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Putting Institutional Economics to Work

From Participation
to Governance

Robert Picciotto

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Foreword

This pathbreaking paper links the literature of institutional economics with the lessons of development experience.

It starts by describing the changing role of development projects, which began as instruments of public or investment finance but have become a key vehicle for institutional and policy reform. It then proposes a systematic approach to the design of institutional arrangements.

Specifically, the paper explores the complementary roles of the state, market, and voluntary sectors in providing development goods and services. It describes their strengths and limitations and explains their mutually reinforcing roles. Next, it classifies development projects according to the nature of the goods they are intended to provide and draws implications for the appropriate organizational mix between the government, the voluntary sector, and the market. And it uses the same typology to probe the art of improved governance.

The implications for development practice are clear. Markets should be used where feasible and

effective. But there is no efficient market, nor a strong civil society, in the absence of good government. Projects can thus be viewed as inputs into balanced institutional development strategies.

The paper concludes by suggesting that we are in the midst of a social transformation which is likely to further modify our views of development needs and objectives. In a rapidly changing global economy in which national boundaries are collapsing, global markets are expanding, and the free flow of ideas is giving rise to an "associational revolution," new institutions and new approaches to development will be required and multilateral solutions will be needed to solve collective action dilemmas at the global level.

In linking these ideas and showing their power to fill gaps in the development paradigm, the paper invites expanded use of institutional economics in dealing with development problems.

Ismail Serageldin
Vice President
Environmentally Sustainable Development

Abstract

This paper explores the intersection between institutional economics and development practice. Intent on shaping development policy and overcoming implementation dilemmas, development decision makers need new and useful ideas about institutions at project, country, and global levels. The paper presents development projects as instruments of policy reform and institutional

change. It proposes a systematic framework for institutional design and deals with the pattern of different kinds of institutional goods in a country context. Last, the paper analyzes the global factors underlying the growing demand for institutional reform and describes why such reform is achieved more readily through multilateral cooperation.

1. Introduction

The new agenda for sustainable development calls for a mix of market-friendly, people-friendly, and environment-friendly policies. It is equidistant from the failed interventionist doctrines of the left and the "state minimalist" precepts of the right (Streeten 1993). Given complex and highly differentiated development problems, policy makers need relevant support from the academy in their search for pragmatic, tailor-made solutions.

In particular, the design of responsive and accountable institutions has become a central preoccupa-

tion of practitioners. Therefore, institutional economics has been put to work to enhance the impact of development programs and projects. In this context, Chapter 2 describes the privileged role of projects in development assistance. Chapter 3 proposes a systematic approach to their organizational design. Chapter 4 deals with the governance dimension of development assistance. Finally, Chapter 5 attempts a global synthesis.

2. The Institutional Economics of Development Projects

The Project as an Institution

Development is a long-term, incremental process. A key instrument of development is the investment project.¹ Projects aim at finite, specific, monitorable objectives. They incorporate resources commensurate to the task and aim to overcome market failures. They are the building blocks of development programs and their selection for external assistance implies that they have priority for concentrated attention.

Thus, according to Albert O. Hirschman (1967), projects are "privileged particles of development." They are meant to address problems that are especially relevant to the achievement of priority development objectives. They are expected to produce benefits well in excess of their costs, including the opportunity cost of the capital invested in them.² Often, they bring in new technologies and skills or help to capitalize on forward and backward linkages. Their indirect and external benefits are as important as their direct benefits. Conversely, they frequently involve unintended social and environmental costs.

The project achieved initial prominence as a development instrument because it reflected the experience of wartime planning. The presumption of a direct and unambiguous relationship between public expenditure inputs and development results made it easy to "retail" development programs for external support and was consistent with the blueprint approach to development then in vogue. Thus, development projects were originally conceived as "one shot" efforts geared to physical investment carried out over a limited period of time. Such a straightforward approach

appeared well adapted to public sector activity until issues of economic policy and governance emerged as central to the realization of sustainable project benefits.

As development experience accumulated, it became evident that policies and institutions matter more than public investment. In turn, the requirements of a new development agenda emphasizing social, environmental, and institutional concerns led to gradual changes in the very conception of what constitutes a project. Increasingly, projects came to be viewed as policy experiments and as instruments of institutional reform.

Precisely because the project proved a flexible tool, adaptable to changing priorities, it has survived as an effective and influential development instrument.

Project Modalities

The institutional architecture of projects reflects the principles of economic organization elaborated by business economists (Milgrom and Roberts 1992). Fundamentally, a project is a set of contracts linking principals and agents, that is, owners, employees, contractors, consultants, and beneficiaries.

An overarching contract also links the country and the external development agency in the form of a negotiated project agreement which incorporates rewards and penalties. Standard clauses define rules of the game for the procurement of goods, the disbursement of funds, the auditing of accounts, the evaluation of impact, and so on. Tailor-made clauses raise the costs of noncompli-

ance with respect to project-specific performance objectives.

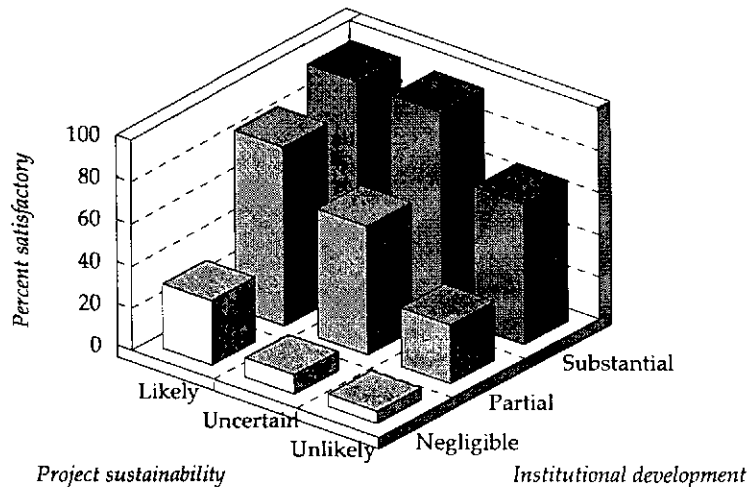
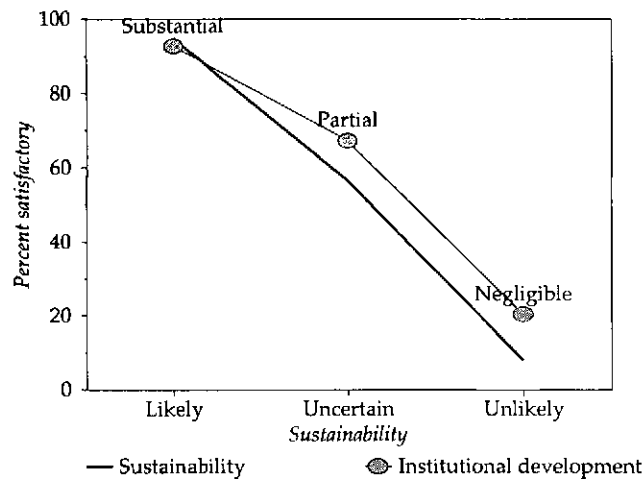
Incentives for effective performance are embedded in project agreements. Reporting requirements provide for monitoring of contract compliance. Disbursements may be suspended or project loans canceled if misprocurement takes place or if fundamental provisions embedded in the agreements have been violated. Conversely, effective project performance produces positive spillover effects, for example, with respect to the use of

project savings, the provision of implementation support, or the financing of "repeater" projects.

Project Dilemmas

Moral hazard is a central preoccupation of development lenders. For reasons of efficiency and reciprocity, a cooperative mode in the handling of unexpected problems is the norm. Yet, opportunistic behavior must be discouraged. While relatively minor infractions are not penalized, egregious free riding is inhibited by incentives and penalties.

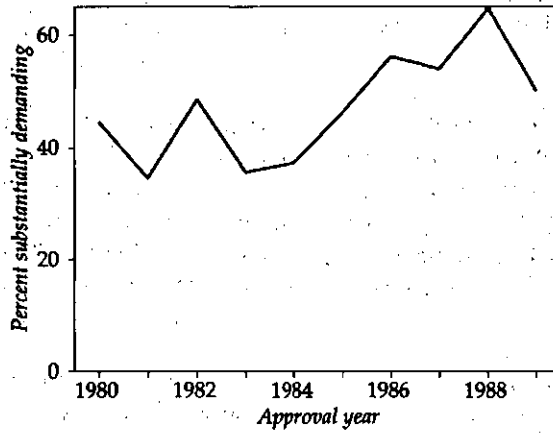
FIGURE 2.1: INTERRELATIONSHIP OF PROJECT SUSTAINABILITY, INSTITUTIONAL DEVELOPMENT, AND PERFORMANCE RATINGS, 1989-93 EVALUATION COHORTS



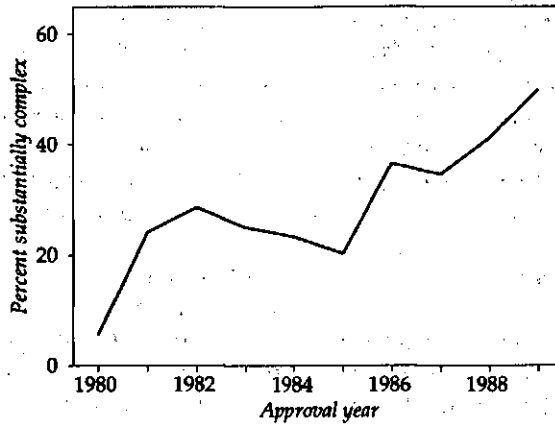
Source: World Bank 1995.

FIGURE 2.2: PROJECT DEMANDINGNESS, COMPLEXITY, AND RISKINESS

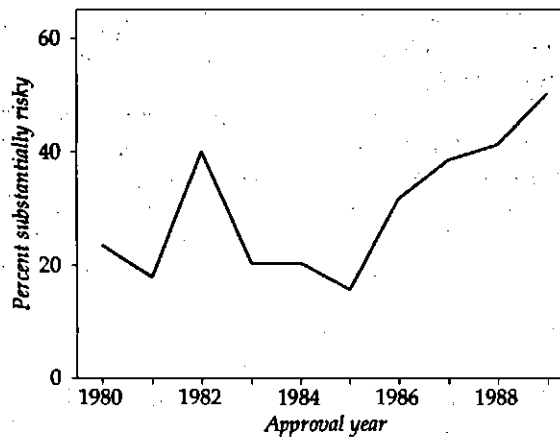
**Project Demandingness, by Approval Year,
1993 Evaluation Cohort**



**Project Complexity by Approval Year,
1993 Evaluation Cohort**



**Project Riskiness by Approval Year,
1993 Evaluation Cohort**



Source: World Bank 1995.

The familiar tradeoffs explored by business economists—with respect to the depth of monitoring versus the capacity constraints affecting information processing, the degree of contractual completeness versus the resort to performance incentives, and the demandingness of performance standards versus the risks of adverse selection—are routinely faced in development assistance operations.

These considerations translate into transaction costs. Some are borne by the borrower—others by the development agency. The benefits of development learning arising out of individual projects are shared throughout the membership. At their best, projects act as pathfinders for the overall development enterprise.

An Evolving Development Instrument

Projects tend to reflect the development conceptions of their time. As long as planning dominated development practice, projects were perceived as slices of the public investment program. Their design was geared to the achievement of physical goals and government expenditure targets. Optimization was sought through systems analysis. Project preparation focused on issues of size, physical characteristics, and technical parameters. Economic analysis concentrated on shadow pricing to compensate for market distortions. In short, projects reflected the then prevalent “production function” metaphor of development.

Once the neoclassical resurgence set in, projects no longer took economic distortions for granted and, instead, began to address the policies that created them. New lending instruments were forged to provide quick-disbursing assistance explicitly targeted at policy adjustment. More recently, unambiguously close and positive correlations between the institutional development impact of projects, their outcomes, and their sustainability have been uncovered by evaluation. See Figure 2.1.

As a result, projects have become more demanding, complex, and process oriented to respond to the

remarkable enrichment of a development agenda which now encompasses social and environmental concerns and aims at greater participation. Projects increasingly incorporate policy and institution-building features. This is producing more ambitious operations, involving higher benefits but also higher transaction costs and risks (World Bank 1995). See Figure 2.2.

In response, improved internal management programs have been introduced to manage portfolio risks, to enhance the development impact of projects, and to streamline business processes (World Bank 1993b). The very cycle through which projects are conceived and implemented is being reconsidered (Picciotto and Weaving 1994).

Such reforms are consistent with the precepts of institutional economics. The problem of imperfect commitment to project objectives having been identified as a major cause of unsatisfactory development outcomes, more effective routines of project preparation and approval directed at building borrower “ownership” emerged (Johnson and Wasty 1993). Information asymmetries having been found to affect the development impact of projects, more rigorous inspection and evaluation arrangements have been put in place (World Bank 1993b). The streamlining of internal information flows, shifts of administrative resources toward client relations, strengthening of management accountability for results, and tighter budget policies have come to dominate development agency reforms. All of these measures aim to enhance the incentives for successful development performance and lower transaction costs.

Notes

1. It is consecrated as the major vehicle of World Bank assistance by the Bank's Articles of Agreement.
2. The basic project evaluation methodology used by the World Bank is summarized in 1992 *Evaluation Results*, 1994, pp. 57-58.

3. The Fundamentals of Institutional Design

However astute the contractual arrangements, however tight the monitoring, and however relevant the objectives of development assistance, projects are highly vulnerable to implementation dysfunctions and poor organizational designs. Institutional economists have yet to focus directly on such issues. The balance of this paper suggests a possible approach to this challenge.

Choosing Among Institutional Alternatives

Just as reorienting the role of the state in economic management is a recurring feature of macro-economic adjustment, the judicious assignment of responsibilities to the public, private, and voluntary sectors is critical to the design of institutional arrangements at the project level. The purpose of this chapter is to show that the nature of project goods is fundamental to organizational design.

Traditionally, the institutional design of projects was dominated by an *a priori* public sector orientation. As government capacity and fiscal constraints came to light, there was greater emphasis on mobilizing private resources for development. At the same time, in response to pressing social and environmental problems, voluntary organizations multiplied and attracted substantial development funding. The same societal shifts made the involvement of beneficiaries in achieving project objectives (participation) an article of faith for the entire development community (Organization for Economic Cooperation and Development 1991).

Thus, as disillusionment with the capacity of states to control the "commanding heights" of developing economies set in, the role of the private and voluntary sectors increased and the assumptions governing the design of project organizations had to be reconsidered. Missing so far has been a

systematic approach to the choice between the public, private, and voluntary sectors or an understanding of their respective roles in enhancing development performance.

Enter Institutional Economics

The elements for a concerted approach to organizational design are available: the potentials and the limits of government, markets, and organizations have been extensively analyzed by institutional economists. In particular, the literature has brought to light the difficulties of aligning individual incentives to the common good in large and heterogeneous groups (vs. Mancur Olson's pioneering work on the dilemmas of collective action).

By now, the powerful incentives to "free ride" that are inherent to large groups are well understood. Similarly, the transaction cost literature has illuminated the contractual enforcement difficulties associated with excessive reliance on hierarchy and control. Whereas, under the traditional public investment planning approach, there was a presumption in favor of command and control organizations, institutional theory has established that the desirable point of departure for reviewing project design options is the market.

Specifically, where markets can be used efficiently they should be, since—compared with the alternatives—they save on scarce administrative capacities, avoid the public choice obstacles associated with large organizations, and tend to be responsive to consumer needs. This said, not all development problems are amenable to market solutions.

In particular, private transactions are effective only for goods which are consumed by one person at a time (*subtractability*) and in circumstances where

individual consumers can be excluded without incurring substantial costs (*excludability*). It is the combination of these characteristics, which, along with competition, provides the conditions of free entry and exit which results in market efficiency. The implications for institutional design are fundamental (Kessides 1993). See Figure 3.1.

Common Pool Projects

The management of common pool goods (common pastures, irrigation water, and so on) is especially challenging because such goods lack excludability while enjoying subtractability. This hinders market operation. With subtractability high, competition for access to the good is heightened by its finite supply. In most instances, hierarchy is not an effective deterrent to free riding either, because effective rationing requires an elaborate monitoring infrastructure which may not be available or an administrative apparatus so vast that it is easily subverted.

The failure of market mechanisms combined with the impracticability of controls explains why common pool goods are best managed through persuasion and cooperation. Uninhibited market incentives or technocratic management modes unaccompanied by appropriate participatory arrangements are frequent causes of project failures for common pool projects. In particular, projects that depend on the management of finite natural resources tend to fail when they disrupt

traditional arrangements for resource preservation and equitable distribution of benefits without putting in place effective management alternatives.

Thus, allocation of water at the watercourse level, access to community pastures and natural forests, or use of scarce fisheries resources can turn into tragedies of the commons (that is, unintended resource exhaustion) unless effective participatory institutions are in place and support whatever technological innovations or management changes are introduced. In such situations, individual incentives left to themselves clash with the common good and regulatory institutions imposed from the top down can be ineffective, especially in circumstances where they are readily undermined by corruption or collusion.

The privileged role of participation in the management of community projects is illustrated by the Matruh Natural Resource Management Project in Egypt supported by the World Bank and undertaken in collaboration with Bedouin communities; in the National Irrigation Administration Program carried out in the Philippines to improve water management, and in the Pakistan Oragi Pilot Project, which aims to develop affordable sewerage for Karachi's squatter settlements.¹ In all these instances, community involvement and local contributions are combined with technical improvements and reduction of corrupt practices through peer group pressures.

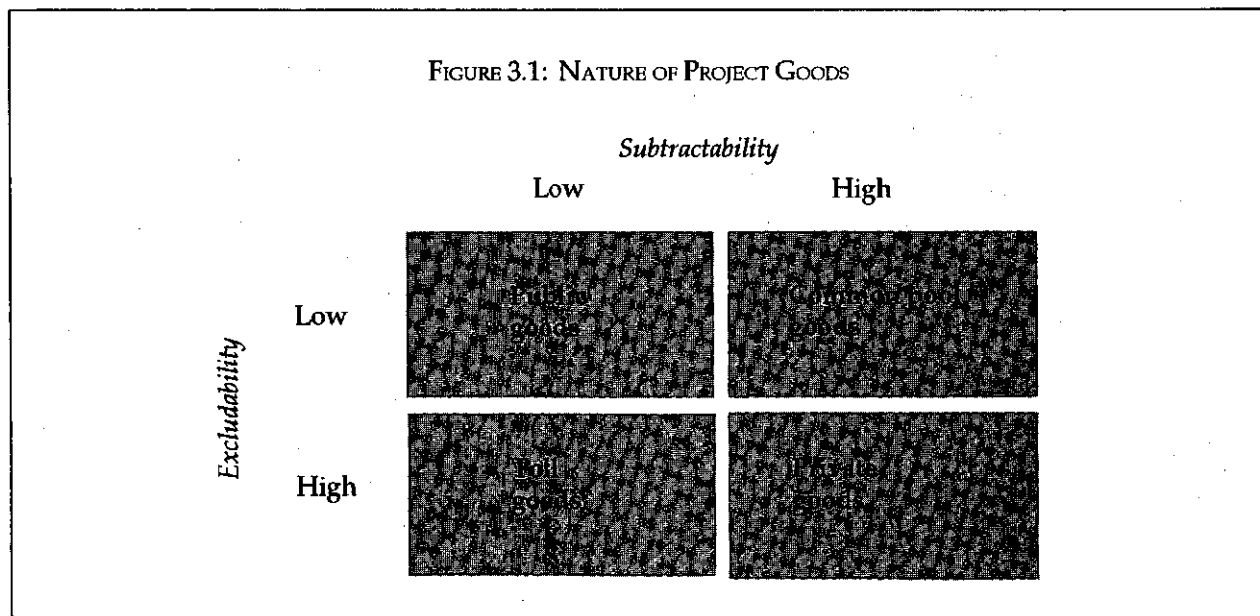
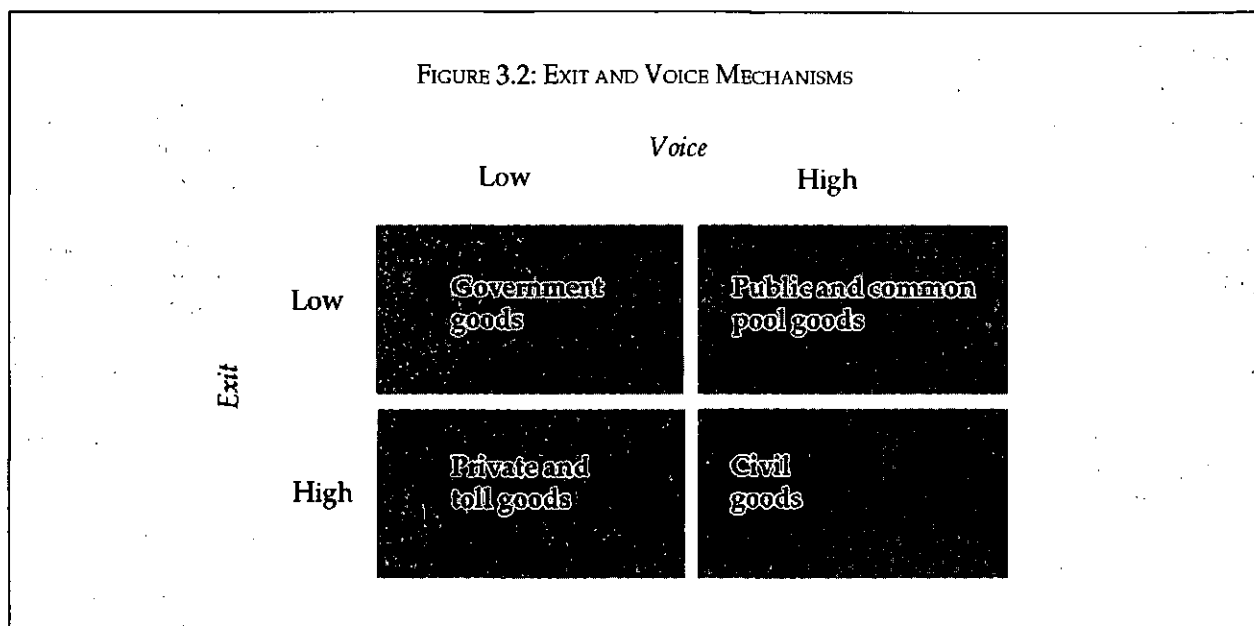


FIGURE 3.2: EXIT AND VOICE MECHANISMS



Thus, cooperative scenarios with happy endings do exist (that is, natural resources *can* be managed) if institutional design takes due account of the prerequisites—selective incentives, relatively small groups, strong leadership—identified by Mancur Olson with respect to the solution of collective action dilemmas.

Exit and Voice

Where consumption by one beneficiary does not reduce availability of the good to others (that is, when subtractability is missing), powerful incentives to free ride exist as well. In such circumstances, hierarchy can help. But experience, as well as theory, suggests that market mechanisms (*exit*) are also needed where control of access is feasible (toll goods), whereas *voice* mechanisms are called for where it is not (pure public goods). See Figure 3.2.

It was a World Bank-financed railways project in Nigeria which pointed Albert O. Hirschman to the discovery of what is arguably the most influential trilogy of institutional economics: exit, voice, and loyalty (Hirschman 1970). Because of the ease with which the railways corporation could tap into the national treasury, Hirschman noted that exit of important customers weakened the very voice option that might have triggered recuperative mechanisms within the public agency. Thus, Hirschman concluded that loyalist (that is, exit

postponing) behavior was a key factor of organizational resilience in many situations. Hence, the role of loyalty-inducing hierarchy. See Figure 3.3.

Organizational design can now be defined as the selection of appropriate exit, voice, and loyalty building mechanisms. When the market represents the most appropriate mode of project operation, exit mechanisms should be given pride of place. When participation is the answer, it makes sense to nurture voice mechanisms. Loyalty (and its ally, hierarchy) intervenes when exit and voice cohabit, but exit needs restraint to give full scope to the recuperative benefits of voice. Thus, for pure public goods (for example, a more rigorous tax policy or a traffic signalling scheme) full benefits occur where loyalty is encouraged by effective policing (hierarchy) and/or users are involved and motivated (participation).

Public Goods Projects

World Bank experience with rural roads and water supply projects confirms the importance of loyalty-building mechanisms and the need for a mix of hierarchy and participation for public goods projects. In the Gurage roads organization in Ethiopia, local maintenance has been handled effectively since 1962 through community involvement, training, and adequate compensation of service operators. Under a pilot program in Côte d'Ivoire, villages were explicitly required to

maintain handpumps at their own expense and were provided with training. The program resulted in more reliable water service.

In the Côte d'Ivoire case, collective action dilemmas arose, when attempting to organize competing interests into water management committees. The problem was especially serious in the larger villages and, in a revealing manifestation of hierarchy, the village chief simply took over the selection of committee members. Similarly, in the Zambia Social Recovery Fund Project, boreholes were dug to relieve severe water shortages without local contribution and, given the perceived urgency of the scheme, with minimal consultations. When pumps failed, the beneficiaries refused to contribute to the needed repairs.

Thus, the authoritative role of hierarchy is vital when a small part of the beneficiary population involved in a project exercises undue influence. In the Central Visayas Regional Development Project (Philippines), community organizations were allowed to organize forest residents in reaping traditional benefits out of protected forest areas. This arrangement had to be revoked when the leaders of these organizations colluded with timber merchants to harvest live trees. This familiar example of the corroding impact of vested interests illustrates the need to align individual incentives with the common good lest the public venture becomes a hostage of minority vested interests as predicted by public choice theory (Gerson 1993).

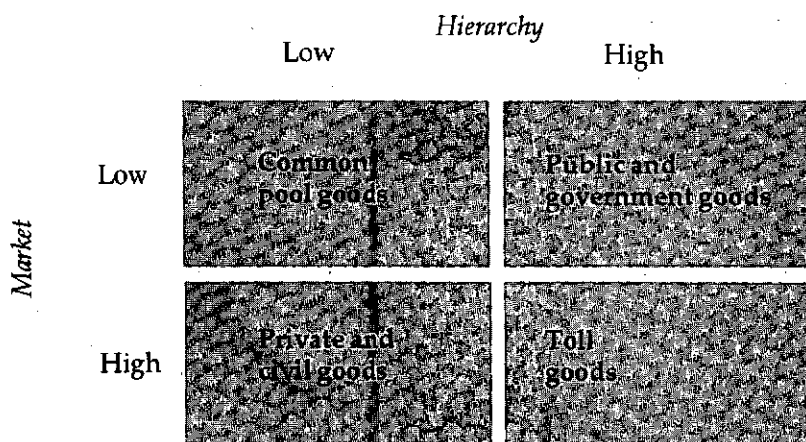
Toll Goods Projects

Toll goods projects (such as for piped water) can only be managed effectively through organizational options which combine market and hierarchy. The choice of options (ranging from regulated private water companies, concessions, autonomous public corporations, to contracting) depends on a variety of project characteristics (whether or not costs are sunk; network features); the administrative resources available, the feasibility of regulation and initial conditions, and so on. The sequencing of reform requires judicious assessments of institutional potentials and constraints.

The regulation of utilities illustrates how systematic institutional design can encourage private investment while maintaining competition and efficient pricing. Institutional economics has helped to shape well-adapted arrangements that ensure compatibility with domestic legislative, executive and judicial institutions (Levy and Spiller 1993).

Credible commitment that regulatory discretion will be restrained within fair bounds, that basic changes in the enabling environment will not take place, and that effective and independent recourse will be available in case of conflict are basic determinants of private utility investment and operation. This is why policy options regarding regulatory reform must take account of the initial conditions characteristic of the country's institutional environment.

FIGURE 3.3: THE ROLE OF HIERARCHY



In the design of appropriate institutional solutions for toll goods projects, the existence of a respected and independent judiciary has been shown to be fundamental. In its absence, reliable external conflict-resolution mechanisms have to be specified. Safeguards can be provided through legislation (as in Chile) or embedded in the operating license (as in Jamaica). Where existing institutions are incapable of effective and flexible enforcement of broad regulations, complex rules are needed, which presumes, of course, that strong administrative capacity is available.

In certain situations, as a transitional measure, international mechanisms may be able to provide comfort to participants to offset domestic administrative weaknesses. For example, World Bank guarantees against noncommercial risk have been used to encourage investment while core institutions are strengthened and a constituency for domestic capacity building and reform is nurtured.

Government and Civil Goods Projects

Where both subtractability and excludability obtain—as they do for most agricultural and industrial products—efficient resource allocation and consumer satisfaction prevail, provided the market is allowed to operate freely and efficiently and market participants are intent on maximizing their incomes (as producers) or their satisfaction (as consumers). This implies, of course, that a suitable policy framework is in place.

The dilemma is that policy itself is a public good: market involvement by an individual producer or consumer does not detract from the involvement of other participants and there is no obstacle to access. In other words, the market cannot operate effectively without the likelihood of contractual enforcement, that is, without the production of certain *government goods*. Thus, a distinction is made between policy formulation, which involves a mix of hierarchy and participation, and policy implementation, which relies largely on hierarchy.

The administration of commercial law, the management of safety nets, or the implementation of environmental regulations are examples of government goods. Such goods are the fruits of the executive and judiciary branches. They differ from the regulations and laws themselves, the production of which typically involves both the

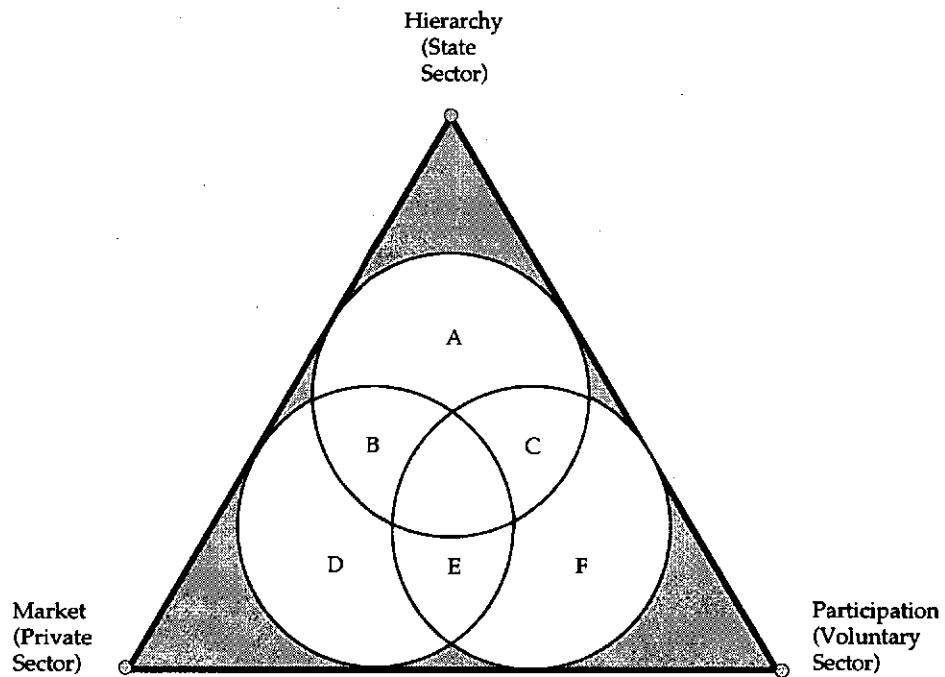
executive and the legislative branches of government, that is, a mix of hierarchy and participation. Government goods are important because without enforcement and the deterrence it produces, opportunism prevails. Therefore, the market needs the state just as the state needs the market. But this cohabitation is not trouble free, since overzealous reliance on one automatically undermines the other, for example through bureaucratic constraints associated with the state or the rent-seeking behavior associated with private parties.

Yet another category of goods—*civil goods*—is needed for effective market operation. It differs fundamentally from the others. Delivered by private voluntary organizations of bewildering diversity, civil goods have grown rapidly precisely in countries where the market and the state are poised in relative balance. In totalitarian regimes, the civil society is weak precisely because hierarchy brooks no dissent. In countries where the state is failing and markets are moribund, voluntary action also tends to be weak. Thus, civil society plays a vital supporting role by filling gaps in private and government activities, by exhorting, motivating, and restraining the state, and by calling attention to the excesses of free and unrestrained markets.

Civil organizations are breeding grounds for participation and cooperation. They operate with minimal reference to hierarchy. Indeed, they often define themselves in opposition to the state—as the “nongovernmental” sector. They thrive on debate and make shrewd use of advocacy to achieve their objectives. Their ascent parallels the decline of the state, the rise of the market, and the growing dissatisfaction with the failings of both the state and the market.

To be sure, there is no guarantee that all components of civil society are benign or genuinely concerned with the fate of the downtrodden. Indeed, theory suggests that the smaller and more motivated the group, the more vocal and effective it is in maintaining cohesion and achieving results. This means that the extremes often rule. Thus, some private voluntary organizations are specifically created to advance the interests of narrow and privileged constituencies. Therefore, failing effective self-policing, the civil society must be restrained to work for the common good both by the workings of the market and by the enabling environment of the state.

FIGURE 3.4: INSTITUTIONAL DESIGN PARAMETERS



	<i>Nature of project goods</i>	<i>Dominant parameters</i>	<i>Institutions</i>	<i>Example</i>
A	Government	H	State agencies	Justice, police
B	Toll	M, H	Public or regulated private corporations	Public utilities
C	Public	P, H	Hybrid organizations	Policy, rural roads
D	Market	M	Private corporations, farmers and entrepreneurs	Farming, industry, services
E	Civil	P, M	NGOs, PVOs	Public advocacy, professional standards, civic action
F	Common pool	P	Local organizations, cooperatives	Natural resource management

Parameters: Hierarchy = H; Participation = P; Market = M

Figure 3.4, drawing on Keidel's (1995) approach to "seeing organizational patterns," shows the full array of project categories described above and their relationship to the three major development institutions: the state, the market, and the voluntary sector. Obviously, the dividing lines between the six categories of goods are not sharp and there is considerable synergy among them. For example, the state requires a mix of government goods (for enforcement) and of public goods (for representation of various interests) so as to yield legitimacy. Yet, the framework can be used with profit to initiate organizational design at the micro (project) level. And it can also facilitate institutional design at the macro (country) level as Chapter 4 shows.

A Delicate Balance

In sum, development requires government and civil goods in addition to a judicious mix of private, public, common pool, and toll goods. Institutional economics helps explain why projects are now seen as mechanisms through which such goods are supplied. This role is fundamental because the art of governance consists of achieving an appropriate balance between the products of various institutional goods so as to achieve a positive interplay between the state, the market, and the voluntary sector. There is a natural tension between each of these actors given their contrasting mandates and their different constituencies.

And an appropriate balance is struck when excessive power by any one sector is counteracted by one or the other two. Thus, if one sector is patently weak, judiciously selected capacity-building projects can help redress the balance (see Chapter 4). Thus, effective governance involves cross-cutting and shifting alliances as well as deliberate capacity-building efforts aimed at mutually supportive operation of the state, the market, and the civil society.

The actual mix is highly dependent on initial conditions: path dependence is an important feature of institutions. External advice may be needed to design arrangements combining well-engineered exit, voice, and loyalty mechanisms. Moving from one institutional equilibrium to the next without losing ground can be an acrobatic maneuver the success of which may be facilitated by an outside party.

Note

1. A Bankwide Learning Group on Participatory Development was launched in December 1990. In August 1994, it produced recommendations to increase participation in Bank work. The recommendations were endorsed by the Bank's management and its Board. Many of the illustrations provided in the paper are drawn from the work of the Learning Group.

4. The Governance Dimension of Development Assistance

Chapter 2 described projects as public goods designed to overcome failures in development markets. Chapter 3 proposed an analytical framework for the design of project institutions within a macroinstitutional structure which was taken as given. In this chapter, the institutional resource endowment of the country is the focus: *institutional capital* is viewed as a primary determinant of economic and social performance. From this perspective, depending on their relevance to the country's institutional development needs, projects deplete available institutional capital or contribute to its accumulation.

Taking Account of Initial Conditions

Poor development management is the inevitable consequence of corrupt, misdirected, or weak government because only government can create an enabling environment for the development of efficient markets and, together with civil organizations, can sponsor programs to protect the poor and the environment.

Institutional endowment varies across countries. In some, traditions, rules, and organizations render development efforts effective. In others, characterized by poor governance, economic performance is hindered by a tendency to divert public resources for private gain; arbitrary, unpredictable government behavior; excessive rules and regulations; or unresponsive, opaque decision making.

Poor development performance (typically induced by external shocks and misguided policies) also contributes to poor governance. Stagnant economies induce weak public finances, dissatisfaction among citizens, and pervasive distrust of government. Just as good governance facilitates the

introduction of effective economic policy, good economic management facilitates the reform of governance arrangements.

Reorienting Government

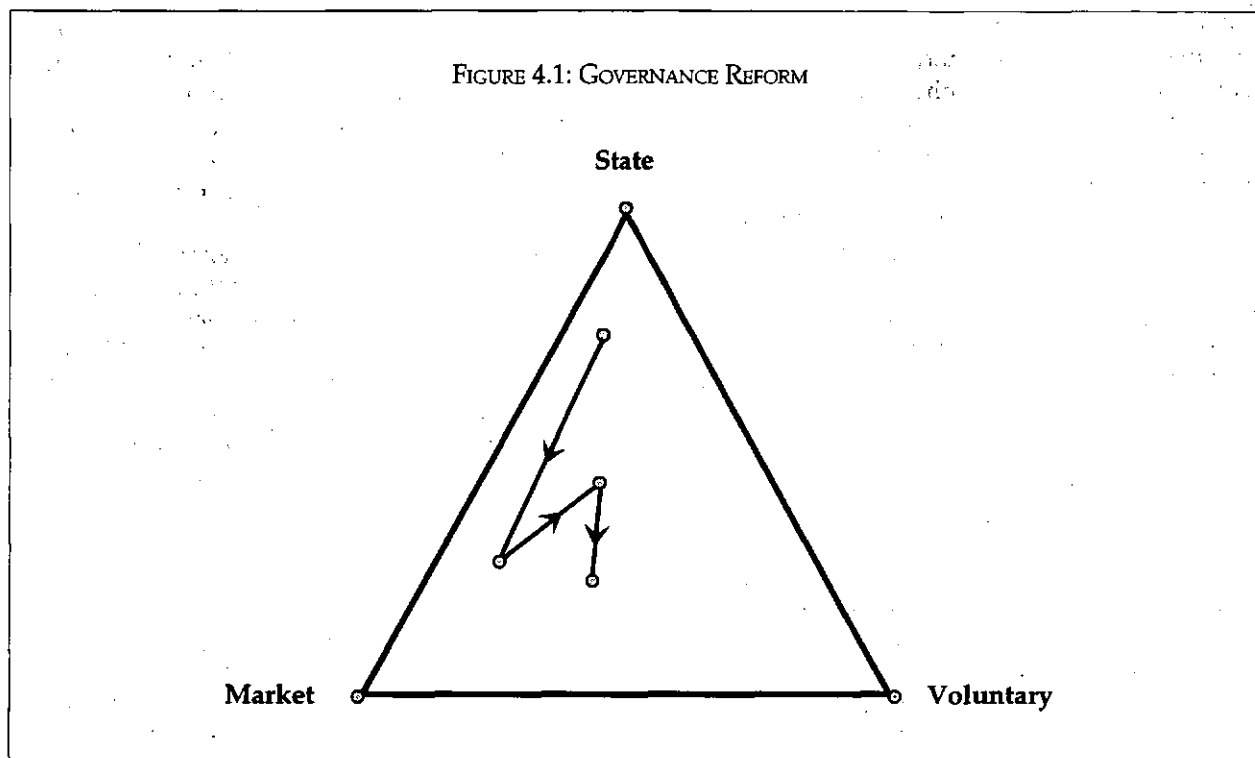
This explains why in addition to providing developing member countries with funding and policy advice, development assistance is now addressing governance issues in their own right (World Bank 1992). With the introduction of policy-based lending, the focus has shifted towards the enhancement of countrywide institutions. One important way of improving governance has been to help ensure that scarce public resources are concentrated on functions that only the government can provide while encouraging a greater role for the private sector and civil society.

Therefore, taking account of country conditions and objectives, the principles illustrated in Figure 3.4 for the micro level apply equally at the macro level. For example, public capacity-building activities are best geared to the discharge of functions for which the state is well suited, while policy advice is best directed to establishing positive enabling environments for private enterprise and voluntary activities to fill whatever gaps are left. See Figure 4.1, which illustrates a sequential approach to policy reform, focusing first on reorienting the role of the state and next on encouraging the voluntary sector to assist in the adjustment process.

Financial Sector Development

Changes in financial systems illustrate how the redefinition of the role of the state has induced pervasive changes in the institutional fabric of developing countries (World Bank 1993a).

FIGURE 4.1: GOVERNANCE REFORM



In the 1950s and 1960s, almost all developing country governments took control of private financial systems and set up specialized banks for agriculture and industry under public ownership and control. The state directed financial institutions to lend to selected industries on subsidized terms. The limitations of this approach were not apparent as long as there was easy access to foreign funding.

After the onset of the debt crisis, high interest rates, low commodity prices, and devaluations increased the domestic burden of borrowing firms' foreign debts and governments had to borrow domestically for their needs, exacerbating inflationary pressures. Given the artificially low lending rates in force, as well as the poor quality of the loans made, the banking system became unviable in many countries and financial sector reform became a top priority.

In some countries, reforms of the company, banking, securities, and bankruptcy laws were required. In others, fiscal policy, banking supervision, and regulation had to be redirected away from credit allocation and interest rate controls toward the maintenance of a healthy and efficient financial system. In Eastern Europe and the former Soviet Union, wholesale restructuring had to take place in

parallel with reform in the regulatory framework and stabilization of the economy.

More recently, the emergence of substantial private flows has put the emphasis on securities-based systems and the development of capital markets. Partly as a result of policy reform, private capital flows to developing countries have risen. They represent portfolio investment (through bonds and equities) as well as foreign direct investment fuelled by privatization. They are concentrated in countries that have achieved effective economic stabilization, policy reform, and institutional development in their financial sectors and capital markets. Just as governments set the rules for markets, markets are now setting constraints on the role of governments.

Public Sector Management

In sum, given the fundamental dilemmas of collective action highlighted by theory, the concentration of public sector activities on appropriate functions has emerged as a necessary condition of effective governance. Hence, the focus of the new development agenda on civil service reform; increased competitiveness of the business environment; improved effectiveness and efficiency of

public agencies; restructuring, liquidation, and privatization of public enterprises; and decentralization of government administration. Experience shows that the success of such programs depends not only on the effective transfer of skills and practices but also on the broadly based "ownership" of reform objectives and the construction of workable coalitions (Johnson and Wasty 1993).

Focus on government commitment to reform is relatively new. Public choice theory has shaped practice by highlighting the gap that often exists between public policy pronouncements and actual implementation and by identifying strategies aimed at aligning individual incentives and social goals.

Accountability

Accountability requires mediation among three distinct groups: (1) recipients of public services; (2) political leaders who oversee service providers; (3) the service providers themselves. The goals and interests of each group differ from those of the other two, and a useful role for development assistance agencies is to help prevent capture of the public good by one of the groups to the detriment of the others—and of the public interest. Where such capture is prevented, loyalty is enhanced.

It is not practical to expect sustainable reform toward accountability through actions limited to the micro (project) level since the role of the modern state involves a myriad of interrelated functions, and projects have a limited focus and a finite life. Macro-level accountability, on the other hand, calls for sustained shifts in public attitudes and government practices, and "path dependence" is a powerful drag on wholesale reform. Given these obstacles, a judicious mix of "micro" and "macro" interventions is needed and mobilization of scattered energies in support of reform is often feasible only in periods of crisis. This explains the links between financial crises, governance reform, and policy adjustment. Beyond the management of public finances and the design of investment projects, policy dialogue, public education, nurturing of consensus, and carefully sequenced strategies of reform have become central to the development enterprise. Ideas matter.

Among the government goods that are underproduced for public choice reasons are those which enhance accountability for financial and

economic performance. Financial accountability at the project level faces obstacles linked to generic weaknesses in countrywide public accounting, expenditure control, and cash management. To address this issue, technical assistance can be devoted to build up domestic institutional capacity.

Similarly, accountability for economic performance may be addressed through budget policy reforms; improved public expenditure management, removal of white elephants from investment programs; decentralization of public administration; elimination of ghost workers from public employment rolls; closure and privatization of public enterprises; making public entities commercial as well as evaluation capacity building.

Thus, the World Bank has provided assistance to Poland and Romania for decentralization, to Indonesia for financial accountancy development, to China for evaluation capacity building, and to Ghana and Madagascar for public financial management. In order to improve accountability for environmental programs, the Bank has required the preparation of environmental impact assessments for the projects it finances and has assisted its member countries in the design of countrywide environmental action plans. Research into appropriate indicators for environmentally sound management of natural resources is underway.

The Rule of Law

Still another dimension of governance capacity building is the establishment of a sound and predictable legal framework for development. Five elements are involved: (1) rules known in advance; (2) enforcement of rules; (3) monitoring; (4) conflict resolution; and (5) timely amendment of rules. Together, they facilitate the production of what was earlier defined as "government goods" essential to the reduction of transaction costs.

To this end, the World Bank has assisted Mauritania and Guinea in disseminating information about the law through official gazettes. In Laos, the Bank has helped to fund legal training and the promulgation of business legislation. In Romania and the Czech Republic, contradictions and inconsistencies in legislation have been identified and removed. In Sri Lanka, financial sector adjustment lending has helped to reform the laws allowing financial institutions to foreclose on collateral.

Under the Philippines Financial Sector Adjustment Loan, the bankruptcy law has been revised to make it less punitive to debtors and more rehabilitative in the interest of both debtors and creditors. In Bangladesh, a financial sector adjustment credit has helped to establish courts, appoint judges, and dispose of cases to implement a law designed to reduce the time needed to settle suits brought by financial institutions against defaulting borrowers.

Transparency and Participation

Voice mechanisms are the lifeblood of participatory modes of governance. Since these mechanisms depend heavily on information dissemination, suitable rules of the game concerning disclosure and dissemination of public information are part and parcel of improved governance. Considerable experimentation has taken place in building solidarity and incentives for participation at the project level and in strengthening voice mechanisms used by beneficiaries vis-à-vis public agencies. To take hold, these often require the provision of special incentives and the involvement of an outside party.

In a pilot project in Bangladesh, for example, where tradition normally excluded destitute women and widows from gainful employment, nongovernmental agencies organized landless contracting societies to involve these women in construction activity to preserve flood-prone embankments. In Pakistan, during implementation of the Integrated Hill Farming Project, it became clear that communities organized to undertake reforestation were not disposed to maintaining and protecting the sap-

lings during their five-year maturation period since the returns were too distant to motivate collective action. Accordingly, undergrowth plants were added to the plantations to be harvested on a rotating basis.

The emergence of a strong voluntary sector depends on a host of cultural and historical factors. In some countries (Bangladesh, Chile, Colombia, India, Kenya, Mexico, Zimbabwe) voluntary agencies have mushroomed. In others, they have not and remain very dependent on official sponsorship and support. Pressures to coopt NGOs are ever-present and must be resisted. Yet, there is great scope for complementary action as NGOs, despite frequent administrative weaknesses, can be cost-effective in reaching low-income groups. Today NGOs act as effective partners of the state (and of development agencies) in a wide range of development operations.

Country Institutional Development Strategies

Institution building is a time-consuming, complex process. It requires a long-term vision, sustained efforts, and well-sequenced operations. The paradox of institutional development is that it is the most needed in the very countries where it is most difficult to achieve. Where commitment from the political leadership is not available, it needs to be nurtured without major resource outlays. Where, on the other hand, ownership is assured, nimble and responsive external assistance can yield very high returns. Judicious choice of instruments and partnership among development agencies are central to cost-effectiveness and selectivity.

5. The Global Dimension of Institutional Development

It should be clear by now why, in the words of Oliver E. Williamson (1994), "institutional economics has been invited to join the arena" of development economics. A pragmatic reaction against the orthodoxies of planning and neoclassicism, institutional economics aims to bridge, encompass, and transcend these orthodoxies so as to provide more reliable guides to development decision making.

In the neoclassical world, a "hidden hand" manages resource allocation. In nonmarket environments, a providential or dictatorial "hiding hand" seeks to maximize social utility. Both conceptions are unrealistic: they ignore transaction costs and take little account of the incentives and interests which underlie policy.

By contrast, institutionalists are concerned with the costs and benefits of transactions and suspicious of the "immaculate conception" school of economic decision making. They seek to understand the motivation of economic agents in order to build effective strategies for reform. Thus, the ascent of institutional economics is partly related to supply factors—the production of realistic and relevant concepts by the new institutionalists. But it also reflects demand factors, that is, the urgent need for new ideas to assist principled and practical decision making in the rapidly evolving development business of an increasingly interdependent world.

Global Factors

Underlying this demand are vast changes in the global economy. The urgent need to reform economic institutions arises out of three main

factors: (1) the growing interdependence of the international economy and the physical environment; (2) the explosive impact of demography and technology; and (3) the tight fiscal constraints on governments and development agencies.

These factors are interrelated. The world economy has become global not only as a result of trade liberalization but also because of innovations in telecommunications and information technologies. These technologies have made governance failures more visible. The fiscal constraints that plague the public sector are themselves the indirect result of unstable monetary and fiscal policies triggered by global shifts in exchange rates, interest rates, and capital flows.

Conversely, fresh opportunities have arisen as a result of the new agility, responsiveness, and location-independence of multinational production (Lindbaek and Rischard 1994). Improved economic policies and new financial instruments are unlocking the enormous potential of private capital markets to meet the pent-up needs for infrastructure investment in developing countries.

At the same time, major ecological threats requiring collective action are looming. Global warming, water scarcity, acid rain, deforestation, public health crises, and large-scale migrations transcend national borders. The need for multilateral action is especially dominant with respect to failed and failing states. The centrifugal forces unleashed by the end of the cold war are fueling regional conflicts, famines, and refugee movements precisely in areas where population growth is galloping, environmental stress is high, and development has been lagging.

It is no accident that where development has failed, basic governance and institutions have usually been weak. Enhancement of domestic capacities simply cannot be handled within reasonable time frames without sustained international cooperation and development assistance. In a sense, government goods and civil goods have become internationally traded services. Shifting boundaries for market solutions, the rise of the voluntary sector, and rising returns to investment in ideas have confirmed the continuing need for responsive international development cooperation.

Shifting Boundaries for Market Solutions

Specifically, technological developments have reduced the natural monopoly characteristics of major infrastructure services. Containerization has introduced competition in port services. The wireless revolution is inducing small telecommunications operators to compete with large wire-based networks. Independent power producers can construct and operate relatively small power plants in competition with large public generation plants (Bond and Carter 1994).

Innovative financing techniques offer institutional investors and venture capitalists opportunities to diversify their portfolios in emerging markets. Learning from the experience of developed and reforming developing countries has also played a role in igniting institutional reform, not only with respect to the encouragement of foreign direct investment, privatization, and financial sector reform but also in the social and environmental areas.

Rise of the Global Voluntary Sector

According to Lester M. Salamon (1994), "We are in the midst of a global associational revolution that may prove to be as significant to the latter twentieth century as the rise of the nation-state was to the latter nineteenth."

The growth of self-governing private organizations is tapping into the enormous benefits that small groups are known to enjoy. Voluntary agencies are able to mobilize grassroots energies through small-scale, flexible interventions. At the same time, the new communications technologies and the rise of global mass media have allowed them to network and influence public opinion on an unprecedented scale.

In the developing world, 4,600 international voluntary organizations are now active and support approximately 20,000 indigenous non-governmental organizations. A growing share of concessional development assistance is being channelled through them. Similar developments are evident in Eastern Europe and the former Soviet Union. The economic and political significance of this trend (at a time when the institutions of the state have been rolled back) are considerable and especially relevant with respect to the global environmental challenge.

Growing Returns to Investment in Ideas

Fiscal constraints have also played a role in shifting institutional boundaries. According to Larry Summers, "with money scarce, we need ideas." Rates of return on the generation of good policies and their dissemination are enormous. As noted earlier, policies are public goods. Their production and delivery calls for a combination of hierarchy and participation.

Policy is useless without an institutional machinery capable of implementing it. The travails of the economies in transition, as well as those of Sub-Saharan Africa, illustrate this simple proposition. Self-help and internal determination are the keys to success but external support has been shown to be instrumental in overcoming public choice obstacles and laying the foundations for sustainable growth. New institutional capital created by the voluntary sector has also come into play in the search for effective institutional-development strategies.

Within the development community of both theoreticians and practitioners, a remarkable global consensus about development strategies has emerged over the past decade, due in significant part to the research and evaluation outputs of multilateral institutions. In addition, a great deal of experimentation has taken place to find the right balance between markets, the state, and the voluntary sector in the design of development institutions. Demographic stress on environmental resources, advances in technology, and greater insights about the role of markets and property rights derived from recent advances in institutional economics have shifted the institutional equilibrium throughout the developing world. These are the trends which underlie the growing relevance of institutional economics to the development business.

The Case for Multilateralism

In this evolving global framework, the rationale for official multilateral intermediation arises from imperfections in information markets, global development challenges, and the risk-bearing advantages related to the special contract enforcement abilities within an international setting of multilateral organizations.

The cooperative characteristics of multilateral development agencies give them privileged access to development information. Furthermore, the high quality and international makeup of their professional staff give them credibility as a reliable source of development advice. Disclosure of development information and dissemination of analytical work help overcome the information asymmetries that plague international capital markets and concessional aid flows.

The high transaction costs involved in cross-border capital flows aimed at developing countries are caused not only by information asymmetries but also by the difficulties of international contract enforcement. Since the obligations of multilateral institutions are backed by all their members, and since they have built up a superior global monitoring capability, they have been entrusted with concessional resources targeted at poor countries and delivery of financial intermediation services to developing countries on terms and conditions that no private agency can replicate.

Economies of scale in information gathering, interpretation, and monitoring as well as in raising long-term funds in capital markets and in sharing portfolio risk also come into play. This combination of money and ideas is synergistic. At early stages of a country's development or market transition, external support can be critical in triggering private or concessional flows. Similarly, by reducing the transaction costs of participants, multilateral institutions can help coordinate international funding both at the country and project levels.

The end result is an improved allocation of development information and global capital and the attenuation of market failures, especially from the perspective of the poorest and least creditworthy member countries. Thus, the economic rationale for development assistance lies in its public goods character, that is, its contribution to redressing market imperfections with respect to information and risk bearing and to the design of cooperative solutions to the looming problems of the global commons.

Whether the advantages of institutional development through multilateral action sketched in this paper will be recognized by the majorities of the electorates of the industrial countries on which development assistance ultimately depends is itself a collective action dilemma. But this is another story.

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