
Public Sector Reform in New Zealand and Its Relevance to Developing Countries

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Does New Zealand's success story have lessons for developing countries contemplating public sector reform? That question usually elicits one of two reactions, both inadvisable in the authors' view. The first reaction is to be impressed with the efficacy of the reforms and conclude that they should be adopted uncritically in other countries. The second reaction is that the special conditions existing in New Zealand are such that none of its reform experience is relevant to others. The authors take a middle position, maintaining that poorer countries can indeed extrapolate from the experience of their higher income neighbor despite the different conditions under which they have to operate. New Zealand's comprehensive overhaul of its public sector affords both general principles and specific elements relevant to countries looking to improve the quality, efficiency, and cost effectiveness of their public service sectors, and a careful analysis of those reforms can ascertain what might be transferable and what principles might apply.

In 1984 New Zealand's newly elected Labor Government took over an economy characterized by comprehensive controls on the financial sector, extensive subsidies to farmers and exporters, and a highly sheltered private sector. Its deficit was a high 9 percent of gross domestic product (GDP), and public debt, at 60 percent of GDP, was rising. High underlying inflation and slow economic growth had reduced per capita income from one of the highest in the Organisation for Economic Co-operation and Development to one of the lowest (OECD 1983, 1984).

The new government put in place a macroeconomic stabilization plan and broad structural reforms to correct the core problems; the design, implementation, and outcome of the reform program are widely cited in the economic literature and business press and will not be elaborated here (OECD 1990–94; Bollard 1992; Evans, Grimes, and Wilkinson 1996). But government expenditures still accounted for about 40 percent of GDP, which, policymakers came to believe, meant that the improved

performance of the economy as a whole might be limited by the large public sector. Government departments were viewed as bloated, inefficient, and poorly managed. The bureaucracy behaved in ways that stereotypically undermine the capability of any government, and service delivery was poor. Departments habitually exceeded their budgets; unused balances were spent in end-of-year shopping sprees; creative accounting was used to give the appearance of good performance; and the management of assets and cash was haphazard.

Most important, politicians felt that some core ministries had their own policy agendas and could override or outlast the wishes of elected officials. Thus the objective of the new government was to create an efficient public sector that was also responsive to the strategic policy direction of the government.

The first step was to decide which activities the government should provide and which could be divested or spun off to the private sector. The second step was to undertake structural and management reforms in the remaining “core” departments—those concerned with broad, cross-cutting, nonsectoral issues such as Treasury, the ministries of Defense and Commerce, and the Inland Revenue Department (for details on the privatization program, see Boston and others 1991; Scott and Gorringer 1991). To paraphrase Holmes and Shand (1994), the government wanted the ethic of value for money and customer service to take its place alongside the ethic of probity and stewardship in the public sector.

Reform of Government Commercial Enterprises

In 1984 the government owned much of the economic infrastructure, including banking, postal, and telecommunications services; a steel mill; a shipping company; production forests; electric power; and a large highway construction business. Most of these activities were being run by departments that also had policy advice functions; nearly all ran at a loss and required taxpayer support. To reform the provision of these services, the government decided to “corporatize” these activities.

Corporatization involved forming government-owned enterprises with clear commercial objectives, a neutral policy environment, managerial flexibility and authority over decisions, performance monitoring, and explicit transfers for noncommercial activities required by government to meet social objectives such as keeping open small, unprofitable post offices or branch railway lines.

To meet these objectives, the enterprises were established under the normal commercial company legislation common in all countries. The only difference from a regular commercial company was that the stock of the state enterprises was not publicly traded but held by government ministers. These firms were required to operate profitably, to take on normal commercial levels of debt from the financial market, and to pay taxes and dividends at commercial rates. Regulatory reform proceeded in

parallel with these reforms to ensure, wherever possible, competition in both the input and output markets. The companies were given the opportunity to succeed or fail based on their commercial performance.

Although corporatization was very successful, it had several drawbacks: the new corporations tied up capital that could be used to repay public debt; they were not subject to the ultimate discipline of the market because of the perception that an implicit government guarantee existed; the large amounts of capital needed to develop the businesses typically came at the expense of government investments in social infrastructure, such as health and education; and the government was exposed to commercial risk if the business suffered losses.

Thus successive governments have moved to sell their interest in commercial activities, a relatively straightforward procedure under commercial law. The government had a single criterion in each sale—to maximize the value to the taxpayers by selling the enterprise in a competitive environment. By mid-1997, 35 companies had been sold, at a value of approximately \$15 billion. Most of the proceeds have been used to retire sovereign debt. The privatized entities have prospered, benefiting from the additional capital available from the private sector. Telecom New Zealand, for instance, went from one of the most inefficient telephone systems in the world to a position of international leadership in telecommunications services (Duncan and Bollard 1992).

All the remaining government-owned companies now run as profitable businesses and pay substantial dividends and taxes. For example, the quality of services provided by New Zealand Post has improved greatly. Although almost 80 percent of its revenue in 1994 came from activities that are competitive, it paid \$22 million in taxes, paid dividends of \$55 million to the government, and posted net profits of \$46 million. In 1995 it lowered the cost of first-class postage from 29 cents to 25 cents and in 1996 offered users a “postage free” day. In 1997 its exclusive franchise over first class mail was removed so that its business is now fully contestable.

Reforming the “Core” Public Sector

To reform core activities, planners took their inspiration from public choice theory, principal-agent theory, transaction-cost theory, and the new public management literature (a brief explanation of these theories and a bibliography are provided in the appendix.) Agency theory was perhaps the most powerful of these concepts. This literature addresses the nature of contracts between two parties: the principal (or government) and the agent (or bureaucrats). In New Zealand planners believed that the problem was not with the bureaucracy—the civil service had many well-qualified and capable managers and staff who were responding in a rational way to the set of incentives they faced—but with the incentives themselves. The reforms were there-

fore intended to replicate, as closely as possible, the types of incentive structures for performance that might be found in a well-functioning private-sector concern, while taking into account the distinctive character of public services. The approach had five characteristics:

- Establishing clear lines of accountability between government ministers and their departments
- Defining performance in an unambiguous and measurable way
- Delegating authority to chief executives
- Establishing incentives that reward or punish results relative to the agreed outcome
- Reporting and monitoring performance.

Two laws were passed to effect these changes: the State Sector Act of 1988, and the Public Finance Act of 1989.

Accountability and Employee Relations

The emphasis on a strong accountability framework implied a new relationship between government ministers and permanent heads of departments. First, department heads lost their permanent tenure and were appointed to fixed terms up to five years, renewable for a further three years depending on performance. Now known as chief executives, department heads work under specified, performance-based contracts that they negotiate with the responsible minister. The State Services Commission monitors performance on behalf of the minister. The chief executives are free to run their departments in the ways they deem best suited to meet the performance goals. It is said that chief executives in the New Zealand public service used to have full tenure and limited authority; now they have limited tenure and full authority (Ball 1994).

Second, public sector employees were placed under the same rules and regulations as the private sector. That is, there are no public service employment regulations; all sectors, public or private, in New Zealand must comply with the same general employment regulations. The chief executive of each department is free to operate under more or less the same conditions as a chief executive officer of a private company, making all decisions on the number of employees needed and the skill mix of personnel as well as all appointments and terminations (based on performance-based contracts for managers and staff).

Defining Performance

Because vague or unachievable performance specifications undermine good accountability arrangements, it was necessary to define the performance that departmental chief executives were expected to deliver. Four elements of departmental performance were considered.

THE OUTPUT–OUTCOME DISTINCTION. In New Zealand accountability between ministers and their departments is based on the conventional distinction between outputs (goods and services produced) and outcomes (the effect of those outputs on the community). Chief executives are responsible for specified outputs from their departments, while the minister chooses which outputs will be purchased to achieve certain outcomes. That is, the minister, not the department, is responsible for the outcome. The distinction is important. Governments are interested in achieving outcomes and would like to contract for them if it makes sense to do so. Outcomes are often not within the control of the chief executive, however, and he or she cannot be held accountable for them. But chief executives can be held accountable for outputs, which can be relatively well-defined and are within the executive's control.

Say, for example, the police commissioner contracts with the minister of police to provide a certain level of policing services, patrols, community security programs, road safety commercials, and so forth. These are clearly outputs. The commissioner does not contract to lower the crime rate. That outcome may be forthcoming, but the crime rate is affected by many variables beyond the control of the commissioner, such as the level of unemployment, immigration policy, social policy, perhaps even the result of certain sporting events. Thus, holding the commissioner accountable for outcomes is not operationally useful; this distinction between who is accountable for outputs and who for outcomes is common in the private sector as well.

Accountability processes are much more effective if the outputs to be delivered are well specified in advance. Vague specifications allow managers to determine exactly what it is their organization will produce. For this reason, the minister and chief executive prepare annual purchase agreements, or contracts, that set out in reasonable detail the outputs to be delivered. The quality and robustness of this system depend on the careful specification of outputs in the agreement. Many ministers have purchase advisers to assist them with this task.

A common concern is that this approach emphasizes outputs at the expense of outcomes. Critics maintain that unless departments are held accountable for outcomes, they will not focus on these issues and therefore are less likely to achieve them. That is not necessarily the case. Greater clarity over what is being produced (outputs) can increase the attention to outcomes. Since 1990 the government, as part of the annual budget process, has reviewed all the outputs produced by departments against the criterion: How does this help achieve the outcomes the government wishes to pursue? This focus makes clear that policy advice should be about the relationship between interventions (including outputs) and outcomes, about what the government is trying to achieve and alternative ways to achieve it. This framework has helped departments understand that, just as in the private sector, their survival is dependent upon meeting the needs of their customer. Because their customer is interested in outcomes, departments, given sufficient competitive pressure, will strive to design and provide public services to help achieve those outcomes.

THE OWNER–PURCHASER DISTINCTION. In addition to purchasing most of a department's outputs, the government is also the department's owner. As the purchaser, the government wishes to obtain goods and services of a specified quantity and quality for the lowest price, whether it is buying from the private or public sector. To enhance price competition, all ministers are free to purchase their outputs from nondepartmental sources. The finance minister, for example, may purchase economic projections and advice from Treasury officials or from any private domestic or international economic consulting firm. As the owner of the Treasury, the government wants to obtain the best possible return on its investments in it. If the Treasury fails to record a positive rate of return, public production lowers the wealth of society. It would better in that case to close that department and contract out all of its work (outputs).

The New Zealand approach recognizes these two perspectives as two different dimensions of departmental performance. Performance agreements with each chief executive separately specify each dimension, and both are monitored. The fact that governments purchase goods and services from their departments and also own those departments could give rise to conflicting objectives. This conflict is solved by pricing departmental outputs at a price equivalent to that charged by the private sector. The department's performance as a business can then be fairly assessed using normal business evaluations that enable governments to determine whether the department is operating efficiently and whether owning the business is advantageous.

Where the private sector produces the same output, this model does not pose a problem. But where there is no comparable private supplier, an alternative benchmark must be established. In some cases, prices charged by different public sector entities can be compared, as in a 1993 study of the unit price of policy advice outputs provided by departments. Where no endogenous benchmark can be established, officials are experimenting with establishing an initial price that applies some pricing rule to costs (such as cost minus x). Although this method will not establish an efficient market price, it does create some separation between cost and price.

Ministries regard the minister as a customer rather than as the recipient of a service. Ministries are accountable *only* to their minister, not to taxpayers and service recipients. Ministers are accountable to taxpayers and service recipients. This contrasts with the citizen charter approach used in the United Kingdom, which creates a dual accountability for departments: to their minister and to the recipients of their services. A difficulty can arise if those accountabilities are inconsistent—for example, if the quantity or timeliness of services demanded by recipients is incompatible with the amount ministers are prepared to pay for the services. The approach used in New Zealand resolves this problem by having ministers make the tradeoff among quantity, quality, time, place, and cost of service delivery; that is, between common interest and individual interest. This does not mean that departments are not concerned about whether customers are satisfied. Such a response will inevitably become a

concern of the minister, whose political antennae should be well attuned to such feedback.

THE GOVERNMENT–DEPARTMENT DISTINCTION. Chief executives make all input decisions, including capital investment decisions (within a defined capital base). Indeed, such authority is necessary if they are to be held accountable for producing outputs in the most efficient manner. Some departments, however, manage inputs over which they do not have full control, that are not used to produce their outputs, or for which the government does not wish to delegate authority. As a result, activities and assets have been divided into two categories: “the Crown” (ministers); and the departments. For Crown activities or assets, accountability remains with the government. For example, the Department of Social Welfare is responsible for administering the social support scheme, but the minister is responsible for the size and number of welfare payments. Understandably, the chief executive cannot be held accountable for, say, the number of people unemployed or the number of single-parent children. Similarly, the national parks are managed by the Department of Conservation for the government but are owned by the government and listed as a Crown asset.

POLICY ADVICE–SERVICE DELIVERY DISTINCTION. Where an agency provides both policy advice and service delivery, a potential conflict of interest arises between the two functions. Separating them reduces the potential for policy advice bias. Under the reforms, policy advice is an output provided by departments in much the same way as consulting advice is an output provided by a consulting firm. Good policy advisers must be able to evaluate the tradeoffs between different outcomes and identify the nexus between outputs and outcomes. They must evaluate spending proposals against all alternative interventions that could produce the same outcome. If, for example, the government decides it wants to reduce road accidents, it may purchase outputs such as highway patrols, road repairs, and vehicle inspection checks. Alternatively, it may intervene legislatively with speed limits, higher alcohol taxes, different speed sanctions, or compulsory driver-education programs.

Viewed from that perspective, policy advice is a specialized business that is inherently different from service delivery. In most cases, it has been decided that policy advice is most effectively and efficiently produced by a department dedicated to its production rather than by one with distinctly different lines of business. For example, in the environmental area, policy advice is the responsibility of the Ministry for the Environment, while another agency, the Department of Conservation, is responsible for delivering services such as operating the national parks. Because the ministry does not deliver services, its advice about appropriate interventions can be independent of the business implications for the department.

A related reason for separating these functions is to reduce the tendency for special interest groups to “capture” the agency that regulates them (Posner 1974). This rent-seeking behavior can be reduced if regulatory policy is designed in one agency and enforced in another.

Reporting, Monitoring, and Coordination

Improved reporting and monitoring of departmental performance was the *quid pro quo* for enhancing the chief executive’s autonomy. This required upgrading financial management systems and skills.

EX POST REPORTING. Defining and monitoring purchase and ownership performance requires information about the full resource cost, including the consumption of assets and the opportunity cost of capital, and about assets and liabilities, their utilization, and the return being generated. For this reason, all government entities are required to report financial performance on an accrual accounting basis, using the same generally accepted accounting practices as does the private sector.¹

Each department must provide a full set of financial statements to its minister and to the Treasury on a monthly basis. In addition, departments must produce and submit an audited annual Statement of Service Performance, outlining the outputs produced versus the outputs agreed and giving information about purchase performance in the same way that private companies produce annual reports showing their financial statements and performance. As a result the government can simply sum all of the accounts to produce national financial statements on an accrual basis. These are published monthly, and annual audited financial statements are presented to the Parliament within three months of the close of the fiscal year. Thus government accounts look similar to an annual report produced by a private company. They show, among other things, the net worth of the government.

EX ANTE BUDGETING. The reforms also changed the budget and appropriations systems in two ways to fit with the performance management system. First, appropriations for departmental outputs (not inputs) are now made on an accrual accounting basis, and managers are free to acquire their inputs from any provider. Second, only capital injections into departments are appropriated (not capital expenditures), reflecting the chief executive’s authority to manage assets within a defined capital base. Budgetary reporting at both departmental and national levels mirrors ex post reporting. Financial forecasts are prepared using generally accepted accounting practices and are identical in form to financial statements produced by private corporations.

CAPITAL CHARGE. Twice a year departments pay a capital charge, calculated on the basis of their net assets, for the cost of the capital the government has invested in

them. This charge has several benefits. First, it ensures that the cost of capital is reflected in output prices because a department's total cost must be allocated to its outputs to ensure comparability with nongovernment producers. Second, the charge encourages departments to manage their balance sheets carefully and to divest surplus or redundant assets. Third, it encourages management to consider the mix of assets needed to produce services efficiently. If a manager finds it more efficient to purchase more computers and sell some cars, he or she is free to make this decision. If the sale of assets reduces the overall capital charge, the savings can be applied to other expenses.

STRATEGIC POLICY COORDINATION. Three means were devised to coordinate strategic policy, which was a key objective of the reforms. Ministers were required to specify and publish the outcomes the government wished to achieve. Coordinating committees were established, made up of senior government officials from departments with an interest in broad areas of government activity, such as social policy, education and training, or environment. Their role is to ensure that policy options are developed in a coordinated way across the government. The third method of coordination is created by the policy-delivery split. Because ministers want advice about policies that can be effectively implemented, and they want output proposals that meet their objectives, policy and delivery departments have a relatively strong incentive to coordinate with each other. Rather than weaken the horizontal linkages between departments, these arrangements have served to strengthen them.

The use of the private sector profit center approach combined with market pricing techniques has also solved one of the common public sector problems: transfer pricing—the price of a good or service for a transaction within an organization. Because there is no market price, the organization can set the price at any level, including zero. Modern business practices require that transfer prices approximate market prices so that accurate profit-loss data can be established by each unit of an organization. Because each department is regarded as a profit center and all transactions between departments are treated as arms-length transactions, the transfer pricing problem has effectively disappeared.

Results

The core sector reforms have succeeded in improving both service delivery and efficiency. The system is widely supported by departmental managers, although the effect of the reforms on managerial behavior has varied depending on the quality of leadership and the levels of efficiency prior to the reforms. In general, performance has improved in tandem with the development of wage scales linked to performance. Savings from improved cash management have been substantial (enough to pay for all the system costs of the reforms), and unappropriated expenditures, which were

quite extensive, have now all but disappeared. Cost per unit of output has declined, in some cases quite markedly (Deloitte, Ross, Tohmatsu 1990). Human resource management has improved measurably, and explicit attention is paid to issues such as succession and the development of management skills. The strategic gains are more difficult to assess, although some improvement is evident.

Economic Policy Reform

The reforms designed to determine the government's overall economic policy are embodied in two pieces of legislation: the Reserve Bank Act of 1989, and the Fiscal Responsibility Act of 1994. The former is intended to make monetary policy decisions transparent. The independent governor of the central bank manages the money supply and interest rates to achieve a target rate of inflation established in an agreement with the government. Apart from periodically determining the target inflation range (currently 0–3 percent annually), the act prohibits the government from involvement in monetary policy. The Fiscal Responsibility Act is designed to provide a similar political discipline on fiscal policy, although clearly fiscal policy cannot be made at arm's-length. In budgetary decisionmaking, officials have a political incentive to trade off the government's aggregate fiscal position against increased expenditures. In countries around the world—and formerly in New Zealand—the negative economic impact of fiscal deficits can be easily pushed off for future generations to deal with. The act uses transparency and accountability mechanisms to put the onus on governments to act in a fiscally responsible manner to control the deficit.²

This approach has two notable features. First, the fiscal aggregates (debt, net worth, operating surplus or deficit, operating expenses, and operating revenue) are defined in accrual terms. As a result, the budget forecasts must include all noncash expenses, such as depreciation and the unfunded liability to the government employee's retirement fund, and exclude capital transactions, such as the proceeds from asset sales. This requirement significantly reduces the government's ability to manipulate the aggregates between years and prevents "off-budget" manipulations. It also forces the government of the day to interpret the requirements of the law in the context of prevailing economic conditions and to justify those interpretations to Parliament and the public. This approach is designed to be more politically and economically sustainable than legislated targets.

The second feature calls for regular reporting of fiscal intentions, forecasts, and results. Transparency in a democracy is a powerful discipline. On the forecasting side, the act requires the government to give Parliament a statement specifying its strategic budget priorities, three-year fiscal intentions, and long-term policy objectives; a fiscal strategy report showing whether the budget forecasts are consistent with the budget policy statement (and if not, why those intentions have changed);

three-year economic and fiscal forecasts at the half-year point and within two to six weeks before a general election; and a current year fiscal forecast with the supplementary estimates that are normally tabled in the last quarter. On the reporting side, aggregate financial statements of the Crown must be released within five weeks after the end of the month. The existing requirement for audited, annual Crown financial statements remains. All aggregate fiscal reporting, including fiscal forecasts, must comply with generally accepted accounting practices.

The Reserve Bank Act is regarded as highly successful and is credited with New Zealand's good record on inflation in recent years. The value of the Fiscal Responsibility Act has yet to be fully tested. It was enacted after the major fiscal correction was completed and has yet to apply during a period of economic downturn. It has, however, provided a frame of reference for public debate over the Crown's fiscal position, and most political parties have cast their economic policy with its principles in mind. The quality and quantity of fiscal reporting has been welcomed by the financial markets and rating agencies.

Relevance to Developing Countries

It is not difficult to understand how dysfunctional public sector agencies impair development and perpetuate poverty. The most common solutions frequently involve mechanics, such as streamlining procedures, banning dual employment, increasing civil service salaries, fighting corruption, upgrading training, and decentralizing government services. These ideas are useful, but they do not appear to offer even a partial solution to the deeper problems encountered by public sector agencies in many developing countries that have been seriously depleted by years of neglect and corruption. In some cases public organizations are no longer able to perform the task for which they were created. Thus civil service reform may require more than minor changes; it may need to be more fundamental and based on a more finely tuned understanding of the causes of the malfunction. Difficulties in the reform of New Zealand's health sector illustrate some of the potential problems that can arise (Box 1). What lessons can be drawn from New Zealand's experience that may be applicable to developing countries?

The Value of a Consistent, Comprehensive Conceptual Model

The one aspect that sets New Zealand apart from other public sector reforms is its underlying conceptual framework. That framework, which was based on identifiable theoretical constructs, proved valuable in several ways. First, it helped ensure that the reform was developed from a broad, systemwide perspective that focuses on the causes, not the symptoms, of dysfunctionality. For example, some involved in writing the reforms considered issues such as financial waste, excessive rules,

Box 1. Reforming Health Care: Anatomy of Limited Success

Historically, New Zealand's health care system has been predominantly publicly operated and funded through general taxes. Before 1993, when the health care system was reformed, secondary and tertiary (hospital) services were the responsibility of area health boards, with funding provided according to population. The new system (which is similar to the United Kingdom's) is based on a Ministry of Health (a policy advice agency), four regional health authorities (who purchase primary, secondary, and tertiary health services for specified regional populations), and a series of Crown health enterprises (government-owned hospitals run on commercial business practices). Primary services continue to be provided by private practitioners (who are heavily subsidized). The regional health authorities determine the mix of health services to be provided to their populations within a given funding level. They are then responsible for purchasing those services and monitoring delivery, with oversight from boards of directors made up of health, community, and commercial representatives.

The results have been mixed, but generally the public health system has failed to achieve the performance gains expected, and considerable political and public debate continues about the desirability of the arrangements. Although the quality of financial management and the degree of transparency among the Crown health enterprises has improved significantly, efficiency gains have been slow to emerge, and government funding has been required to keep many enterprises solvent. The public remains uneasy with the notion of for-profit hospitals. The explicit division of policy and purchasing responsibilities has been less successful than anticipated, health officials maintain significant control over purchasing decisions, and there is a continuing demand for additional funding.

As a result of political compromises, most of the reforms to improve the delivery of social services such as health and education have not been implemented as designed. The reforms were predicated on the existence of market competition (on both the supply and demand side), which has not developed. The quasi-commercial and social objectives of providers have diluted the focus on performance. Political issues were also underestimated. Social policy concerns the public rationing of private goods, and removing these concerns from the political arena has proved to be much more difficult than anticipated. This has resulted in much more direct ministerial involvement (some would say interference), which has undermined the authority of the various providers. The contrast in performance between the purer commercial model versus the political-interference model provides a salient lesson. If quantum efficiency gains are desired and if commercial objectives are to be achieved, it is necessary to divorce political influence from commercial decisionmaking.

and poor staff performance to be the problem. They were, in fact, only the symptoms; the real problem was the lack of management incentives. Second, the framework provided consistency for the multiple layers of decisions required in the design and implementation of the reform. These decisions, such as the nature of the accounting system, the approach to budgeting, and the degree of personnel delegations, were all made in a consistent manner. Third, it focused attention on a comprehensive approach. As a result the reform addressed all aspects of public sector management and all parts of the public sector (departments, government corporations, local governments). Fourth, the framework guided the sequencing and implementation of the reforms. These decisions were based on what was most important from a top-down perspective rather than what took the fancy of depart-

ments. Fifth, it aided in marketing the reforms to departments and the public. The coherence and comprehensiveness reduced fears that the reform was just another ad hoc initiative. The lesson for other countries is clear. Basing reforms on an analytically rigorous conceptual framework appropriate for the jurisdiction concerned and having the framework apply to the entire public sector is likely to improve significantly the chances that the reform will be successful.

The Importance of a Clear Performance Definition

The second lesson relates to performance specification. The reforms were based on identifying the various principal-agent relationships; specifying and reporting performance in a clear and unambiguous manner; and ensuring that managerial authority matched the department's responsibilities. Providing state-owned enterprises with a clear profit-maximizing objective is an example of this expectation. So, too, are the features described in the discussion of performance, which are designed to clarify what performance the principal expects of the agent in a way that holds the agent unambiguously accountable. However performance is defined, the agent must have control over it; for this reason, the outputs approach has great merit.

The existence of several principals (as in the U.S. separation of powers) does not necessarily invalidate the principal-agent approach. Rather, it highlights the need to be clear about the different aspects of performance each principal requires of the agency, and for the principals to reconcile any mutually exclusive conflicts in those requirements.

New Zealand sought to ensure that managers faced incentives congruent with the performance expected of them. This basic notion is often overlooked in the design of public sector reforms. Performance incentives are much more subtle and pervasive than the "personal bonus or reward" incentive commonly mentioned. Other aspects need to be considered, including

- Whether the institutional and organizational arrangements encourage the performance required.
- Whether agencies can be made more efficient and responsive to their customers' needs, either by increasing competition or by direct customer purchasing of services (rather than the minister purchasing services on behalf of consumers). The evidence is that they can.
- Whether all aspects of the management system are sending the same signals to managers. Often budget and accounting systems define and measure performance in totally different ways.
- Whether the actual performance of all the actors in the systems is transparent.
- Whether the system is empowering or controlling.
- Whether the systems encourage managers to actively manage all their resources. The purchase of cleaning services, motor vehicles, or even personnel by central

agencies at no cost to operating departments discourages those departments from efficiently managing their costs.

- Whether the personnel system encourages good performance.

Focusing on What Government Does Best

It is important to focus the government's resources on areas in which government can add value, such as establishing an appropriate regulatory framework and economic environment in which the private sector can thrive. Wherever possible, New Zealand turned over businesses to the private sector because governments do not have the ability to manage and monitor enterprises in the same thorough way as does the private sector. Commercial objectives and decisions are easily compromised by political and social ones. In addition, state enterprises compete for scarce government financial and management resources; thus they tend to be undercapitalized and undermanaged. Governments should concentrate on what they do best—establishing the regulatory and economic environment, financing public infrastructure, and ensuring the delivery of public goods. And these activities can be operated along commercial business lines to a much greater extent than is commonly believed.

A public sector management system is a means; not an end. It will not deliver better fiscal performance on its own, but instead needs to work inside an overarching political economy framework that sets clear macroeconomic goals and has the political resolve to achieve them. This point is clear from the New Zealand experience. All of the reforms were driven by the same central goal: to improve macroeconomic performance by reducing the negative impact of the public sector. A good public sector management system will provide politicians with the tools they need to achieve those targets; a poor one will make a politician's task more difficult.

It is more difficult to draw conclusions about whether specific practices adopted in New Zealand are applicable to developing countries. If the cultural and political environment is too dissimilar, the applicability of these practices may be limited. The following precedents formed the basis for the reforms adopted in New Zealand: a tradition of a politically neutral, relatively competent civil service; little concern about corruption or nepotism; a consistent and well-enforced legal code, including contract law; a well-functioning political market; and a competent, but suppressed, private sector.

The right reform mix for any developing country must reflect any major differences in these preconditions; New Zealand's reforms cannot simply be transplanted. For example, because reducing corruption or nepotism and increasing democratic participation were not objectives in New Zealand, the reforms did not address these issues. If financial performance and service delivery are concerns, however, then specific New Zealand techniques may be appropriate. Subject to this caveat, the following techniques are likely to find broad applicability in developing countries.

- If the performance of government commercial activities is an issue, developing countries would find it useful to separate trading activities from core departmental functions, apply a “level playing field” regulatory regime, and appoint independent boards with business—rather than political—expertise. The success of such reforms is dependent on acquiring the necessary governance and managerial skills from the private sector. Many developing countries have this expertise.
- If the concern is about users of the service heavily influencing policy advice, then separating policy advice and service delivery functions into different agencies is likely to lead to both better advice and better service delivery because conflicting objectives have been removed. If this route is pursued, the institutional design should put more emphasis on processes to coordinate advice. These can operate at the political level, the bureaucratic level, or both.
- If service delivery is a concern within core government agencies, a management system focused on outputs would be relevant to developing countries. Politicians and managers would need to make a significant paradigm shift in the way the government operates, not least in securing the political commitment to such a change. Publishing the agreed outputs would be a first step in transparency and has the potential to improve accountability. To be fully effective, the planning, budgeting, appropriation, performance assessment, and reporting systems all need to be based on outputs. This does not preclude accountability for input management as well, if that is considered desirable.
- If financial performance is an issue, improved measurement of financial performance (through the use of accrual accounting) and explicit attention to this information in budgeting and reporting systems is important, although skill shortages may make implementation difficult for some countries. Significant gains can be achieved through improved financial management and financial control systems even without accrual accounting. The establishment of an effective cash accounting system may be considered a precursor to accrual accounting.
- If personnel performance is a concern, performance-based personnel systems are likely to improve the staff's incentives to perform. Such contracts may be politically difficult, but they have been a central part of institutional reform in New Zealand, are viewed as very effective, and were the key to changing the public service culture. Even if this model is not fully acceptable in developing countries, changing the appointment, appraisal, and promotion systems so that they are based on performance is likely to be possible and beneficial.
- Transparency is an important incentive device. Providing that voters are able to replace their politicians if they do not make decisions in the public interest, developing countries can require improved specification and reporting of performance to government and to the public.

- The performance of civil service managers is often impeded by a lack of authority. New Zealand's approach of delegating authority for input management to managers is likely to be useful in many developing countries providing that a meaningful output accountability system is implemented. In cases where delegating process decisions, including personnel and capital matters, may not be appropriate, separating the role of politicians and managers may be useful. The former can determine the output to be produced, while the latter determine the method of production.

Transplanting the system and structures in one country unchanged into another is seldom possible because the efficacy of a system depends so much on the complementary structures. At the same time, countries commonly study and adapt systems and structures from other countries to fit their particular circumstance. In the last decade, many industrial societies have moved to narrow the government's role in the economy and insist on a more sharply focused and less intrusive conduct. Part of that process has been not only a questioning of what governments do, but also a reexamination of how they do it. Thus even if developing countries must adapt the reform agenda to their own circumstances, policymakers can learn from what may well be a best practice and draw lessons and principles from New Zealand's experience.

Appendix. The Theoretical Underpinning of the New Zealand Reforms

The theoretical concepts that influenced New Zealand's reform program included public choice theory, agency theory or principle-agent theory, transaction-cost theory, and new public managerialism. This discussion draws heavily on Boston and others (1991).

Public Choice Theory

Closely associated with the work of Buchanan and Tullock (1962), Tullock (1965), Olson (1965), and Niskanen (1971), this theory seeks to explain how voters, politicians, bureaucrats, and lobbyists will behave in different institutional settings with different incentive rules. It is based on the idea that human behavior is dominated by self-interest. Thus, government officials will attempt to enlarge their department budgets, say, without regard to the overall government budget. Similarly, public and private groups will undertake rent-seeking activities to the disadvantage of the broader society, and politicians may pursue their own objectives at the expense of many of their constituents. As a

result powerful interest groups may capture a disproportionate share of national income, and politicians may misuse their power. Democracy is thus undermined.

Principal-Agent Theory

At the core of this theory is the idea that interchange between parties can be characterized as a series of contracts where one party, the principal, enters into agreements with another party, the agent, who agrees to perform tasks on behalf of the principal in return for compensation (Moe 1984, 1990; Pratt and Zeckhauser 1985; Bendor 1988). Moe (1984:765) notes that politics can be seen as a series of principal-agent relationships from citizen to politician to senior bureaucrat to subordinate bureaucrat to service providers.

Agency theory assumes rational, utility-maximizing behavior by individuals. Hence conflicts will arise between principals and agents as their self-interests differ. Add to this asymmetric or incomplete information, the difficulty of observing and monitoring agents' behavior, and the imperfect mapping of agents' outputs and the outcomes desired by the principal, and an even larger ground for conflict will exist. Principal-agent theory is concerned with the best way to construct and monitor contracts so that these kinds of conflicts are minimized. The theory is useful in analyzing the selection of agents, designing incentives and pay systems, and choosing between in-house or outside contractors.

Transaction-Cost Theory

This approach compares the costs of planning, adapting, and monitoring under alternative governance structures. Decisionmakers wish to minimize their aggregate costs of production and transaction. But like agency theory, this approach assumes that principals and agents will act in their own self-interest and thus may be unreliable parties to a contract.

The literature on transaction costs indicates that some transactions are better suited to market-type arrangements, while others are better suited to hierarchical or rule-driven organizations. For example, contracting out is likely to be desirable where the supply of a good is contestable, quality and quantity can be easily measured and specified, and suppliers are numerous. In-house provision is likely to be more efficient when the opposite conditions exist. When transactions occur frequently, are associated with uncertainty, and involve specific assets or skills, hierarchical organization tends to be more efficient.

Where the supply is competitive and transactions costs are "average," the preferred organization is less clear. But generally, in-house provision is likely to be more efficient where there is a high risk of self-interest, conflicts of interest, substantial uncertainty,

and recurrent, complex transactions. According to Williamson (1985), these factors explain the concentration of production in some sectors in a few large firms. Thus direct provision may be preferable when maintaining quality is critical and opportunism poses a serious threat. It is for these reasons that governments are hesitant to contract out the gathering of military intelligence and the collection of taxes.

The New Public Management

This approach (see Aucion 1990 and Caiden 1988) centers on the presumption that a distinct activity called “management” can be applied to public and private businesses alike, and that it includes the following elements: a move away from input controls, rules, and procedures toward output measurement and performance targets—the “accountability” framework; the devolution of management control with improved reporting and monitoring mechanisms; a preference for private ownership, contestable provision, and contracting-out of publicly funded services; the adoption of private-sector management practices in the public sector, such as short-term labor contracts, performance-linked remuneration schemes, the development of a mission statement, greater concern with corporate image, and the development of a corporate strategy and action plan; an emphasis on efficiency, often referred to as “value for money” (Hood and Jackson 1991).

Notes

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1. Accrual accounting is an accounting method that recognizes transactions and other events when they occur and not as cash transactions or their equivalent. The events are recorded in the accounting period and reported in the financial statements in the periods to which they relate.

2. The five principles of responsible fiscal management are (1) reducing total Crown debt to prudent levels by ensuring that total operating expenses for the Crown are less than total operating revenues in the same financial year; (2) maintaining prudent debt levels, once they have been achieved, by ensuring that on average over a reasonable period of time, Crown operating expenses do not exceed Crown operating revenues; (3) achieving and maintaining Crown net worth at a level that provides a buffer against future adverse events; (4) managing prudently the fiscal risks facing the Crown; and (5) pursuing policies that are consistent with reasonable predictability about the level and stability of tax rates.

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