- *Career Streams and Institutional Autonomy:* Perhaps the single largest factor that is constraining the flow of human capital into government is the unified National Pay Scales (NPS). These grades have established the relative price of doctors, lawyers, economists, engineers, market regulators etc. and have locked them very rigidly against each other. Thus, for example, a Nobel laureate like Salam can only be a grade 20 professor in his own profession of research and academics while a civil servant who was successful in his exam 30 years ago will be two grades above him in grade 22. Similarly, a world famous neurosurgeon like Ayub Umayyia cannot aspire beyond grade 20 in his own field. The professionally qualified also recognise that professionalism is only capable of taking them upto grade 20, and attempt very quickly to work their way into the political, non-professional world to make their way to health secretary, secretary energy etc.[11, 12]

*Uniformity and Egalitarian Policies Favouring Large Centralised Governments are Outmoded.* No system anywhere in the world locks local government, provincial administration and the federal government into rigid hierarchy as the Pakistani system does. The NPS clearly specify that the functionaries at all levels in the local administration are paid less and fall lower on the NPS scales than those of the provincial government and the latter are at a lower level on the NPS than the federal officials. Thus, for example, the provincial secretary is a grade 20 official the equivalent of a federal joint secretary. The establishment of such a hierarchy means that the local levels can really not compete for human capital of independent decision-making with the federal government.

- *More Autonomous Professional Institutions with Hard Budget Constraints should be Established.* Regulatory bodies, such as the Securities and Exchange Commission and the Power Regulatory Agency, and service

[10]Job performance would be monitored by the mechanisms suggested above. However, they should be supplemented with regular and intensive training activities. Such an approach as well as offers from other sectors will automatically throw up the good officers who may or may not be promoted depending on external competition.

[11]This has been most harmful to education where all professors and teachers have been relegated to a position that is inferior to that of administrators who not only get paid better but are also in charge of resources. A university professor is valued less than university administrators and bureaucrats. Professors therefore have no incentive to hone their skills in their subject; instead they vie for administration jobs such as the vice chancellor. The quality of teaching has, as a result, suffered and less and less of the truly qualified teachers are offering themselves for teaching positions.

[12]Responding to the incentives of the political system, the professionally qualified are prepared to trade their professional competence for a political appointment. In this way we have lost many a capable doctor, lawyer, economist and engineer to the political maneuverer-cum- bureaucrat. What is worse is that the incentives are set for the young to not specialise in a profession and towards political maneuvering.

provision agencies, such as educational and health provision institutions are prime candidates for such autonomisation. Such autonomisation could be based on two principles:

- As far as possible these autonomous agencies have to be subjected to supervision through boards of directors that are rooted in their clientele—the people who demand their services. Often the government retaining enough residual control to interfere in the organisation washes out such autonomisation attempts. This is through the government control of boards and the hiring and firing including the tenure of the CEOs of such agencies. Rather than have a public services commission that attempts to ensure that equality in recruitment is maintained across all institutions, perhaps an alternative commission might be set up to investigate and make public the performance of such autonomous agencies.
- Financing should only be provided based on the achievement of clearly stated objectives. Managers of those institutions should be very seriously held accountable for the management of the finances of the institution and the meeting of the objectives of the institution. They should be forced to public audits and be subjected to a public examination annually. In such a system, we will see that the managers will have to value professionals and not treat them like second class citizens.[13]

- *Performance should be Monitored and Non-performance and Malfeasance should be Penalised.*

## THE NEED TO RETAIN DOMESTIC HUMAN CAPITAL

We must not move along without paying tribute to some of the local talent that even in these adverse circumstances chooses not to migrate. However, those that remain for their own reasons are scattered and overworked, and frequently unable to retain their professional edge.[14] Whatever remains of governance and administration often falls on the few skilled individuals who stay in the civil service. Professions rarely exist in any serious manner in these countries. Those with skill who have not migrated often do not have the resources to do any serious independent work. More often than not, the only choice open to them is work for the local branch of the donor office in a junior position.

The question arises, “how is policy analysis and formulation conducted in such an environment?” The answer is that it becomes the responsibility of the international agency by default. All information on socio-economic development in

[13]Managers should have clear tenures and depart once their tenure is over. The current system of high turnover or exceptionally long tenures is harmful to institutional development. At the initial stages especially, every effort should be made to recruit managers from the non-government and private sector.

[14]Under-funded and low quality universities serve to drive away good faculty rather than develop any critical masses of serious academics in their departments.

these countries is to be found in the reports of these agencies. Domestically, there are no more than a handful who understand these issues and reports, and they are heavily involved in the negotiations and the work of the international agencies. Few, apart from them have access to much of this information. The debate on the issues is restricted to the staff of the international agency and the senior technocratic officials with the former having the luxury of the time and resources to actually conduct serious inquiry. The latter, being in such short supply and spread thinly over the many administrative functions of the country can, at best, act as informed discussants.

Policy ideas originate in donor and international agency offices and are transmitted to the government. Between these two groups decisions are taken. At times, a limited effort is made through a seminar to inform concerned people of the findings. There are two important limitations of approach:

- First, policy initiatives have limited local input or participation and hence may not be fully in consonance with local problems. Hence it is easier to follow the "fad" in the west rather than learn about what is needed domestically.
- Second, there is limited domestic ownership of a product whose origins lie overseas. It is no wonder then that serious efforts at privatisation and downsizing of government were resisted for a long time at considerable cost to the country. Often when these ideas are implemented, they are often resisted locally or nullified through lackluster implementation.

Surprisingly, the current approach to policy formulation has not been examined using the incentive framework. Are the interests of the governments and the donors always in consonance with those of the people? Are the donors who formulate policy always fully informed? Where is the quality check? How is accountability enforced? It is hard to see how mistakes in making policy are even discovered in the current approach. There is little serious review or criticism of the research underlying policy except by those who prepared the policies in the first place—developing countries.

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## Comments

Let me first of all congratulate the author for presenting a useful professional paper with conceptual and theoretical rigor. More importantly, the subject matter of the paper is extremely germane to the public sector and civil service matters in the present Pakistani contest. The paper provides deep insight into the urgent and dire need to introduce an incentive-oriented civil service reform particularly if the government is serious about improving the efficiency and effectiveness of the public sector. Let me recall the author's quote from the authoritarian but visionary, forward-looking former Prime Minister of Singapore, Mr Lee Kuan Yew: "if you pay peanuts, what you get is monkey". This was said over three decades ago and this, in a nutshell, summarises the so-called "incentive-oriented civil service reform". Mr Lee Kuan Yew fully implemented his views and, as a result, the Prime Minister's current annual salary in Singapore is US$ 1.94 million, which is five times more than the salary of the President of the United States. This sort of salary structure does not stop at the highest level but also permeates throughout the bureaucratic set-up.

We now turn to the author's view in a more theoretical perspective. In his paper, he refers to the role of government and governance in growth models. Here the critical question is: What exactly is the role of these non-economic variables in an economic growth model? In the traditional neoclassical growth models developed by Robert Solow and Trevor Swan in the 1950s, the output of an economy grows in response to larger inputs of capital and labour (all physical inputs). Non-economic variables have no function in these models. Furthermore, the economy under such a model conforms to the *law of diminishing returns to scale*. With these assumptions, the neoclassical growth models afford some implications to the economy; particularly that as the capital stock increases, growth of the economy slows down, and in order to keep the economy growing it must capitalise from incessant infusions of technological progress. It is well-known that this type of mechanism in the neoclassical growth model is neither inherent nor does it strive to explain much; in economic lexicon, this simply means that the technological progress is "*exogenous*" to the system. Yet the reality is quite contrary to that, particularly for the East Asian economies, where the economies kept growing for well over two and a half decades. This implies that it is not only technology which is the main driving force accountable for maintaining such high growth performance in these economies, but that there are other factors which are outside the realm of the neoclassical growth model.

Addressing the above issues, in the mid-1980s, a new paradigm was developed in the literature, mostly due to the Paul Romer (1986), which is now commonly known as the "*endogenous growth models*". By broadening the concept of capital to include *human capital*, the new endogenous growth model argues that the law of the diminishing-returns-to-scale phenomenon may not be true as is the case for East Asian economies. In simple terms, what this means is that if the firm which invests in capital also employs educated and skilled workers, then not only will the labour be productive but it will also be able to use the capital and technology more efficiently. This will lead to a "Hicks-neutral" shift in the production function and thus there can be *increasing* rather than *decreasing* returns to investments. In other words, technology and human capital are both "*endogenous*" to the system.

Indeed the advent of the "endogenous growth models" with human capital (providing externalities) have certainly enhanced the understanding of the mysteries of rapid and long sustainable high growth performance of East Asian economies for non-economists; however, both theories seem to be deficient in one important imperative, which is government or government policies—these are all non-economic factors. In fact, Robert Barro (1995) and Jeffrey Sachs and Andrew Warner (1995) have found in their large sample empirical studies that nations with good, transparent government policies and small governments along with educated human capital tend to grow faster than the ones where these elements are missing. Here, I should point out that governance and civil service reform are an integral part of government policies. So what I am arguing here is that it is not only the economic variables that are relevant and important, but that there are other, non-economic variables mentioned above which are equally important in explaining the high growth phenomenon. And it is from this perspective that I believe the author is trying to emphasise and explain the governance issue.

The author has also raised another important issue in terms of the inefficiencies of the civil service, and its remuneration structure at least from the perspective of economic theory. In basic economic theory, under perfect competition, to ensure efficiency and maximisation of output, one needs to ensure that the workers' remuneration or real wage rate should be equal to its marginal productivity. However, if the public sector, which acts as a monopsonist, at the margin offers real wages to its civil servants that are not in conformity with their respective marginal productivity, then this may lead to building distortions and inefficiencies into the system. If the public sector insists and continues to offer rigid wages not in line with the workers' marginal productivity, or if it pays far below the competitive wages, then the consequences of such rigid non-competitive wages will eventually lead to readjustments in the marginal productivities of the workers. Thus, in this type of non-competitive system, there will be an exodus of efficient and qualified civil servants from the low-paid public sector. Eventually, these workers will be replaced by inefficient and, probably, corrupt civil servants.

Another important issue related to the building of human capital is that it has a long gestation period. While with additional capital, technology, and labour it is possible to reduce the gestation period of an economic investment activity (such as a road-building project or a dam project), the same cannot be said about social sector investment, particularly that of education. If there is a 10-year school programme to produce graduates, then by pouring in more resources one may perhaps improve the quality of graduates; but so far as the gestation period is concerned this cannot be changed. So the human capital issue is a long-term proposition, and governments will have to address this issue from that point of view.

In the end, I would again commend the author for raising such an important issue of the public sector which deserves immediate attention of the policy-makers and the government, if they are serious about introducing meaningful reforms in the country.

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