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PROVISION OF PUBLIC AND MERIT GOODS:
TOWARDS AN OPTIMAL POLICY MIX?

Reino Hjerpe

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UNU World Institute for
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(UNU/WIDER)

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ABSTRACT

This paper is part of a larger UNU/WIDER research project which examines the problems of the provision of basic social goods, such as health care, education, maternal care and safe water, in the developing countries. These services have characteristics in common with quasi-public goods, and the debate on their provision and financing has revolved around two topics: state provision and market provision (based either on the concept of market failure or government failure). We are here interested in new models of provision according to which, in addition to the state and the private for-profit sector, the non-governmental sector and civil society play an important role.

We have also introduced most of the issues to be studied further during the project.

To find an optimal model for provision, our attention, instead of being devoted to two players, the state and markets, should be focused on the interaction of four agents: the family, the state, the private for-profit sector (usually called the 'market') and the non-governmental non-profit sector ('civil society'). The picture of provision is incomplete if any of these players are overlooked.

The paper first offers an overview of the current problems in the provision of public services in developing countries. Second, the arguments concerning market failure and state provision are reviewed, together with those on government failure and market provision in an historical context. Then, the actual policy mix for provision is examined. This varies from country to country.

The origin of current failures is not always clear. Are the failures due to imperfections in the market or to policy imperfections? As an optimal mix of providers, the study suggests a situation in which the combined effect of market and public failures is minimized. We also believe that this 'new' model requires the interaction of different players and that the players have unique strengths and weaknesses which need to be assessed in order to find the optimal mix.

We find that the strengths of non-profit organizations may be centred on the ability to avoid certain collective action failures and especially the use of participatory methods to motivate people and deal with the problems of information more efficiently than competitive organizations are able to do.

Finally, problems in social policy implementation are studied, with a focus on the role of institutions and social capital. We argue that weak institutions and insufficient social capital are the major reasons for weaknesses in social service provision in virtually all developing countries.

In conclusion, we argue on behalf of the promotion of human and social capital as instruments in the development process. Government involvement is needed in order to set the targets and goals of provision. The capacity of the people must be utilized, and to accomplish this the participatory approach and the involvement of non-profit non-governmental organizations are essential.

1. INTRODUCTION

Recent discussions on development have emphasized the positive role of human capital in economic and social progress, and, according to a general consensus, the development of human capital is necessary for successful social and economic development and growth (for example, see Choksi 1995).

In this paper we study the provision of goods which contribute to the formation of human capital. In principle, these include the following: i) health care (preventive, promotive and curative, and basic and tertiary), ii) education (primary, secondary, vocational and non-vocational), iii) maternal and child care, family planning, services for youth, iv) basic nutrition (food security, food supplements, diet information), and v) water and sanitation (fresh water supply, sanitation facilities).

In public policy decisions in this area, basically four types of questions are involved:

- i) How many public resources should be allocated to finance goods or services which contribute to the building of human capital?
- ii) In what proportions should the resources be allocated among the services?
- iii) To what extent should the public sector be involved in the production of these services?
- iv) How can the efficient implementation of social policy be guaranteed?

In answering the first question, we are seeking to allocate resources in ways which are socially optimal. The answer will depend on the assumptions we make about the basic mechanism of resource allocation in the economy through markets or non-market mechanisms, political allocations, etc., and the assumptions we make about our own social welfare function (Whose welfare is considered important? What do we hope to accomplish with regard to distribution and how do we hope to accomplish it?), which in practice will be carried out in the social decision-making process either through democratic elections, or some non-democratic rule.

The answer to the second question will approach from a microeconomic perspective the choice of the services to be provided. Here, we assume that the total amount to be spent on health and education, etc., is a given and that our role is to identify where these available funds should be spent. Should the money be spent on individual types of services within these broad categories? For example, what should be the division between preventive health care services and clinical health care services? How much educational expenditure should be allocated to the basic, secondary and tertiary levels?

In this paper, we are mainly interested in the third and the fourth questions. Which organizations should be responsible for the provision and the application of public and merit goods in order to minimize the failures? Here, our overview of basic concepts and issues is based on a survey of the relevant literature for the purpose of pinpointing the essential ingredients of the new models of provision that have been

recently discussed in the literature. This area of provision and finance has been characterized by various failures both in the public sector and in the private sector. Thus, a closely related question is: Who should finance the provision? This question is only briefly touched upon here.

2. THE BASIC CONCEPTUAL FRAMEWORK

In dealing with these questions, we must identify the providers. In principle, in the provision of public and merit goods, we can delineate four major players: the government or state sector, whether central or local (S), the individual or the family, either core, or extended (F), profit-making private household enterprises (M), and the non-profit non-governmental sector (NPO), including community-based (CBO) and other non-governmental (NGO) organizations (NPO = CBO + NGO). The activities and interactions of these players form the market for goods. These are either formal, or informal, or money or barter markets.

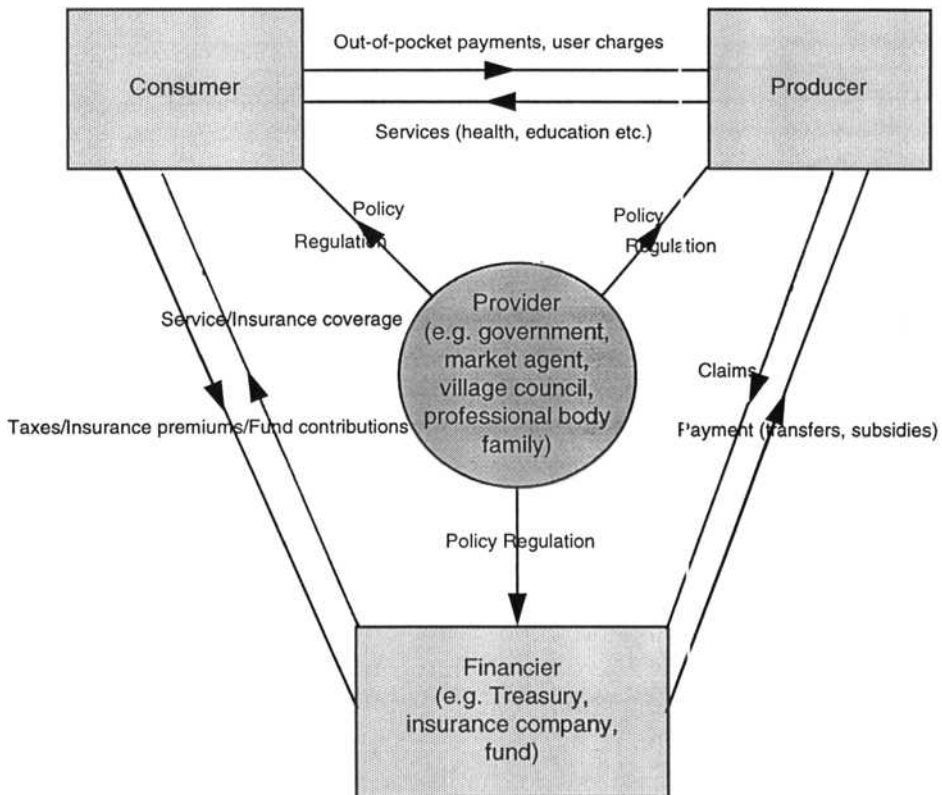
At the conceptual level, a distinction can be made among various actions: the provision, the production and the financing of social goods. We use the term 'provision' here in the sense of someone taking responsibility for 'making something available'. In this sense, provision does not necessarily mean actual production. Both provision and production can be public or private, and therefore we have four combinations. Public provision means that the public sector takes responsibility for making goods available and that it also tries to guarantee sufficient financial resources for the acquisition of these goods. Within public provision, production can be either public, as in the case of goods produced by a government bureau, or private, as in the case of goods produced by private agents, but purchased by the government. For example, a government may want certain goods to be made available to the poor. These might be produced by a private enterprise and financed through a government subsidy for this enterprise.

The different actors are therefore consumers, producers, purchasers, financiers, planners and regulators. Final consumers are individuals in families. In principle, all the actors can be producers. For example, families may produce services which they use themselves (a mother teaching her child). The financing of services may occur through government taxation, through the payment of insurance premiums to insurance companies (which may be private or public), through user charges, or through voluntary contributions made directly by consumers. The system is planned and regulated by government policy and monitored through laws and official regulations, but also through formal or informal private contracts and norms. The relationship among all these concepts can be seen from the following figure (Figure 1), which has been modified on the basis of the framework developed by Creese (1994).

On the basis of the figure, we can immediately see that provision is not simply a matter of whether the government or the market is the provider. Basically, the goods

can be provided or produced by the family, the government, the market or civil society (S, M, F, NPO). Traditional societies rely largely on family provision.

FIGURE 1
CONCEPTS AND A FRAMEWORK RELATED TO THE PROVISION OF PUBLIC SERVICES



In the case of pure private goods, we can assume that private provision is efficient in well functioning markets. However, since the goods considered possess features of both public and merit goods, it is not at all certain that market provision will lead to efficiency. In addition, society may favour distribution considerations which affect decisions on the way to provide these goods. The role of the government has varied substantially from country to country and over time. Of course, legislative and regulative roles have always been basic to government.

In advanced welfare states, a large amount of human capital is created through public expenditures on health and education. Many of these 'mature' welfare states are, however, under pressure to solve budget deficits, and there is a great deal of interest in the development of 'alternative' models for provision. These alternative models are also important for the developing countries which are currently trying to enhance human capital, and some of these countries are in the throes of deep economic crises

and fiscal deficits.¹ Since the provision of public and merit goods has been characterized by either public, or market failures, it is important that the developing countries find alternatives which would avoid the 'failures' that the more advanced economies have already experienced. The 'new' models of provision start by minimizing both state and market failures and then seeking appropriate optimal roles for the various actors.

In the 1950s and 60s, the idea of market failure dominated policy debates and the argument for state provision was preferred. Starting in the 1970s, the idea of government failure gained ground, and the concept of market-oriented provision was advanced. The general economic policy reforms of the 1980s also influenced the provision of public and merit goods. During the 1980s, there was a major shift from the concept of market failure and state intervention to government failure and market revival. In particular, the new political economy approach (NPE) challenged the traditional role of the public sector and the state in the provision of these services. The NPE approach highlights the rent-seeking nature of the state, and this is seen as a mechanism enabling various interest groups to seek benefits or 'rents' through the state apparatus, often by corrupting public officials. Rent-seeking fosters inefficiencies, including the inefficiency linked to the excess time spent on rent-seeking instead of on more productive activities. One remedy is to reduce the size of the public sector so that opportunities for rent-seeking diminish. It would seem that rather quickly the pendulum swung from one extreme to the other and that market reforms are seen as the panacea to the ills of failures by the state. The provision of public services (health care, education, child care and water), especially in developing countries with structural adjustment programmes, has been directly affected by these trends.² This has also led to debates on the basic content and orientation of reforms (for instance, see Cornia, Jolly and Stewart 1987).

3. CURRENT PROBLEMS IN PROVISION IN DEVELOPING COUNTRIES

Although top incomes have grown globally during recent decades, large numbers of people continue to live at the subsistence level. However, in spite of the widening gap in income distribution, there has been remarkable progress in human development, and life expectancy on average has consistently climbed, mortality declined, and literacy increased. Nevertheless, severe problems remain. There are

¹ For example, the Economic and Social Survey of Asia and the Pacific reports social security developments in the ESCAP region. As a result of their efforts to improve the situation, several countries have plans to introduce national health insurance schemes (ESCAP, United Nations 1995).

² The macroeconomic adjustment programmes of the IMF and the structural adjustment programmes of the World Bank emphasize the need to balance budgets by cutting or re-allocating expenditures and by containing the role of the public sector in the market. These programmes are based on the so-called 'Washington consensus' to include fiscal discipline, the redirection of public expenditure priorities towards health care, education and infrastructure, tax reform, including the broadening of the tax base and the reduction of marginal tax rates, unified and competitive exchange rates, secure property rights, deregulation, trade liberalization, privatization, the elimination of barriers to direct foreign investment, and financial liberalization (Rodrik 1996).

wide differences among countries and among various groups within countries in the developing world. As indicated in the *Human Development Report 1994* (UNDP 1994) and other studies, countries at the same income level may exhibit vast differences in the human development indicators of social welfare, such as life expectancy, infant mortality, access to safe water and basic level of nutrition. There can also be vast chasms within a country based, for example, on gender (UNDP 1994).

3.1 Health care

Problems in the provision of health care in low-income countries have been outlined in a recent study by the World Bank (1993).

- There is little public or private health insurance available in these countries. Out-of-pocket spending for drugs and traditional medicines and user fees usually account for more than one half of total spending for health care, while only the remainder is covered by general tax revenue.
- Government hospitals and clinics provide the bulk of modern medical care. However, these institutions suffer because of highly centralized decision-making, wide fluctuations in annual budget allocations and the poor motivation of both facility managers and health care workers.
- Ministries of health and other government agencies often have only limited capacity to formulate health policy, implement health plans and regulate the private sector. Therefore, private providers (mainly religious organizations in Africa and private physicians and unlicensed practitioners in South-east Asia) account for a substantial share of health care facilities and deliver most outpatient care. Large segments of populations, especially the rural poor, do not have access to modern health services.
- Sometimes the provision of social services depends substantially on donor contributions. Potential changes in these contributions make the provision quite uncertain in the long-term perspective.
- Female literacy and the enrolment of girls in primary and secondary schools are low.

The World Bank study also documents a number of weaknesses in middle-income countries. For example, governments subsidize health insurance schemes which protect only the relatively well-off minority. Government services are not accessible to the poor because of, for instance, the long distances which must be travelled to the locations where services are offered, and this is often exacerbated by poor transportation systems. The quality of care is low, and drugs and equipment are in short supply. Patient waiting times are long, and medical consultations are short, resulting in misdiagnoses and inappropriate treatments.

Some general observations should be added. In a centralized state, there are many levels of government officials, making the chain of implementation long.³ Decentralization may be the remedy. However, even though governments are taking steps in this direction, many countries are still overly centralized.

There is little interaction between traditional care and modern care, even though the majority of populations in the poorest countries rely on traditional care. Low population densities and the geology of Africa render the provision of potable water, for example, costly in many areas. The environment is often conducive to the spread of parasitic diseases. There are major weaknesses in the availability of scientists, nurses and medical supplies.

When the coordination of international aid donors is weak or absent, significant amounts of aid are wasted. Often, development in general and the provision of public goods in particular have been retarded by political struggles. This has damaged the institutional capacity to manage, administer and implement reforms. Adverse conditions have frequently been compounded by extensive fraud and corruption, adding to inefficiencies and inequity.

3.2 Education

In education, the problems are severe. Illiteracy is still widespread. In 1980-89, the world literacy rate among the 15-24 age group was 69 per cent (including the 99 per cent literacy rate in industrial countries). In all developing countries the rate was 65 per cent, in the least developed countries, 36 per cent, and in Sub-Saharan Africa, 37 per cent.

The budgetary crisis of the 1980s led to underfunding in education and cuts in educational programmes (Watkins 1995:79-82). Various countries, particularly in Africa, where structural adjustment programmes are often blamed for this phenomena, have recently reported declines in school enrolments (Hutchful 1994). According to Psacharopoulos (1995), school enrolments declined in 20 countries between 1980 and 1990 (based on statistics of UNESCO). These countries were located not only in Africa, but also in Latin America, the Caribbean, the Middle East, Central Asia, and Eastern Europe, and there was even one in Western European, namely, Portugal.

In order to show that education is highly valued, we refer to the income elasticity of the demand for education. It is 1.35 to 1.47 at the primary and secondary school level. Elasticity with respect to teacher salaries is around -0.8 and -0.7, as estimated by Schultz (1988). There is too much emphasis on secondary and tertiary (university) education (Psacharopoulos 1994), and substantial improvements in the distribution of educational benefits could be achieved by reallocating resources to basic education.

³ For example, in Tanzania there are five levels of government, all of which may cause large transaction costs in implementation.

A major fault in education systems is related to curricula. Generally, curricula have had little relevance to the demands of everyday life. Teaching may be too theoretical, and the focus on pragmatic skills may be insufficient (Cornia and de Jong 1992). The skills to boost manufacturing and technological capacities in industry and agriculture are seriously lacking. Limited teaching capacity affects the quality of teaching, and the shortage of good teaching materials adds to this problem.

Often, in poor countries, there is a major problem in the basic education of children, who are too often disregarded or employed as labour. The opportunity costs of a child going to school may be neglected by many parents who discount the future and favour immediate income needs, which may, of course, be urgent. Individual rationality and collective rationality are in conflict. In the longer term perspective, children and perhaps even the entire society could gain more from education. In human capital studies, it has been established that the private returns on education are high, especially at the primary level. Even if the returns were declining, primary education is still necessary as a step towards the secondary and tertiary levels. It has also been demonstrated that the social returns, although lower than the private returns, are still substantial (Psacharopoulos 1994).⁴ Non-attendance at school may also be caused by the long distances which must be travelled to reach schools and the incurred school costs, such as user charges.⁵ Government subsidies to aid parents could help remedy these problems, but governments may not be in a position to use this option.

Education policy has important distributional consequences because public expenditures for primary and secondary schools tend to redistribute income to the poor, whereas similar expenditures for tertiary education (universities) tend to redistribute income to the rich. The choice between the two therefore affects the overall costs of education since the ratio of the costs of tertiary education to the costs of primary education in the developing countries varies from 40:1 to 100:1 per student.

Finally, it is important to note that education has other functions, in addition to the improvement in human capital. It is valued as a means to enhance civilization, transmit social values and increase national cohesion. These are sometimes called the 'non-economic values' of education.

3.3 What are the suggested remedies?

The World Bank study on health (1993:13) quoted above states that 'millions of lives and billions of dollars could be saved' with the adoption of the Bank's main policy recommendations, which could enormously improve the health status of poor households and could also help to control health care spending. Several recommendations aimed at improvement in low-income countries are made.

⁴ In the human capital approach, education is seen as an investment which yields positive returns. Even though this conception seems to dominate the field, the battle with the competing hypothesis, which considers education only as a screening device that merely sorts out the various innate abilities of people, is still basically unresolved.

⁵ These problems were also common in the developed countries in the past.

- Solid primary schooling should be provided for all children, but especially for girls;
- More resources should be invested in highly cost-effective public health activities which can substantially improve the health of the poor;
- Health spending for clinical services should be shifted from special (or so-called 'tertiary') care facilities to district health infrastructure capable of delivering essential clinical care;
- Waste and inefficiency should be reduced in government health programmes; and
- Increased community control and financing of essential health care should be encouraged.

However, the report warns that the adoption of the Bank's recommendations will not be easy, since the vested interests of the potential losers from the reforms may constitute a major constraint. Changes may take years to implement because a major reallocation of public expenditures and the development of new institutional capacities would be needed (World Bank 1993:15).

In a recent study by UNICEF (Mehrotra and Thet 1996), the potential scope for the reallocation of public expenditures for basic social services was found to be nearly 10 per cent of total public expenditures in the target countries. Due to their unproductive nature, military and police expenditures and the losses of public enterprises were considered in these calculations as spending which, in principle, could be shifted to social services.

The study also mentions major constraints on expenditure restructuring. These include i) the resistance of the current beneficiaries of existing expenditure patterns; ii) the excessive amount of domestic debt; iii) the overwhelming amount of external debt; iv) the large budget deficit, probably in combination with a weak tax effort or a weak capacity to increase tax revenues, and v) in countries where foreign aid is important, as it is in many African nations, the lack of donor interest in social service projects.

3.4 The various approaches of different professionals

Limited cooperation among different groups of professionals is often a major obstacle to efficient project management. Different professionals focus their attention on different sectors in the system (see Figure 1). However, from an analytical point of view, there are other, alternative ways to look at these questions.

An economist might tend to adopt the production function approach (the 'producer' block in Figure 1), which focuses on the economic inputs, such as the labour, capital and materials in the provision of services, that are transferred as public goods outputs (health and education; for example, see Hanushek 1986). This approach does not help identify who should provide educational services. However, the new

institutional economics emphasizes organizational issues and addresses sociological problems which are often centred on organization and management. Educators concentrate on the pedagogical process; physicians focus on medical treatments (the links between producers and consumers), and political scientists may be interested in regulatory aspects, that is, in determining the way in which decisions are made and implemented. An eclectic approach attempts to combine all three viewpoints. Although there are only a few studies along these lines, one recent example is the work by Glewwe, Grosh, Jacoby and Lockheed (1995).

In practical work in development projects, all these viewpoints must be taken into account.

3.5 The 20/20 initiative

Within the UN system, the so-called 20/20⁶ initiative of UNDP is an important policy effort emphasizing human development and basic social services in the allocation of direct investments. Agreement on a definition of basic social services was reached, and follow-up measures and principles of application were also identified. Nonetheless, even though the initiative has been successfully implemented, it is not yet widely utilized.

Apparently, the priorities of development organizations have changed in recent years. For instance, the World Bank is now giving top priority to social expenditures; its lending for education, health care, nutrition, population programmes and other areas of human development has tripled since the early 1980s and now averages more than USD 3 billion per year (Choksi in van der Gaag 1995). However, critics continue to say that the World Bank's lending does not fully reflect important social priorities (for instance, see Taylor and Pieper 1995: 14-15).

4. GRAND VIEWS OF THE WELFARE STATE

Models of the provision of public and merit goods can be examined from several perspectives. In political debates, the ideological views are important. Since the view of who should be the provider usually depends on these ideological beliefs, it is difficult to introduce more analytical elements in the debate. Different ideologies are based on separate concepts of the 'good society'. These concepts contain a strong normative content.

Taking a more scientific, positive approach, one can first look at the historical development and try to determine the essential features of the historical process. It is also possible to consider the more analytical features of models. Here, one can distinguish at least two approaches. In the first, one tries to characterize the essential features of welfare states, for example, the residual models, the Scandinavian model

⁶ '20/20' means that donors and recipients each allocate 20 per cent of their resources for social programmes.

and the corporatist models, the so-called 'grand characterization of models of the welfare state'. In the second approach, the starting point is the failures, whether market or government. With an eye on these, one attempts to develop appropriate models.

This paper adopts the latter approach. However, the ideological and 'grand model' approaches will first be briefly reviewed.

4.1. Ideological views on the provision of public goods

Much of the discussion revolving around the dimensions of the state and the market, that is, around public or private provision, is based on political views. Libertarians, recommending a minimum 'night-watchman' state, emphasize market provision since they consider goods like health and education to be predominantly private goods. However, this idea undermines the reasons for market failure (see later).

Liberalists emphasize the individualistic perspective and private property, but accept some redistribution. The equity-efficiency trade-off is emphasized, that is, it is widely felt that greater equality leads to less efficiency. This is a common element not only in utilitarian thinking, but also in Rawlsian thinking, where the attempt is made to maximize the position of the least well off person. In this trade-off concept, too much equality is seen as detrimental to economic growth. The Rawlsian approach in particular accepts inequality if inequality tends to improve the position of the least well off person.

In the collectivist tradition, there are two main branches. One emphasizes Marxist class divisions and distribution according to need, while the other branch (for instance, the British Fabian Socialists) emphasizes equality and is quite critical of market performance, but accepts a public-private mix in the production of social goods. Of course, various views can also intermingle.

4.2 Grand models of the welfare state

Ha-Joon Chang and Rowthorn (1995) compare the rise of the welfare state and the situation after World War II. The theoretical underpinnings were the development of welfare economics (by Pigou) and macroeconomic management (by Keynes) before World War II. Social welfare systems which had existed only in rudimentary form before the war were vastly extended after the rise of the so-called 'corporatist' political coalitions, and the state was expected to stabilize the economy by deliberately injecting purchasing power into the system by rejecting the old dogma of balanced budgets. One saw the birth of industrial policy in France and Japan, for example, and centralized wage bargaining and active labour market policies in Scandinavia. State involvement in the economy was substantial, even in countries which were the least open to industrial policy, such as the UK and the US. With the establishment of the ECSC and the EEC in the 1950s, one could even see grounds for the coordination of international economic policies.

This approach coincided with a period of development strategies that has also been called the 'big economic push' prevailing during 1955-65. Governments sought to stimulate broad economic growth and social change by transferring technology and encouraging capital formation within the largely underdeveloped private sector at the national level (Chenery and Syrquin 1975; see also Riker 1995).

The birth of the European welfare state was influenced by the Bismarckian view which saw the welfare state as a device for the establishment of peaceful relations in society. From this developed the 'corporatist model' of the welfare state (Esping-Andersen 1987). In this model, employment relations are important in defining various benefits.

In the Anglo-Saxon tradition, the failures of the market to heed distributional concerns, for example, have generated a welfare state which many people see as a 'residual model'. In this model, the predominate function of the welfare state is to correct market failures.

In the Scandinavian countries, where the 'universalist' approach is applied, a welfare state with the extensive public provision of social goods has been justified because, it is believed, in the long run the welfare state improves the productive ability of the nation (Esping-Andersen and Micklewright 1991). Health care and education are seen as major social services which build human capital and improve the productivity of people. This perspective has now been challenged because some researchers believe that the productivity effect in an extensive welfare state is constrained and that the long-term incentives created by the welfare state work quite in the opposite direction (Lindbeck 1995).

In these grand characterizations of the welfare state, the Mediterranean countries are sometimes treated as a unique group, in which family and non-governmental or voluntary organizations such as the Church have a relatively important role.

These 'grand models' have been grounded on different aspects of welfare states (like universalism versus the needs-based approach and employment-related benefits versus general benefits). The models are clusters of various characteristics, and individual countries conform more or less accurately to the 'types'.

4.3 The economic and social reasons for the welfare state

Recent literature has once more emphasized the importance of human capital for growth. For example, Lucas (1988) introduces a model according to which human capital generates an externality which increases economic growth. This appears to come close to the Scandinavian concept of the role of the welfare state in the improvement of the productivity of people.

The provision of public and merit goods can also be viewed in the light of social security. According to the ILO conventions, social security can be taken to mean the protection society provides for its members through a series of public measures against the economic and social distress which would otherwise be caused by the

elimination or substantial reduction of earnings resulting from old age, invalidity, death, sickness, employment injury, maternity and unemployment.

According to a more sophisticated modern theory, the welfare state is insurance to make lifetime careers safer and increase risk taking. It therefore improves welfare and productivity, though it is open to moral hazard. In fact, Sinn (1996) has recently argued that, from the allocative point of view, the main advantage of a welfare state is the 'risk reducing function' of redistributive taxation. Every insurance contract involves redistribution from the lucky to the unlucky, and in the context of a lifetime a progressive tax system plays a similar role, since whether an individual is lucky or unlucky cannot be foreseen at the moment the individual is born (Sinn 1996). This is accomplished through taxation rather than through private insurance perhaps because large-scale taxation is probably less expensive to administer than is the corresponding private insurance under market conditions. This is especially true since fiscal taxation is inevitable for the provision of pure public goods (Christiansen 1990). The entire welfare state can therefore be seen as a response to the inability of the private insurance system to offer a better solution.

Indeed, it is not difficult to believe that the struggle against life's uncertainties is a major motivation for many public sector activities. The importance of the motive, however, is not clear, since the size of the public sector varies considerably from one society to the next, and no doubt attitudes towards risk also vary widely. This is not to deny that the production of safety is a significant aspect of the welfare state.

A key justification for the state provision of public goods is, of course, equity. The goods are provided by the state because of redistributive considerations. Health care, education and other social services affect human welfare directly and are in demand not because of their indirect effects through increased productivity or reduced risks, but because they are valued and enjoyed as such by the people.

In concrete policy-making, both social security and human capital aspects may be intermingled. Health care and education are often treated as merit goods (see below). For example, in the developing countries today, safe water and sufficient nutrition level are key issues affecting the health and well-being of people. Therefore, wide consensus now exists among researchers that several sectors interact substantially in the development of human capital. Health care, education, nutrition, safe water, sanitation and subsistence income are closely related and support each other in contributing to better human capability and well-being. Thus, for instance, better education seems to foster better health. In particular, better education for women is emphasized because it also leads to lower fertility.

5. OLD MODELS OF PROVISION

5.1 The era of planning: market failure leads to government provision

During the 1950s and 60s, market failures were largely recognized, and the remedy was public provision: if markets fail, governments have to take action. The 'rationalist planning paradigm' emerged. Public provision was based on a planning model. The heyday of the model was represented by the planning-programming-budgeting-system (PPBS), which originated at the Pentagon during the era of Robert McNamara.

Market failure can be classified according to three sets of causes: i) technical reasons, ii) collective action failures and other behavioural reasons and iii) reasons based on asymmetric information availability among market participants.

Among the technical reasons, one set of causes is based on the nature of the goods to be provided. These are public goods and goods with externalities (positive or negative). Market failure can be caused by increasing returns to scale that under market conditions can lead to a monopoly situation. Similar conditions can arise in cases of imperfect competition (monopoly, oligopoly) resulting from natural monopoly. Because taxation is unavoidable and will not or cannot take the form which permits the most efficiency, there will always be efficiency losses or dead-weight losses in taxation. This may also be classified as a technical reason.

Collective action failures are more related to the behaviours of groups. In this case, free-riding is an important aspect; people will not contribute voluntarily to a provision from which they will benefit if collective goods or actions are being provided.

The actual behaviour of market participants may not conform to the model of competitive markets. For example, market institutions may be inflexible or individuals or enterprises may adjust slowly. Finally, individuals may not act so as to maximize anything, either explicitly or implicitly.

Information failures occur when there are asymmetries in information availability among market participants. A typical example is insurance market failures. i) Moral hazard arises when, without the insurer's knowledge, individuals seeking insurance can affect either the probability of the insured event, or the size of losses. The latter problem is known as the third-party payment problem. ii) Adverse selection arises when only significant risk-holders apply for insurance because premiums are sufficiently small. Those with low-risk premiums which are larger than the potentially expected compensations are discouraged from joining insurance.⁷ Insurance does not pay off, and the market fails. This is typical in the unemployment market. Another type of information failure occurs when the flow of information is

⁷ The actuarial premium 's' is defined as $s = p l + t$, where p = probability that a loss will occur, l = the size of the loss, $p l$ = the expected loss to the individual buying the insurance, and t = the administrative cost and normal profit of the insurance company.

slow. Individuals or enterprises may be poorly informed about products, prices, the production possibilities, etc. These failures are believed to be particularly acute in the developing countries.

It is widely recognized in economic theory that private markets undersupply public goods and externalities. Undersupply may affect not only final outputs, but also inputs with a collective character, such as collective infrastructures (the supply of safe water), or some collective inputs for production processes, like scientific innovation (Schultz 1988).

5.2 The problem of public goods in detail⁸

Public goods are services or goods which have the characteristics of non-rivalry or 'jointness' in consumption. There are different types of 'publicness', depending on the extent of congestion in consumption and the costs of exclusion. Another distinguishing feature of these goods is that once they have been made available at the local or national level, 'consumption excludability' for individuals unwilling to pay for them is either impossible or too costly to effect. In the literature, goods with these features are referred to as 'pure public goods'.

The private provision of public goods is characterized by 'market failure', a situation in which market performance is Pareto inefficient from a social perspective (for example, see Besley 1988), so that, with the available resources, social welfare can be improved via alternative modes of provision. The public provision of public goods also suffers from what has been called 'government failure', the case in which government performance is socially Pareto inefficient.

It should be noted that it is not obvious *a priori* which of the two forms of failures is more serious, and *ex-ante* opinions about their relative severities are the source of much controversy concerning the appropriate way to provide and finance public services, particularly in developing countries. Moreover, *ex-post* information on these failures has not helped resolve the controversy, because evidence on the performance of a 'control' mode of provision has never been examined.

TABLE 1
THE CLASSIFICATION OF PRIVATE AND PURE PUBLIC GOODS

| <i>Consumption</i> | <i>Exclusion</i> | |
|--------------------|------------------|--------------|
| | Feasible | Not feasible |
| Rival | 1 | 2 |
| Non-rival | 3 | 4 |

Source: Laux-Meiselbach (1988:127).

⁸ This failure is characterized by i) failure in coordination, ii) the prisoner's dilemma and iii) the collective action game (see Nabli and Nugent 1989).

TABLE 2
THE CLASSIFICATION OF PRIVATE, QUASI-PUBLIC AND MERIT GOODS

| <i>Consumption</i> | <i>Large social externalities</i> | |
|--|-----------------------------------|-------------|
| | Present | Not present |
| Consumer well informed | A1 | B1 |
| Consumer ill informed | C1 | D1 |
| Consumer sovereignty socially acceptable | A2 | B2 |
| Consumer sovereignty not socially acceptable | C2 | D2 |

Source: Hjerpe and Mwabu (1996).

This study is partly concerned with the category of public goods defined above, but more extensively with a class known in the literature as 'quasi-public goods' (Nafziger 1997) and a related group of goods termed 'merit goods' (for instance, see Musgrave 1959, Atkinson and Stiglitz 1980, Besley 1988). The principal feature of quasi-public goods (for example, immunizations and primary schooling) is that exclusion is feasible, but the private consumption of these goods is characterized by pervasive social externalities, so that public provision may be warranted. Immunizations and primary schooling also have attributes of merit goods, goods about which individuals are not sufficiently informed to assess the true private benefits which can be derived from their consumption or for which individuals have defective preferences (see Besley 1988). The sovereignty of consumer choice in the case of these goods would often lead to inefficient consumption by most individuals and thus, in aggregate, give rise to a socially unacceptable situation. There is here a case for public choice and public action. Note that either consumer uncertainty about the nature and benefits of a good, or a fault in consumer preferences for a good is a sufficient characteristic for a merit good. Tables 1 and 2 depict simple schemes for classifying goods into various categories according to their attributes.

Table 1 distinguishes between private and public goods, whereas Table 2 further classifies goods which do not fit in the category of pure public goods. In Table 1, cells 3 and 4 represent pure public goods (examples of these in our study include sanitary community environments and immunity from infectious diseases). Cell 1 represents the case of a private good (since it is rival in consumption and fails the criterion of non-excludability). The type of case 2 is ambiguous, since it is rival in consumption and yet non-excludable.

Table 2 classifies the goods falling under cases 1 and 2 into additional categories. The classification is based on the extent of the external effects of individual consumption, the degree of consumer uncertainty about the nature of a good, and the social acceptability of individual preferences. Assuming the classification as private goods in Table 1, these goods fall under cases B1 and B2 in Table 2 and retain their status as private goods. Cases A1 and A2 in Table 2 are typical examples of quasi-public goods (goods the individual consumption of which generates positive externalities, for example, immunization services or treatments for infectious diseases). However, the same goods and many others – for instance, water and sanitation services, basic education and child care – would also fit in cells D1 and D2 (in which case they would be merit goods) or in cells C1 and C2 (the cases of quasi-

public and merit goods). For cases D1 or D2, government interventions would be undertaken in markets to avert inefficient individual consumption due to imperfect preferences or information. Note that if a private good has the attributes of cases D1 or D2, it is a merit good.

The goods under study here share the features of cases C1, A2 and C3 in Table 2 and of cases 3 and 4 in Table 1, that is, they are characterized by attributes of pure public, quasi-public and merit goods. As an example, the private use of preventive health care is typically associated with large positive externalities (cell A1 or C1 in Table 2) or with the indivisibility of the 'protection from diseases' that it brings about (cell 3 or 4 in Table 1). In contrast, the use of curative medical care is associated with information asymmetries between users and providers (cell D1) or with faulty consumer preferences (cell D2), as, for instance, when individuals refuse medical treatment due to religious or other reasons. Education and other social services can be similarly classified.

The bulk of consumers of these services are usually at vulnerable stages of the life-cycle, for instance, children, youth and the aged. Methods for the provision and financing of these services should thus be sensitive to the fact that the purchasing power of many consumers cannot support minimal social consumption levels. For this reason, in some industrialized countries these goods constitute an important component of social security systems (for example, see Drèze and Sen 1991).

The identification of merit goods opens up the possibility of extensive provision by the public sector to replace market behaviour and market outcomes. A bare majority in a parliament may decide that access to these goods is in the interest of the entire collectivity and thus that they should be provided through public policy.

While the public sector usually provides goods which are not public or possess the properties of 'publicness' only to a limited extent, the private sector can provide goods of which an important characteristic is their publicness. Club goods, that is, collective goods provided to members of a group or a club are examples.

5.3 Failures in collective action

Since Olson's (1965) pathbreaking analysis of failures in collective action, the problem of coordination has been studied intensively; a recent account is in Sandler (1992).

Collective action arises when the efforts of two or more individuals are needed to reach an outcome. Collective action involves the coordination of individual actions, the interactions among individuals and groups and the costs of organization. Attaining coordination is endogenous in the system. Groups try to organize themselves without the help of a central decision-maker. The gist of collective action failure is that, while all individuals of a group may act rationally, they fail to act together even though they would benefit from collective action.

The basic problem is free-riding; since collective action benefits an entire group, there is an incentive for individual members not to take part in the collective action because he benefits without contributing. Many studies have tried to describe situations in which this failure is serious and the conditions which would ease the severity.

Before the logic of collective action was examined by Olson (1965) and before the tragedy of commons was analysed by Hardin (1968), it was assumed that groups behave rationally and that they collectively seek common interests so that the social benefits surpass the social costs. Losers, if there are any, could be compensated, at least in principle. We recognize that Olson's theory revolutionized the view of the concept of collective action.

5.4 What are the solutions to collective action problems?

It is important to decide whether the state can take the initiative in solving problems linked to collective action and to define in practice the criteria for determining whether the conditions for beneficial collective action exist. Once the conditions for collective action have been established, methods for the implementation of collective action must be identified. Experience shows that even when the proper conditions for collective action have been established, it may not always be possible to resolve the problems in implementation; for example, environmental protection on a global scale has still not been realized.

Are there conditions which render collective action failure less probable? The literature offers the following suggestive list.

- Repeated games: if people know that they have to repeat a non-cooperative game forever, then they may have the incentive to cooperate. However, there is a fear that when the game is finite, cooperation may be impeded and break down.
- Political entrepreneurs may appear to solve the problem. If political entrepreneurs can show that they have solved a problem for the benefit of many people, they can expect to be elected.
- It has been suggested that the adoption of social norms which are embedded in the local culture is an efficient way to avoid a collective action problem. Norms may demand the punishment of an individual who deviates from a collective decision.
- The group, especially when it is relatively small, can develop psychological attitudes which favour collective action. Members may be threatened with expulsion from the group if they do not act collectively. Alternatively, in order to remain in the group, members must persuade other members in a specific matter.
- Reference to the behaviour of other groups which are successful in acting collectively may be helpful.

- In the organization of communication, one can target organizational skills, knowledge and even technology in order to minimize collective action failure.

In principle, it is also possible to devise selective incentives, for example, in the provision of private goods to group members who promote collective action. In the literature, collective action is said to be more likely to succeed:

- i) the smaller the group is;
- ii) the more homogenous the origin of the group is;
- iii) the longer the members of the group have been associated with one another or the longer the group has been in existence;
- iv) the closer the social and physical proximity is among group members;
- v) the more differentiated (in a complementary way) the goals of the various members of a group are;
- vi) the greater the sensitivity of the group is towards a threatened loss arising from inaction, and
- vii) the more unequal the distribution of wealth or power among group members.

The importance of these features will become apparent when the role of community and non-governmental organizations in the provision of public and merit goods is considered (see later).

6. SOME EXAMPLES OF MARKET FAILURES

There is a general argument by Stiglitz that externalities are very common and pervasive in an economy (1995). A good has an external effect if its consumption by an individual has some uncompensated effect on others. These effects can be beneficial, as in the case of positive externalities, or harmful, as with negative externalities.

Externalities can be viewed as the result of incomplete property rights. Important concepts about externalities have emerged from the new institutional economics. First, Coase's theorem states that a small group can negotiate a solution to a problem. Another important theorem states that new property rights develop to internalize externalities when the gains from internalization become larger than the attendant costs (Demsetz 1967). According to this view, externalities are not 'fixed', but reflect changes in economic conditions. This implies that different services should be examined separately to discover the externalities involved.

6.1 Public goods aspects and externalities in health services

One may take health care services as an example. Even though excludability is a feature of health services, some of these resemble services which possess characteristics similar to those of public goods. There are two basic types of health services: public health programmes and clinical services. Public health programmes strive to resolve the health problems of an entire population or certain subgroups within a population. Their objective is to prevent diseases or injuries and to provide information on self-cure and the importance of seeking care.

Public health programmes work in three ways: i) they deliver specific health services, such as immunization, to a population; ii) they promote healthy behaviour, and iii) they promote healthy environments. Since these programmes create positive external effects, governments can play a leading role in their provision, and education is a central feature of many programmes.⁹

In contrast to public health programmes, clinical services respond to demands from individuals and seek to cure or to ease the pain of those who are already sick.

In effect, health goods are different with regard to the externalities involved and the extent of their involvement. Externalities are indeed widespread in the public health programmes which produce preventive health services. As mentioned above, these services function on the basis of preventive health care for the individual, for instance, a mother's health affects her infant's welfare. Preventive health care also emphasizes the responsibility for the preservation of productivity in society.

Due to their nature, clinical services exhibit more limited aspects of externalities. In some cases, even these services may almost take the form of a pure private good, such as an aesthetic operation.

Basic health care should be distributed evenly throughout a country through the establishment of or support for communal health care centres. Some economies of scale exist as well in the operation of specialized hospitals, although certain treatments are linked to only limited demand, and, therefore, the health ministry needs to evaluate whether the particular specialization unit is needed. In planning and implementation of important and selected health care, the expert knowledge and

⁹ Public health programmes consist of activities in various areas:

- immunization,
- mass treatment of infections,
- mass screening,
- diet and nutrition,
- family planning and fertility,
- the reduction of the abuse of tobacco, alcohol and drugs,
- water and sanitation,
- indoor air pollution,
- occupational environment,
- global environment, air pollution, ozone layer,
- road transport systems,
- AIDS.

participation of professionals and scientists cannot be ignored. Thus, the idea put forward by Fuchs (1996) that one must rely on the knowledge of professionals in health care should be supported. Consequently, professionalism, instead of being considered a negative aspect which promotes the self-interests of professional scientists, should be seen as a necessary component which enhances a good health care system.

Information failures are common in health services. In health insurance, both moral hazard and adverse selection are relevant. In a patient-physician relationship, it is normal that the physician has more information available about a disease than does the patient.

6.2 Child care and fertility control

It can be argued that child bearing imposes externalities, that is, costs, on society when the mother in a household is expecting a child. These costs include: i) the excessive use of common property resources; ii) congestion in such public services as education, health care and sanitation; iii) the less direct effects of crowding the labour market, and iv) depressed wages (Birdsall 1988). In several poor countries these negative effects may outweigh possible demographically induced improvements in the methods of production that some pronatalists point out (Bardhan 1996). Especially in countries which offer subsidies for child bearing, the tax costs of an extra child can also be quite considerable. This form of 'tax externality' or 'redistributive externality' varies, of course, from country to country because subsidies differ. The problem with fertility control is the lack of information and the fact that children are needed and acquired to secure basic subsistence for the family because no other means of social security exists.

Bardhan (1996) points out that high fertility is associated with lower parental spending per child on education and health care and that, even if this is voluntary, the social consequences are adverse. Public policy is also needed because poor people often lack knowledge of contraceptive options.

This is a specific area in which the organizations of civic society can operate effectively. A community-based organization may have more 'credibility' or 'reliability' in sensitive issues than do government organizations. The experience with publicly provided services in communal health centres has been very positive, for instance, in Finland, which has the lowest infant mortality in the world. (More examples revolving around education, wealth and other issues will be examined later.)

7. PUBLIC FAILURE LEADS TO A MODEL OF MARKET PROVISION: GET THE PRICES RIGHT

In spite of much discussion about market failure, the link between mainstream theoretical welfare economics and policy recommendations on the role of the public

sector, the optimal degree of redistribution and social insurance, etc., is not very strong. Mainstream neoclassical economics argues that, in certain circumstances, private markets will allocate resources efficiently, and no public involvement is needed; thus, the state has only a limited role in the development of welfare (Sandmo 1995). In welfare economics, people usually refer to the first and second theorems of welfare economics. The first theorem states that a competitive market economy allocation is Pareto efficient. The second theorem argues that any Pareto efficient allocation can be supported by a price system which may be the result of a competitive market. These theorems explain the relationship between Pareto optimality and competitive equilibrium in which prices are equal to marginal costs. Economists who think along these lines might well recommend a 'night-watchman state' (Nozick 1974).

During the period when the planning model of provision dominated, it was believed that the existence of a public good and the failure of other markets required public provision and probably also public production. Already in the 1950s, there was a counterattack based on the research on public failure by Buchanan (1965), who, for example, proposed the voluntary provision of public goods as the more efficient alternative to public provision. The problems in practical budgeting and policy-making were emphasized, for instance, by Wildavsky (1974). This criticism was gradually adopted in policy-making, first in the US during the Carter Administration and then with more publicity during the Reagan Administration and later in the UK under Thatcher. This liberalist counterrevolution led to the revived emphasis on markets and widespread efforts to privatize.

A number of reasons for public failure have been documented:

- i) individuals may know more about their own preferences and circumstances than does the government;
- ii) government planning might make bigger mistakes than do markets because it does not necessarily explore a sufficient number of alternatives;
- iii) the government planning machinery may be rigid;
- iv) a government may be incapable of administering detailed plans;
- v) government controls through bureaucracy may prevent individual initiative;
- vi) incentives for innovation, cost control and efficient allocation may be lacking in government enterprises and organizations;
- vii) coordination problems may exist among the various parties within the government (for example, due to the lack of appropriate price information);
- viii) markets impose constraints on what the government can achieve. As an illustration, government regulations or high tax rates may lead to problems in 'incentive compatibility', the emergence of a shadow economy;
- ix) controls create rent-seeking activities which are not productive;
- x) powerful interest groups can manipulate government planning procedures and results;

- xi) planning may be dominated by narrow interest groups, and planning may intensify the position of these groups (Stern 1988).

There are two kinds of information failures, since government and citizens each acknowledge different values and subsequently have more diverse information available. Implementation may be difficult because the incentives of private agents do not conform to the goals of the government. These are problems of the citizens as 'principals' and of the government as an agent. Furthermore, one major failure is caused by the different preferences exhibited by the bureaucracy and the citizenry. Finally arises the problem of rent-seeking, since public money is used primarily to serve private interests rather than the interests of citizens in general.

7.1 Privatization

Privatization, a dominant trend since the 1980s because of public failures in several countries, has been used as a tool to reduce the opportunity for rent-seeking. Initially, it was adopted in the general belief that private markets were more efficient than was public planning.

Privatization can involve the movement of either production, or finance towards the private sector.

Privatization means that the government should emphasize its role as a regulator and coordinator, whereas the private sector should function as a supplier in the system (see Figure 1). Among the numerous methods of privatization, most common is the outright sale of public property and enterprises. Another scheme is the increased private purchase of the inputs for the government production process, whereby markets are opened to private enterprises as well, instead of only government entities. Parallel to this, the government may try to foster competition among the various suppliers.

Another option is to shift away from universal taxation by increasing the role of 'user fees'. The application of these fees is a step forward from benefit taxation, in which there is no direct connection between the tax and the service; for example, if the government taxes vehicles and uses the funds collected for road construction, a direct connection does not necessarily exist between the tax and the intensity of the use of the road. On the other hand, through user charges, the government directly links the use of a service to its attendant fee. Through vouchers and tax benefits, the users of services select the supplier, while the public sector provides subsidies by offering free vouchers or granting specific tax exemptions (tax subsidy or tax expenditure).

In principle, one important type of reform is deregulation or the reform of regulations. This is a very challenging reform and, on the basis of most recent research on this issue, the concept of optimal regulation has been found to be quite complicated.

7.2 Competition

Generally, competition is essential for the efficient functioning of private markets. There is a strong *a priori* belief in the ability of private markets to create more efficiency, and for this major reason, privatization has recently been advocated. Competition is secured if there are many independent agents in the market. Yet, problems do arise from oligopoly or monopolistic positions or other situations in which the market failure arguments discussed above apply.

Nevertheless, even in relatively monopolistic situations, efficiency can be achieved, according to the theory of contestable markets, according to which the threat of entry is equivalent to active competition among incumbents if markets are perfectly contestable (Tye 1990).

Contestability can be achieved if i) there are no barriers to entry or exit and ii) the entrant has time to enter the market, make above-market profits and then exit before retaliation. According to this theory, regulators should act as surrogates for competition unimpeded by entry barriers.¹⁰

Many recent theories emphasize that competition is also important for public provision. According to studies on the privatization of public enterprises, competition is even more important than is public/private ownership. The structure of the market is a major factor in the determination of whether any competition prevails. In several developing countries, markets for some goods may be totally missing or it may be difficult to establish private markets. For example, the supply of professionals such as physicians in the area of public goods may be limited. The market may be 'narrow', with only a few potential suppliers, and therefore it is difficult to stimulate proper competition. In these circumstances, privatization may not be a solution at all and may, in the worst case, lead to an even more adverse situation.

8. THE CURRENT PUBLIC-PRIVATE MIX OF PROVISION IN DEVELOPING COUNTRIES: AN HISTORICAL BACKGROUND

It is not clear whether the governments of the developing countries have been affected by the theoretical discussions about market failures and the need for benevolent governments to undertake corrective measures and interventions, although government intervention in the past has been extensive.

Some contradictions are evident when one looks at the state of affairs in the provision of public and merit goods in developing countries. The structural adjustment view stresses that there is excessive state involvement in the economic

¹⁰ The problem in this theory is that the non-pricing components of the market – oligopolistic cooperation, collusion, market sharing, technology pooling, demand manipulation, political participation, etc. – are not considered. No welfare criteria, except Paretian, are admitted. In public sector pricing, the private sector is involved because enterprises are often important suppliers, and there may be only a few suppliers.

system, and on this basis alone it recommends that the excessive size of the public sector be cut. However, this argument may be inappropriate because the public sector provides the bulk of the goods which we are examining. It is a paradox that, in reality, the state provision of public goods such as health care and education is often limited and, at times, the exception rather than the rule.

Studies of the informal economy, notably the prominent study by Hernando de Soto (1989), take the view that the state is overly repressive, causing a vigorous rise in the informal sector. De Soto calls the Peruvian economy 'mercantilist', and according to him the major reason for this is overregulation, not government production. Therefore, it can be argued for good reason that a major government failure exists there. As a result, the private sector, or simply the family, assumes responsibility for services supplied informally, often by traditional means, or the services are not produced at all, or they are produced only to a very limited extent.

Historical observations prove that almost all public goods can be privately provided. Indeed, observations have revealed that in the past most of the provisions were in private hands. An important stylized example is the birth of cities. Renting land to those willing to pay, landlords also arranged protection and community services for their tenants. As more people moved onto the land, these arrangements gradually generated cities (Foldvary 1994:87). Throughout most of recorded history, people have gone to private teachers and private schools to receive an education and to private doctors and hospitals for treatment (van der Gaag 1995).

The healing profession, if not the oldest profession in the world, is certainly one of the oldest. Except for the health care offered to armed forces, medical services have been mainly provided privately throughout history (Roth 1987). The institution of government-financed social security and the right to free medical services are fairly recent phenomena, originating in Bismarckian Germany. Private health services still play a leading role in all developing countries; particularly in Sub-Saharan Africa, for example, traditional, indigenous systems are preferred, and modern facilities are used only as a last resort. Private provision is also important in Asia, North Africa and Latin America.

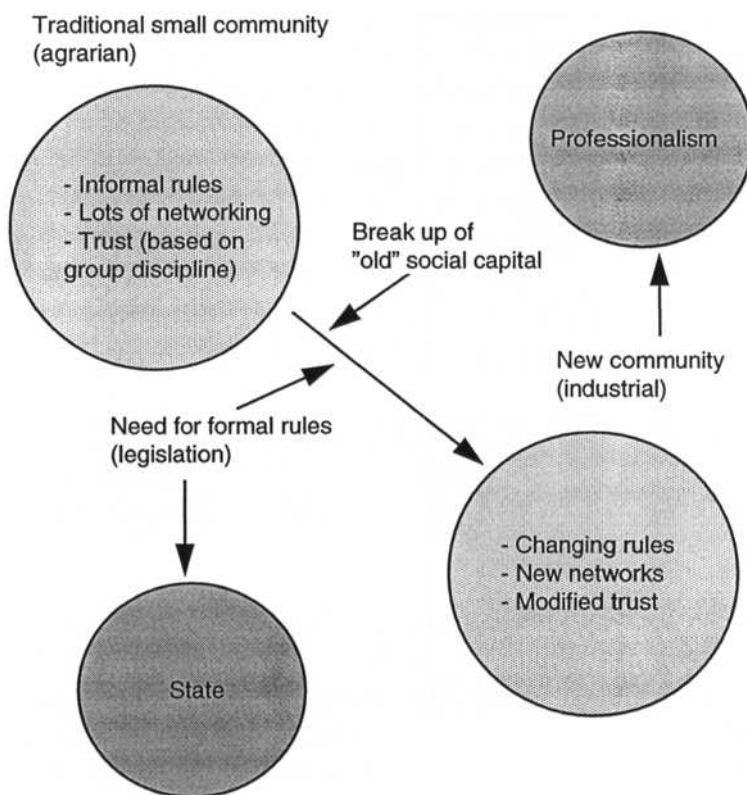
The survey by Roth (1987) shows that the role of the private sector in education and health care is quite large in the developing countries, but also that it varies a great deal among countries. There are great differences in public-private mixtures, with no obvious general pattern, clearly pointing to the fact that optimal provision represents not merely a choice between the state and markets, and, furthermore, that the issue is quite complicated.

Foldvary (1994) offers a number of case studies to demonstrate that decentralized private communities today are providing public goods abundantly to their members. These goods are 'territorial' and are available only in certain locations, such as cities. In fact, the theory of clubs has also evolved around the group provision of collective goods. For example, many community associations, such as those based on the condominium (house ownership), arrange the provision of a variety of public goods to their members.

An estimated 50 per cent of all global spending on health care currently comes from the private sector, but the amount varies from a small percentage to about 80 per cent. Worldwide, an estimated 5.8 per cent of GDP is spent on education, of which government spending accounts for an estimated 70 per cent, and private spending 30 per cent (van der Gaag 1995).

The study by de Ferranti (1985) includes data on the share of private expenditures in total health expenditures. There can be no doubt that private health providers are important in developing countries, often more important than they are in industrialized countries. For instance, in Asia in 1970, private health expenditures accounted for 84 and 75 per cent of total health expenditures in India and the Philippines, respectively, and in 1975 for 75 per cent in the Republic of Korea (Roth 1987).

FIGURE 2
ECONOMIC TRANSFORMATION AND THE CHANGE IN THE SOCIAL CAPITAL



Almost 80 per cent of total health expenditures in India, Syria and Sudan are private. In the developed market economies, the share is highest in the USA, at around 55 per cent (Murray, Govindaraj and Chellaraj 1994). Why did governments in the

developed countries and basically only during the last century become deeply involved in the provision of the services? One explanation may be the change in the industrial structure. The advance of manufacturing industries required formal education and improved social services to such an extent that the private markets in most countries were not able to satisfy the increased demand. Mass production also required standardized education, which involved such large-scale efforts that only government were able to respond. As discovered by Becker (1964), there was also an incentive problem; individual employers were unwilling to participate in educating their employees because the employees could later move to another company. which would then reap the benefits of training without being responsible for the costs.

Since state involvement in provision is substantial in various countries. the reasons state provision has become so important represent an interesting issue. Governments have become major providers of social services only in the 20th century and in extreme cases have even excluded from the private sector. Moreover, it seems that government involvement is more significant in most developed countries! Thus, it can be concluded that the formal provision of social services has remained limited in the developing countries, which are predominantly agrarian. The role of core or extended families is of primary importance in the provision of human capital and of functions related to social security. Developments in the formal social security system are very much related to the development of industrial structure and the division of labour. In an industrial society, old family ties break up, and it is impossible to maintain traditional systems for the provision of security. From the human capital perspective, a traditional society is unable to provide the new skills required by modern industries, and society is thus obliged to develop specialized institutions to educate professional people to carry out this task.

Generally, in the early stages of development in traditional agricultural societies, the role of government has been mediocre, since voluntary or community provision was often common. People also often paid for services. This is contrary to what many believe to have been the case.

Figure 2 outlines the way in which the development of industrial society has given rise to more significant state involvement. However, in addition to the state, industrial society also boosts professionalism. The shift from agriculture to industry weakens traditional ties in the social system and creates the need for formal legislation, which is one of the basic functions of the state. At the same time, the increased division of labour generates a class of professionalists and the need for specialized skills. One might be tempted to think that public provision at first seems to expand until it reaches a maximum, and then society again tries to lean towards the private sector.

9. NEW MODELS: GET INSTITUTIONS RIGHT

There has been a remarkable trend lately to move towards private provision. This study has analysed the theoretical reasons which justify state provision. The existence

and the significance in society of state provision should not be underestimated. Therefore, another relevant issue should be examined: excessive privatization and its dangers. At this stage, it seems appropriate to consider the optimal mix in public-private provision as well.

It can be concluded that the appropriate policy must involve more than simple privatization. There is probably a wide range of possible, successful combinations of private and public activities. The 'classical' reasons for state involvement have not disappeared. Even experience on the political front shows that neither Reaganism, nor Thatcherism could abolish state participation in the provision of various kinds of services.

In the search for 'new' provision policies, we start from the idea that both market and government failures exist and therefore that there must be various solutions for different problems, that is, that there are 'mixed solutions'. This more eclectic role for government has emerged because of the experience in the growing Asian economies. It was found that these were 'managed economies' to a high degree. Public policy was strong, but it operated in combination with strong competitive markets, in which especially small and medium-sized enterprises participated.

It should also be noted that in the developed countries, state provision has achieved remarkable results in terms of life expectancy, mortality and morbidity.

There are basically two ways to approach new models. The first one is to examine ways in which government can improve its activities. The second is to study ways in which government can more effectively interact with the private sector, that is, to develop more efficient participatory models involving civil society in addition to outright privatization.

In the process of reform, the reinforcement of civil society and the process of decentralization are different channels: decentralization is one of the methods which can be used to reform the government sector, whereas the reinforcement of civil society is occurring in the private sector.

During recent years, much has been written about the new role of NGOs and civil society, but there seems to be no clear view on the ultimate nature of the comparative advantages of civil society. The microeconomic foundations of the relevant organizations also require some clarification. Should one move towards more fruitful cooperation between the government and civil society, or are these processes inherently competitive? A number of studies show that participatory involvement has led to greater benefits and more efficiency in the provision of social services, especially those related to health, nutrition, education and income generation. Nevertheless, often regardless of this, efforts to harmonize community participation and public effort have not been adopted (Taal 1993).

9.1 Increasing efficiency within the public sector

There are a number of ways for a government to try to reduce 'failures' in its activities. In recent years many of these measures have been applied in various countries. First, one can develop budgetary planning and control systems oriented towards 'management by outcomes', instead of resource controls. The traditional budgetary process has been based on the control of the resources available to officials. Yet, there are no general results for determining the success of the change to an outcome-oriented management system. One of the major difficulties has been the identification of proper methods for the measurement of outcomes. Incorrectly defined outcomes can lead to misallocation because of distorted incentive effects.

Another method is to re-organize public production in line with private enterprises. This method works quite well for public enterprises and corporations which produce goods of a predominantly private character. These re-organizations may in the end lead to outright privatization, as has happened in Finland, for example, over the past ten years.

Another approach to increase efficiency within government is to utilize the principle of benefit taxation and user charges more extensively. For instance, specific taxes on transportation can be collected in order to improve transportation infrastructure. This can reveal the willingness of taxpayers to participate, since the purpose for which the money is being collected will be tangible.

The development of compensation systems for government employees through the creation of incentives for increased efficiency (for example, wages, salaries and other 'rewards') is related to the outcome-oriented budgetary system. However, there are many problems involved in this, as well as in the outcome-based budgetary system.

Perhaps the reform within government which is being advocated the most since the 1980s is decentralization, which is also part of the structural adjustment programmes. Many developing countries continue to be too centralized today, and decentralization can be justified in most cases. Nevertheless, there are problems involved in these reforms as well. For instance, local governments may not have sufficient capacity to handle decentralized activities in which the consideration of and appropriate measures for local spillover effects are also important. However, decentralization is generally viewed as the simplest method to reduce the size of central government.

10. PARTICIPATION

Participation means that citizens have the opportunity to influence decisions and activities not only through elections and representation, but also through direct involvement in shaping and implementing programmes which affect their lives and their well-being.

Non-participation is linked to the model of government provision and top-down planning. The failure of top-down development methods to eradicate poverty and to improve the living conditions of the poor in developing countries has stirred interest in strengthening the power of deprived groups and in the adoption of more participatory approaches for development efforts and projects (see Taal 1993, which surveys a number of cases of community participation). While mainstream economists strongly believe in the efficiency of markets, they have had much less to say about the participatory approach and the interaction between the state and civil society.

The participatory approach is not new, and many have been advocating it since the 1960s. Nonetheless, the participatory approach has been neglected. This is shown by Korten, one of the leading pioneers of the participatory approach, who in 1980 demanded new approaches 'to bring the poor more rapidly into full participation in development decisions, implementations and benefits' (Korten 1980).

Participation means, naturally, an increased role for community-based organizations and NGOs as producers, as well as advisers for citizens, and in efforts to involve voluntary contributions in the provision of public and merit goods.

In development literature, there is currently a large and growing interest in 'civil society'. In several countries, in addition to the state and the profit-making private sector, there is a burgeoning non-profit, non-governmental sector within civil society. This is becoming an important factor in the provision of traditional public and merit goods. However, civil society is still very weak in some countries.

We may take developments in Asia (Riker 1995) as a case in point. In 1965-75, with the 'basic needs approach', governments placed primary emphasis on direct poverty alleviation, especially for those living below official poverty lines. There was also a tendency to decentralize the administration of essential services in health care, education and nutrition. Sri Lanka and the Indian state of Kerala offer examples. Although this approach was mainly directed by governments, a few NGOs targeted selected isolated and impoverished areas in several Asian countries that were beyond the reach of governments.

In 1975-85, efforts were increased to promote 'grassroots' development through local organizations such as NGOs and community organizations. There were recommendations to relate these local initiatives 'from below' with the attempts of governments to realize administrative decentralization 'from above'.

In 1985-90, the emphasis shifted to the creation of an 'enabling policy environment for development'. Intermediary level organizations (NGOs and private voluntary organizations operating regionally, nationally and even internationally) sought to eliminate the economic, institutional, and legal constraints on citizen-based development by influencing policy at various levels and in specific sectors (Riker 1995).

10.1 The benefits of participation

What is the appropriate role of the public sector and civil society in the provision of public goods and goods with social externalities? What are the characteristics of the 'new model' of provision? Various successful cases have been reported in the literature: What are the essential features of these successes? Can success in one part of the world be transferred to another? Can one learn the best ways to provide services from the historical experiences of advanced countries? Can these methods be transplanted in a systematic and planned manner to historically and culturally different places? Can the South learn from the South? If potential benefits from increased participation are enormous, then why are societies not able to utilize these benefits?

While top-down planning efforts have often failed due to the paternalistic fallacy, it is equally possible that participatory efforts may fall into a populist fallacy because of the assumption that the poor themselves possess all that they require for their advancement and that they have no need of 'bureaucrats' and 'technocrats' (Uphoff 1988:48).

The microeconomic benefits of participation are realized when the approach leads to a better cost-benefit ratio than does public provision and market provision alone. Health care, education, infrastructure and research are all areas in which a judicious blend of government and private effort is needed.

An increasing number of development practitioners agree that the participation of the intended beneficiaries improves project performance (Isham, Narayan and Pritchett 1995).¹¹ While participation used to be advocated mainly by non-economic social scientists and grassroots organizations, now the largest and most influential aid agencies are arguing for participation as well (op. cit.). However, it is not clear which basic economic factors make certain models of participation more efficient than the traditional hierarchical ones?

One answer is related to the problem of information. By participation, one can reduce the 'noise' in communication and information flows in a more efficient manner. Participatory models are also efficient in avoiding some principal-agent problems. In a typical principal-agent situation, the principal, after giving a task to an agent, then tries to control the acts of the agent so that they conform to his own wishes. Particularly in small groups such as mutual insurance companies or savings banks, participation reduces this problem of control. However, it is possible that in a large participatory group, the typical principal-agents problems are widespread.

Participatory models may also succeed because they conform to the preferences, whether ethical, moral or sympathetic, of the participants.

¹¹ Isham, Narayan and Pritchett use subjective data linked to 121 water projects and conclude that participation improves performance.

In principle, there is a continuum of cases starting from very centralized top-down planning by a government to complete, direct governance of the people (the Lok-Niti model of Gandhi, see Heyzer, Riker and Quizon 1995). The Lok-Niti model is close to anarchism, with no government.

Studies which demonstrate that beneficiary participation can improve project efficiency emphasize that, for the maximum benefit, participation has to be viewed as a process which involves beneficiaries in decision-making from the beginning to the end of a project. A command-and-control approach to participation does not work. In the context of foreign development aid, one has started to speak about 'ownership' of those who are supposed to benefit from the projects.

Holcombe (1995) lists the following benefits of participation:

- better information for project design and feedback for project adjustment;
- the adaptation of programmes to local conditions;
- the ability to tap local technical knowledge and resources;
- the more efficient use of existing government services and improved access to the poor;
- the more effective cooperation of the intended beneficiaries.

Both information processing and motivational problems are alleviated in this approach.

It is important to note that many governments will never have the resources to solve urgent problems through centralized operations. Therefore, it is absolutely necessary for them to mobilize people for grassroots activities.

However, important issues remain. Only a few systematic studies empirically test the effects of participation, and certain issues still need to be determined. For instance, are the results sector specific? The studies mentioned above have dealt only with water projects. Taal (1993) includes several interesting, successful cases from other areas.

Another issue is the problem of the way to achieve more efficient participation. The evidence is still limited on the way to create efficient incentives within public sector agencies to promote participation. This is clearly a problem of management in public agencies and development aid agencies.

What are the full costs and benefits of participation? Is participation justified just because of improved outcomes? Additionally, since the forms of participation vary substantially, it is still not known which types of participation would lead to the best results and to what extent the various models of participation are important. In any case, there is little doubt that participation is a potential means to overcome free-riding, the basic problem of collective action. If this is the case, participation also

offers an option for bridging the failures of government and the failures of the market.

10.2 Different concepts of participation

It is not always clear what is meant by the participatory approach, because there are several concepts, and they are not always specifically defined. Participation and decentralization are sometimes used more as slogans than as well thought-out strategies. Participation can be both an 'end' in itself and a 'means' to the efficient provision of goods and services (Streeten 1995).

A report on the Grameen Bank gives the following definition.

...one can suggest that participation and empowerment are degrees on a continuum. The greatest degree of participation and empowerment may exist, when operating staff are seen as the starting point for action and as the source of skills and capacities. Participation and empowerment thrive when Staff become the Subjects and the decision-makers. Decisions and planning emerge from those who are closest to the action; and responsibility is given and accountability demanded from staff. There is a psychological element to participation and empowerment; that of achievement of a sense of worth by being on the inside and by taking responsibility. (Holcombe 1995)

This has revolutionized the approaches traditionally used in the authoritarian and hierarchical systems which seem to be so common everywhere, but particularly in the developing countries. This is the operationalization of the expression 'let's release the energy of the people'.

11. CIVIL SOCIETY, NON-GOVERNMENTAL ORGANIZATIONS AND COMMUNITY-BASED ORGANIZATIONS

Participation may mean the involvement of non-governmental organizations. The participation of NGOs, usually non-profit organizations which work for the benefit of non-members, has become almost a new orthodoxy in development work, and these organizations are receiving increasing support from donor organizations. The nature of NGOs varies quite substantially, and NGOs are by no means a homogenous group. NGOs are different from popular and social movements which are more political and which try primarily to promote the interests only of their members.

The involvement of NGOs is very popular because of the non-profit activities which do not involve explicit membership. However, questions about the efficiency of NGOs relative to that of more traditional ways to promote projects do arise.

De Tocqueville (1969) has argued in *Democracy in America* that citizens have a strong tendency to form all types of civil associations and that these contribute to the

effectiveness and stability of democratic governments. Following de Tocqueville's social theory, this may be one of the reasons why there is now so much interest in NGOs and community-based organizations as important elements in fostering efficiency in society.

11.1 Non-governmental organizations

Non-profit, non-governmental organizations are active in the Third World in areas of development such as rural development, poverty alleviation, nutrition and health care, reproductive biology and education and in such global issues as the environment, human rights, refugees and the population crisis (Yamamoto 1995).

There has been a significant increase in the number of these types of non-profit organizations in Asia (Yamamoto 1995, Riker 1995) and Latin America (Reilly 1995). The expansion has occurred at both the national level and within organizations dealing with global issues. What are the reasons behind this explosion? Some have considered it to be a result of the strengthening of the democratization process. Reforms in the state sector create the need for new types of services. As government structures become more decentralized, broader citizen participation occurs and begins to address social issues. Another reason is the emergence of new global issues, especially in the area of the environment and the population explosion. This may be called 'a global associational revolution' (Salamon, quoted by Yamamoto 1995:4). Finally, the UN summit conferences, especially the Women's Year and the Women's Decade, have had considerable impact on women's NGOs throughout the world (Yamamoto 1995:14).

It remains to be seen whether the rapid growth of these organizations will continue. What the final impact of this growth will be is also an open question.

There is great variance in the organizational forms and the activities of the NGOs which have emerged, and common features are not easy to pinpoint. However, one typical feature is that they often integrate a range of initiatives combining, for example, economic operations with health-related activities or social activities with education and personal development. Members of an organization often also participate actively in the decision-making process, in carrying out tasks and in promoting cooperation and mutual aid. A very significant aspect of these organizations is the participation of women in management.

What are the characteristics of NGOs? For instance, Chilean health care NGOs exhibit the following features.

- they are private, independent of the state apparatus and have no permanent public financing;
- they operate on a non-profit basis;
- they are made up of interdisciplinary technical teams heavily weighted towards health care and the social sciences;

- they carry out actions geared mainly towards the popular sectors and seek to respond to the most urgent health needs and problems;
- they take as their point of departure a comprehensive and participatory approach to health, and they develop dignified and humanized models of medical care;
- they develop practices which generate relatively permanent links with the popular sectors at the individual, family and organizational levels;
- they operate primarily through local programmes and projects and in the areas of direct action, research and training, placing more emphasis on the quality of actions rather than on the number of beneficiaries;
- they constitute areas of application for a broad concept of primary care and local development strategies.

What general conclusions can be drawn from this? Why do these organizations exist? Do they replace state provision or profit-motivated private enterprises? How large a responsibility can these organizations bear? These questions remain at present largely unanswered. However, one hypothesis seems to emerge. If the state or the market does not provide social services, then NGOs tend to take up the slack. In the developed countries, NGOs also complement the services provided by the state. In some cases, the state may even support these organizations financially.

According to Williamson (1985), organizations are created to minimize transaction costs. Perhaps NGOs represent a response to large transaction costs created by governments. Another interpretation of this organizational popularity is offered by the theorem of Coase and Demsetz, that is, that these organizations are created to internalize the externalities.

Community institutions provide an informal framework for the coordination of the design and implementation of projects in areas like water management, environmental protection, the prevention of soil erosion, the regulated use of forests and grazing land, and the provision of other local public goods (Bardhan 1996). Local information can be helpful in identifying less expensive and more appropriate ways to provide services.

Peer monitoring and the enforcement of local sanctions and common sets of norms have been used to create systems for local borrowing (for example, the Grameen Bank and revolving credit associations).

NGOs have the ability strongly to motivate people because beneficiary participation is involved. They are also able to combine various activities in a 'non-standard' way in order to create efficiency. They have demonstrated great capacity for addressing specific problems at the local level; they have developed technological innovations of considerable scope, especially in health care, education and promotion and have designed health-care models from the family and community perspective.

NGOs are capable of promoting innovative practices in local health care work, and they are very familiar with current needs and processes in social organization, including community and social participation. Their successes are facilitated by strong motivation, commitment to work, and the flexibility of operations ensured by their distance from the state bureaucracy.

Probably the most important features of NGOs are social interaction and networks which deliver information and knowledge on essential issues. NGOs are also important in creating new attitudes and common values. Finally, they encourage people to deviate from traditional methods. Nevertheless, social interactions can have both 'positive' and 'negative' effects. For instance, Glaeser, Sacerdote and Scheinkman (1996) argue that criminal behaviour can be explained through negative social interactions.

11.2 Problems

NGOs may also be affected by certain weaknesses related to local activity. For example:

- Local institutions may be quite inadequate for dealing with severe social and economic inequalities.
- Some supra-local coordination is needed if there are regional spillovers in the form of local externalities. For example, education in one locality may spill over to other localities when people move.
- These institutions may have quite weak administrative and revenue-raising capacities. Even local governments in many developing countries have weak abilities in raising local taxes.

NGOs often provide services only to a limited segment of the population since they may not be able to extend services to the large majority in essential areas. However, this is debatable. Likewise, their activities may not be efficient if there are large economies of scale.

The evidence from Asia also points up the fact that the recent surge in the number of NGOs is partly a response to government policies. The rise of the non-profit sector in Asia is related to the negative consequences of the rapid economic development in these countries. Asian governments have not been able to induce equitable economic development, and thus NGOs have struggled for alternative development policies and strategies which would lead to sustainable development (Pongsapich 1995).

For instance, in Thailand, a non-profit sector has gradually evolved from religious institutions to include social welfare NGOs and, more recently, development-oriented non-governmental organizations. In New Zealand, more traditional NGOs are increasingly supplementing the social welfare initiatives of the government rather than functioning as mainstream providers. However, with the economic restructuring taking place in New Zealand during the past eight years or so, the potential of these NGOs to act as mainstream service providers may resurface (Yamamoto 1995:7-8).

There is also a dilemma here. If NGOs are born mainly in response to the weaknesses of government policies and are independent, it follows that they cannot actually become a part of national social policies and strategies. Governments cannot regulate the supply of services through these independent organizations. A solution to this problem would involve limited financial support by governments for the activities of these organizations, thus allowing the governments to exercise some control over supply. However, this may interfere with the autonomy of these organizations, since governments could attempt to convert these organizations into mere government subsidiaries.

11.3 The relationship between governments and NGOs

The relationship between governments and NGOs is not always harmonious, and conflicts and problems in cooperation do arise for various reasons. The activities of an NGO – for example, as in the case of Greenpeace – can imply strong criticism of a government. On the other hand, an NGO may be a complementary party (as often occurs in health care services and family planning), or it may even act as a surrogate for government activities (private provision in which the financing may be private, or public, or a mixture of the two).

11.4 How does the demand for NGOs arise?

Often, successful participation seems to require some support from the central government, which conversely is also able to eliminate gains already achieved. Although the benefits of participation and the need for government or donor support are now well recognized (Streeten 1995), the nature of successes varies from case to case, and the general prerequisites for success are not well understood. Success seems to be limited and remains linked to specific instances. Fuchs (1996) argues that successful health care systems have to be based on the management of professionals, rather than 'unskilled' voluntary participation.

In conclusion, we find that NGOs are capable of avoiding some collective action failures. This is especially true when these organizations are small; they conform to criteria which can ensure success (see section 5.4 above).

12. EXAMPLES OF CHANGING MODELS OF PROVISION

In the models of provision, an almost archetypal case of change is represented by Chile.¹² Starting in the 1930s, for many decades Chilean social policy has been closely linked to the state. This led in the 1950s to the creation of a national health service, the aim of which was to offer health care services for workers and the indigent. The public health services contributed significantly to the professionalization and modernization of the health care sector. The system was

¹² The discussion hereafter follows Salinas and Solimano (1995).

financed from the general revenues of the state, by workers through social security payments and by employers through contributions proportional to wage payments.

After the military coup, the existing national health service was dismantled in 1979 and then reformed according to the neoliberal model; private, for-profit institutions were to provide retirement schemes and health care for the middle- and upper-income portions of the population. Although decentralized to 27 regional health units, the system remained administratively under the control of the general government. The system became polarized: an expensive and sophisticated private system for the small upper-income segment of the population alongside an underfunded and deteriorated state system for everyone else. These conditions sparked a search for day-to-day solutions to the problems of survival that led to many innovations and a variety of organizational forms directed towards assistance and promotion; many were church sponsored.

According to Salinas and Solimano (1995), the democratic reconstruction currently underway in Chile should also lead to a rethinking of general social policy models. One of the key issues is the role of non-governmental organizations in the formulation and implementation of social policy. According to the authors, one reason this issue requires serious reflection and review is because of the work of NGOs during the military dictatorship.

Another illustrative case is Egypt (Handoussa 1995). During the past three decades, the country has been characterized by central planning and regulation, the dominance of public enterprise activity in the productive and tradables sectors, and the operation of an elaborate welfare system. The scope and degree of state intervention are now being questioned. Problems in the delineation of the boundaries of the state and in the analysis of the structure of the incentives and organization with which the country guides its economic activity are now being re-examined, and the economy is moving towards the market. Handoussa also cites similar tendencies in many Middle East countries which have adopted similar growth and development policies. This gives the impression of very substantial state involvement. Many developing countries, in effect, have weak private sectors, and the state sector may practically be the only one able to provide more appropriate opportunities. Of course, this has not only economic, but also political consequences.

13. THE ROLE OF INSTITUTIONS AND SOCIAL CAPITAL

13.1 Implementation problems

There is no lack of evidence to confirm that the implementation of a development project or larger reforms in the provision of public services represents a major constraint in many developing countries, particularly those in Africa. Considerable weaknesses in political institutions exist in several countries. Even if the participatory approach is accepted as the option of the future, existing institutions may not allow it to be implemented. What are the foundations of these institutional

constraints? Can they be changed or modified? If so, in which time perspective? It is frustrating to admit once more that very little is known about the general situation. However, in the literature there is a number of examples of success, and these case studies can be utilized. In order to understand more thoroughly the fundamental forces shaping institutional constraints, in-depth knowledge of the role and behaviour of institutions is also needed. Institutional economics attempts to tackle this problem.

Good governance means accountability, transparency and participation, as well as freedom from corruption. All these attributes are seriously lacking in many developing countries today. Moreover, the global trend too often is one of exclusion instead of participation.

Basically, according to the institutional approach, it is not sufficient to get the prices right by using more market mechanisms through privatization. Successful markets need successful institutions, and one has to get the institutions right in order for society to benefit from markets.

13.2 Policy questions

Reforms cannot be implemented without political decisions and support. However, there are several political constraints to reforms. First, there are interest groups which want to preserve the *status quo*. The groups which may lose can oppose the reforms, and this coalition usually does not represent the most vulnerable members of society.

There is also a debate about the issue of whether democracy makes it more difficult to implement reforms simply because of the existence of powerful pressure groups. However, there is no guarantee that reforms in a dictatorship, for example, are pursued and implemented for the benefit of the poor. Chile during the Pinochet regime was an exceptional case in that the dictatorship devoted attention to the most vulnerable.

The capacity of an administration to implement reforms may be weak due to severe corruption, lack of skills, or lack of appropriate qualified people. For instance, there may be no administrative capacity to provide income transfers. In this case, an alternative might be the provision of jobs, basic infrastructure or targeted subsidies such as food coupons or food stamps.

A recent World Bank *Newsletter* report on Bangladesh states:

There is a direct relationship between the efficiency of public institutions and economic growth, and it is becoming increasingly clear that the inability of Bangladesh to get out of the low growth trap is largely due to the weakness and inefficiency of public institutions, the government's inability to plan and manage key reforms, and its tendency to micro-manage economic activities.

One cannot be more direct than the statement that growth problems are being caused by the inefficiency of the government!

To remedy the situation, the report's recommendations include:

- a focus of the energies of the government on core functions which only government can provide and on programmes which are not adequately provided by others;
- an increase in the accountability and responsiveness of public agencies. They should be responsible to their 'owners', namely, the citizens;
- an increase in the transparency and fairness of laws and regulations;
- an overhaul of the rules and the processes of policy and decision-making.

The importance of the political situation – broadly defined in the African context – as a prerequisite for a successful climate for economic performance has been emphasized by Ndegwa and Green (1994), who state: 'In a number of African countries, better political management, including establishment of legitimacy of the state and government, focus on public objectives and creation of a coherent decision taking process is really the starting point for action before any economic agenda can make sense.'

The need for institutional reforms has focused attention on 'institutional economics'. It seems that there are missing links in the traditional 'quantitative-production' function types of explanations: the quantity of labour and capital seems to be insufficient to explain the development of outputs. Is this also the case in the production of public and merit goods? Which precise factors in institutional developments are crucial? The major obstacles are the lack of data and often the non-quantitative nature of explanatory factors. More eclectic views seem to be gaining popularity. Economic or political explanations no longer satisfy. For pragmatic reform and policy applications, it should be possible to combine the various aspects.

The main theoretical basis for structural adjustment programmes has been standard neoclassical economics. Many believe that the tools of the basic neoclassical model are far too simple or totally unrealistic relative to the actual situation in developing countries. The Walrasian theory of multimarket equilibrium and associated welfare theorems are interesting intellectual constructions, but whether they are relevant to the central issues of development is still debatable. Instead, the relevant issues are thought to include fragmented, imperfectly competitive and often non-existing markets. technological backwardness, the pervasive role of various non-price institutions (such as long-term contractual relations, interlinked contracts, and social norms) in resource allocation, sticky prices and non-clearing markets, large-scale poverty, large-scale malnutrition and unemployment, overpopulation, rural-urban migration and urban overcrowding, environmental degradation, balance of payments crises and monetary instabilities, and hopelessly inefficient and corrupt forms of public sector organizations (Mookherjee 1994). According to the strict neoclassical model, there is no scope for institutions; what is needed is only a well-functioning price system with guarantees for private property and the stable value of money. On the other hand, according to institutionalist approaches, specific institutional features and historical factors are important in the development process. The theories of

institutions have been developed to tackle the problems in development discussed in this paper.

According to van Arkadie (1989), institutions can two different connotations. First, they can signify the set of rules which prevail in a society, including both the legal system and other behavioural norms. Second, alternatively institutions can signify actual organizations, enterprises, public sector entities, etc.

Institutionalist theory has evolved into various branches. The 'new institutionalist economics' (NIE) has developed a theory to delineate some of the key features which are believed to be important for the efficient functioning of the economy in general and of the economies of the developing countries in particular. These include i) clear property rights, ii) the clear nature of contracts, their credibility and enforcement, and iii) information asymmetries.

Why is a new institutionalist economics view necessary? Is it not true that most institutional problems have already been tackled in the traditional literature dealing with institutions?

In the 'old institutional economics' (Veblen 1919, Hodgson 1988), historical tradition and habit formation are strongly emphasized. Unconcerned about the powers of the market, old institutional economics proposes that history and habits (overall culture) have to be modified in order for behaviour to be changed. Old institutionalists are also critical of the assumption in neoclassical and new institutional economics that economic agents are fully rational. Instead, bounded rationality (Simon 1957) is accepted. Prices are seen as the result of certain historical processes, not as equilibrium prices. Prices must also be 'legitimate', and a change in relative prices does not necessarily lead to a predictable outcome, as it does in the neoclassical theory.

Old institutional issues have involved questions such as: What is an appropriate mix of the private and the public sector in the field of constructions? Should one promote large- or small-scale enterprises? Are there remarkable economies of scale that will not be realized by the market? Does policy favour large and inefficient enterprises? How are informal sector enterprises to be treated? Is there too much regulation?

The problem with the old institutionalist view is the fact that this approach is too scattered among ideas with few common elements. The approaches – many of which have proven to be very fruitful (Williamson 1985) – have been devised without a coherent theoretical framework.

In the new institutional economics (summarized in Coase 1992, North 1990, Williamson 1994), the key concept is that transactions and information costs are considered in addition to the production costs of neoclassical theory. Production costs can be compared to the 'laws of motion without friction' in Newtonian physics. In the same analogy, transactions costs have been compared to 'friction' in movement that, at times, is of decisive importance (such as skiing in the sand). Efficient institutions lower transaction costs and, by providing the necessary incentives, enable

people to achieve their goals efficiently. Therefore, more efficient institutional structures would release the potential powers of supply. Removing inefficient institutional impediments will motivate the energy of the private sector.

It follows that the rules applied to actual transactions have a crucial effect on the efficiency of construction in the developing countries. Clear rights to ownership (of land, for instance) and regulations concerning productive activities (contracts) and their enforcement would create the necessary incentives for private agents to achieve efficient solutions. A well-known example from the developing countries is the illegal occupation of public land for squatter settlements (Gilbert and Gugler 1994). The establishment of clear property rights is not always obvious in societies where private property has been unknown or has existed only to a limited extent and thus poses a challenge for legislation. Property rights are often quite complicated (Barzel 1989).

Furthermore, new institutionalist theory emphasizes that the efficiency of production depends not only on the skills of managers and labour in the private sector, but also on transaction costs as a whole.

The main argument of institutionalist theory is that merely allowing the price system to work or permitting privatization is not sufficient. Governments must be actively involved in the new strategies. This boils down to management issues and the administrative role of the government in the process of reform. It appears that government can either promote, or impede development. So, government is neither good, nor bad; it can be either, depending on local and historical circumstances. This has also been demonstrated in recent literature on the role of governments in the fast growing East-Asian economies.

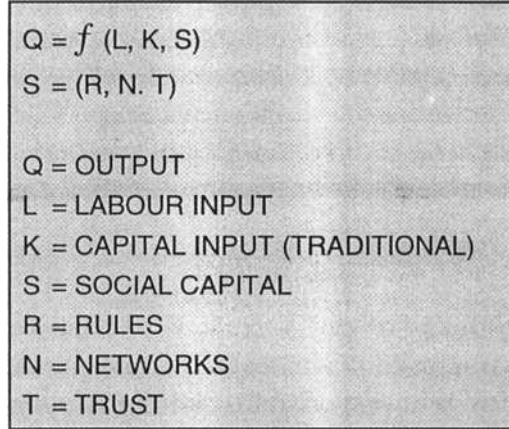
14. SOCIAL CAPITAL

Closely related to the thinking behind institutional economics is the concept of social capital. Social capital (Putnam 1993) refers to features of social organization such as trust, norms and networks. These improve the efficiency of society by facilitating coordinated action. In this connection, social capital can also be considered a factor in production (see Figure 3). Trust is needed to lower transaction costs; networks are needed to transmit information efficiently, and norms are needed as rules of the game.

Putnam argues that social capital facilitates spontaneous cooperation. An example is offered by rotating credit associations, which are common all over the world. In this association, a group of people contribute on a monthly basis a certain sum of money to a common fund. Each month one of the members receives the entire fund and may use it as he or she wishes. This member is then no longer eligible for subsequent distributions until all members of the group have received the pot, although he is expected to continue making regular contributions. These associations vary widely in size, social composition, organization and procedures (Putnam 1993:167-8).

The rotating credit association is an example of cooperation which successfully side-steps the collective action problem. Of course, there is an incentive for a member to defect from the group after receiving his pot, but the fact that these kinds of arrangements are found all over the world demonstrates that defection is not common. The interesting question is: Why do these associations succeed?

FIGURE 3
SOCIAL CAPITAL IN PRODUCTION


$$Q = f(L, K, S)$$
$$S = (R, N, T)$$

Q = OUTPUT
L = LABOUR INPUT
K = CAPITAL INPUT (TRADITIONAL)
S = SOCIAL CAPITAL
R = RULES
N = NETWORKS
T = TRUST

Trust is one of the keywords in the concept of social capital. It is not yet well understood why some societies exhibit more trust than do others. Clearly, trust is embedded in culture, but it also seems to be true that trust or the lack of it can be very persistent, and it is not easy to move from a position of non-trust to one of trust, even when this could be socially very valuable. We may presume (see Figure 2) that social change affects trust, and furthermore that in traditional societies trust may be considerable. A shift to an industrial society changes the relationship.

It is one of the main arguments of Putnam (1993) that social trust in the civic regions of Italy, in contrast to Naples, has long been a key ingredient in the ethos which has sustained economic dynamism and government performance. Trust lubricates the cooperation between legislature and executive, between workers and managers, among political parties, between government and private groups, among small firms, etc.

The dilemmas of collective action (the tragedy of commons, public goods, collective action failure, the prisoner's dilemma) can be avoided through the cooperation of the parties concerned. However, to stimulate cooperation, there must be mutual trust which is a basis for a credible mutual commitment to act for the benefit of each other. Which conditions favour mutual trust? Societies differ in this respect, and these differences may constitute an important explanation for differences in performance ability. It also seems apparent that mutual trust cannot be easily created if it does not exist. Which incentives might lead to increased trust?

Trust may have decreased as a result of industrialization (see Figure 2). The loss of informal trust has been offset by formal legislation and created a demand for professionalists.

One of the tragedies of the former colonies may have been the elimination of the traditional elements of trust in these societies by the colonial powers and the colonial culture. Even if traditional society had possessed 'enough' trust, this may have been damaged by the strange governance system of colonial rule. Some elements of the colonial system have remained, but have never been fully adopted by local cultures. Therefore, they persist in the society as 'strange' elements, like cancer.

It might seem on the surface that third party enforcement is the easiest way to do ensure that contracts are kept. On closer examination, the conditions for successful third party enforcement are seldom, if ever, met in the real world. It requires a neutral third party with the ability to measure the attributes of a contract and to enforce the contract without cost agreements, so that an offending party always compensates the injured party to a degree which renders violation of the contract costly (North 1990).

14.1 Civic virtues

As a solution, Putnam (1993) offers the concept of 'civic virtue', a concept which was used by Nicolo Macchiavelli. According to Macchiavelli (1970), the success of free institutions depends on the presence of civic virtues in society.

'A steady recognition and pursuit of the public good at the expense of all purely individual and private ends' seems to come close to the core meaning of civic virtue (Skinner 1984).

'Interest in public issues and devotion to public causes are the key signs of civic virtue' (Waltzer 1980).

The concept of civic society is also aimed at correcting the biases in methodological individualism, where only individual utility matters. It has to be emphasized that, in civic society, citizens are not required to be altruistic. Altruism would go against common sense and the majority of empirical observations. Instead, in civic society citizens pursue 'self-interest properly understood' (de Tocqueville 1969). In the context of broader public needs, self-interest is sensitive to the interests of others, and it is 'enlightened' rather than 'myopic' (Putnam 1993:88). However, since some think that altruistic behaviour also exists, this model fits well with the concept of civic society. For our present purposes, it does not matter whether the underlying behaviour is individualistic (taking into account the public good) or altruistic.

Participation in a civic community is public-spirited; it is more than merely the maximization of short-run self-interest, and it is more oriented to shared benefits. Citizens are not selfless saints, but they regard the public domain as more than a battleground for pursuing personal interests (Putnam 1993).

The 'moral dimensions' of Etzioni (1988) come very close to this concept of civil society, forming the basis of the so-called 'communitarian' thinking. Putnam (1993:87) argues that communitarian thinking was the basis of old republican ideas.

Republicans emphasized community and the obligations of citizenship, while liberals stressed individualism and individual rights.

This introduces some problems. It is not difficult to imagine that the republican emphasis on 'community' might lead to mercantilist economic policies, whereas individualism was clearly a basis for the thinking of Adam Smith, economic liberalism and the free market. The key issue seems to be the way for human society to establish a proper balance between mercantilism and the free market and between civil virtues and individual freedom. This is the dilemma of a 'good society'.

Recent studies by Persson and Tabellini (1994) and Alesina and Rodrik (1994) show that inequality and growth are negatively correlated. Persson and Tabellini find that the effect of equality on growth is not only statistically significant, but also quantitatively important. Thus, a rise in equality of one standard deviation, by changing the income share of the middle quintile of income distribution by about 3 per cent, could increase growth by one half a percentage point. Moreover, this relationship seems to hold only for countries which follow democratic policies. Other studies also confirm the relation. However, some emphasize that the relationship between growth and equality exists, but that statistically it has little significance (Fishlow 1996). This correlation perhaps exists because countries in which equality and growth go hand-in-hand also have strong social capital. Equality strengthens social capital through the feeling of solidarity. One could also surmise that the communication networks in these countries are more extensive than are those in less equal and less democratic countries.

Social capital may also increase because of the homogeneity of a population. This is a specific problem in African countries, where populations typically speak dozens of languages. In fact, language can be a very important factor since communication among linguistic groups can be difficult. Transaction costs climb when a common language must be learned, and, if the learning process is less than satisfactory, communications remain inadequate.

We conclude that social capital is a major ingredient in the production of goods and services in all countries. By improving social capital, the efficiency of provision is raised. One should look at the 'soft' elements of social capital. However, since social capital is not easily quantified, one may too easily forget its importance.

15. CONCLUSIONS

In this paper we have systematically assessed and conceptualized the provision of basic public and merit goods in developing countries. These goods are important in the building of human capital, which today is considered a key factor in the promotion of the development process.

Finding ways to enable and encourage individuals to participate fully in the development process is one of the big problems of development. However, in

principle, society is capable of directing this capacity towards those actions which promote development (empower people). But society can also prevent this from happening. Thus far, it has been clear that empowerment cannot be achieved through measures generated through centralized top-down planning. That methods of market provision alone may be successful is equally doubtful. Therefore, a more promising option would be the establishment of a new system of cooperation among the government, individuals and families, the for-profit enterprise sector and local community groups (the non-governmental, non-profit sector).

It can be argued that the problem of the appropriate extent of state involvement in the provision of public goods is badly posed. The right question to be asked is: What is the nature of an appropriate state involvement in provision.

State involvement is needed in order to determine the goals and targets of provision. The comparative advantage of a government does not hinge on actual production activities. The private for-profit sector is strong in areas in which the goods to be provided are predominantly private in nature. In reviewing the strengths and weaknesses of the non-profit, non-governmental sector, we observe that this sector seems to be able to avoid some of the important failures of collective action and asymmetric information. Furthermore, the non-governmental, non-profit sector is also efficient in complementing the activities of the government in many fields. This comparative advantage should be utilized much more in the participatory approach to development than it is today.

This means that the community should become more involved in the provision of public and merit goods. The state should facilitate this process by reforming its own activities and regulations. All in all, there is a need to develop new tools for the strategic management of the process of provision so that all the relevant actors are involved in ways which promote their comparative advantages. The participation of community-based organizations may be seen as an important means to tackle the problem of collective action failure. However, the position of an NGO is often opposed to that of a government. In such a case, NGOs may still play a major role by raising relevant criticisms of the actions of the government. For the sake of democracy, it is also important to preserve the autonomy of NGOs.

Improvement in the implementation of the new models requires improvement in institutions and in social capital. Social capital consists of the norms of society, the trust of the people in these norms and the networks of communication in society. The main thesis of this study is that, in the ideal case, the state should work with civil society, in which the formation of social capital is promoted. The challenge is for the state to promote civic virtues (trust in norms) in order to improve social capital. This will be difficult to accomplish; social institutions and the extent of social capital are not easily changed.

Much remains to be empirically tested. Unfortunately, there are many serious problems in the collection of the appropriate data for empirical tests, but many of the case studies which are available seem to support the ideas presented in this

paper. The ongoing UNU/WIDER project on the provision of public goods should help advance our understanding of the issues involved.

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