

Why Most Developing Countries Should Not Try New Zealand Reforms

Developing and transitional countries have an understandable desire to accelerate public sector reform by adopting the most advanced innovations devised by developed countries. In many countries, interest has been stimulated by the New Zealand model which gives public managers broad discretion to operate within an accountability framework that specifies the results to be achieved and closely monitors performance. During the past decade, dozens of countries have sent delegations to New Zealand to observe its avant garde management practices and to interview government officials on how the new systems and procedures have affected the cost and delivery of public services. The World Bank and other international organizations have showcased New Zealand's reforms at various conferences, and some of the architects of the reforms have crisscrossed the globe extolling the virtues and portability of their country's version of results-oriented public management.

Despite the interest and the sales efforts, only a few developed countries (such as Iceland and Singapore) have adopted selected features of the NZ system; others (such as Sweden and the United Kingdom) have embraced a managerial ethic without subscribing to the hard-edged contractualism that differentiates New Zealand's reforms from those tried elsewhere. To this writer's knowledge, however, not a single developing or transitional country has installed the full New Zealand model, though quite a few have been enchanted by the prospect of leapfrogging to the front ranks in the international reform sweepstakes. A few countries (such as Mongolia) are in the early stage of adopting selected features of the New Zealand reforms, but it is much too early to gauge how far they will go in embracing its basic tenets. On the whole, developed and developing countries have not implemented New Zealand-style reform because it is beyond their reach or does not fit their current needs. In their article on New Zealand published in this issue, Bale and Dale paint a largely favorable picture of what has been accomplished via reform. They describe basic features of the reforms and some of the concepts rooted in agent-principal theory and transaction cost economics that provide the intellectual underpinnings for the changes that have been made in New Zealand's managerial institutions. They are correct in noting the coherence of the various elements, and the rigor with which the model has been applied. This was not a case in which reformers selected discrete entries from a large menu of reforms. The change agenda was driven by ideas that have only recently entered mainstream economics, and the New Zealand Government applied the ideas with full fidelity to their internal logic. But I do not accept their view that New Zealand offers practical guidance on how developing countries should surmount deficiency in public management.

In contrast to the views espoused by Bale and Dale, I believe that there are important preconditions for successfully implementing the new public management (NPM) approach; these should not be ignored by countries striving to uplift themselves after decades of mismanagement. Whereas, Bale and Dale take the position that

managerial deficiencies should be the driving factor in determining the suitability of NZ-type reforms, this article argues that they should be deterring factors. The greater the shortcomings in a country's established management practices, the less suitable the reforms are.

My argument unfolds in three stages. The first part appraises the underlying aims and concepts of the NZ model in terms of its emphasis on internal markets and contract-like relationships in the public sector. The key questions here are: is the NZ system suitable for developed countries? Has it brought the promised improvements, and if it has, which of its many elements have contributed most to public sector reform? The second part analyzes the management practices and problems of many developing countries in terms of rampant informality in operating government. The basic question here is: can a country which gets things done by relying on informal practices that violate prescribed management rules sensibly broaden the discretion of managers while resorting to contractual formalities to safeguard public values and interests? The final part acknowledges that the informality retards development and is an inadequate basis on which to build governing capacity. It therefore considers the sequenced, measured improvements that developing countries should make before experimenting with avant garde remedies.

The NZ Model: Government By Contract

NZ has implemented an enormous number and range of management reforms since 1988. These include accrual-based accounting and appropriations, budgeting for outputs rather than for inputs, decoupling service-delivery functions from the provision of policy advice, replacing permanent department heads with chief executives appointed for a fixed term, discretion for managers to spend their operating budgets as they deem fit, individual employment contracts for most senior (and many middle) managers, a charge on the use of capital by government departments, annual purchase agreements between ministers and their departments, annual reports, and audited financial and performance statements. Although each innovation can be considered on its own, the reforms add up to an integrated concept of how government should work.

That concept is expressed in the heading to this section. Virtually every element of reform has been designed to establish or strengthen contract-like relationships between the government and ministers as purchasers of goods and services, and departments and other entities as suppliers. Hundreds of contracts are formally negotiated each year; the typical contract specifies the resources that one side will provide and the performance the other side will produce. Ministers are always on the resource-providing side of the relationship; chief executives can be on either side, depending on the role they are playing. A chief executive provides resources in negotiating employment contracts with managers, but promises results in negotiating purchase agreements with ministers and performance agreements with the State Services Commissioner.

This “new contractualism” replaces implicit or relational contracts which characterize traditional public administration¹. Contracts convert the budget from an understanding between the government and parliament on the amounts to be raised and spent into an explicit statement of what will be done with the resources to be made available. In a similar vein, performance agreements displace the old civil service ethic of trust and responsibility with accountability for the results expected from each chief executive.

New Zealand has gone to extraordinary lengths to create conditions under which formal contracts are negotiated and enforced. It has restructured many departments, decoupling policymaking functions from the delivery of services. For example, the national defense organization was split into two separate entities: the Ministry of Defense which provides policy advice to government, and New Zealand Defense Forces which carries out assigned operations. Appropriations are made to ministers who, under the new system, can purchase services from government departments or from any alternative public or private supplier. Appropriations are on an accrual basis, so that the full cost of the goods and services is incorporated in the purchase price. In fact, to promote competition among suppliers, appropriations include an amount for the goods and services tax that would be paid in a private transaction. In a similar vein, a capital charge is levied on the net worth (as shown on its balance sheet) of each department. This charge reflects the opportunity cost of money and resembles the internal rate of return expected by firms from their operating units.

Contract-like arrangements have been extended to policy advice, so that ministers can opt to obtain information and ideas from consultancies and other external sources. To put alternative suppliers on an equal footing, the government accords the chief executives of departments the same operating flexibility that is enjoyed by executives in nongovernmental organizations. Chief executives are given a block of resources for each class of outputs they contract to purchase, and they have discretion to select the mix of inputs used in producing the outputs. These outputs are specified in detail so that the government can have reasonable assurance that departments are producing the outputs contracted for. Under the present system, when the budget is tabled in Parliament, each department publishes a departmental forecast report which, among other things, specifies the outputs it will produce in the next financial year. Shortly before the start of the year, the outputs are specified in greater detail in purchase agreements signed by the chief executive and the minister purchasing the services. Multiple purchase agreements are written when more than one minister purchases services from the same department. After the year is done, each department publishes an annual report that specifies the outputs actually produced, thereby enabling the government to determine whether the terms of various contracts have been fulfilled.

Before an assessment can be made of the appropriateness of the New Zealand model for developing countries, it is necessary to consider the effectiveness of

¹ The term is taken from Glyn Davis, Barbara Sullivan, and Anna Yeatman (eds) The New Contractualism?, (Macmillan Education Australia PTY LTD, 1997). See especially the chapter in this book by Alex Matheson, “The Impact of Contracts on Public Management in New Zealand,” pp. 164-79.

contractualism in the country that brought forth this extraordinary invention. I endorse the general finding by Bale and Dale that organizational performance has been significantly enhanced. But this favorable assessment carries some caveats, some of which were discussed in my report on the reforms commissioned by the New Zealand Government.²

- (1) The NZ model emphasizes matters that can be specified in contracts, such as the purchase of outputs, but gives inadequate attention to outcomes and the government's ownership interest because they do not fit easily into the contracting framework.
- (2) Robust contracting depends on voluntary, self-interested action. Sometimes however, self-interest defeats the government's collective interest. This happened in the early years of reform when efforts to establish a senior executive service were undermined by the preferences of many managers to contract on an individual basis.
- (3) Contractualism may weaken traditional values of public service, personal responsibility and professionalism. It can induce managers to take a checklist approach to accountability -- if it's not specified, it's not my responsibility.
- (4) Contract-like arrangements do not themselves create arms-length relationships in the public sector, nor do they enable the government to toughen its insistence on performance. In most cases, government has little choice but to contract with internal suppliers, typically its own departments. If these fail to perform, the government can sack the chief executive and apply some pressure. But it rarely has the exit option which is essential to the effectiveness and enforcement of private contracts.
- (5) Chief executives, senior managers, and others attribute most of the improvement in government performance to the discretion given managers, not to formal contracts. Managers differ on the value added by contracts, but few think that this distinctive feature of the NZ reforms has been the main contributor to higher operational efficiency.
- (6) Contracting is not costless. Negotiating and enforcing the many contracts entails enormous transaction costs. These costs have not been systematically studied in NZ though they take a deep bite out of operating budgets, especially those of small departments.

² The report was published as The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change, State Services Commission, August 1996.

These concerns point to the unfinished business of public sector reform in New Zealand. There is much more to be accomplished before a final assessment can be made. At this early stage, one is justified in acknowledging that the country has vastly enlarged the stockpile of public management ideas and practices. In promoting internal markets within government, it has devised creative alternatives to privatization while carrying the pursuit of operational efficiency well beyond standard market-type mechanisms such as user charges.

Yet one should not lose sight of the fact that these are not real markets and that they do not operate with real contracts. The contracts written in New Zealand are between public entities -- the owner and the owned. The government has weak redress when its own organizations fail to perform, and it may be subject to as much capture in negotiating and enforcing its contracts than it was in pre-reform management. My own sense is that while there may be some gain in mimicking markets, anything less than the real thing denies government the full benefits of vigorous competition and economic redress.

The Informal Public Sector

Formal contracts and internal markets were feasible for New Zealand because the country already was developed- it already had a robust market sector and established mechanisms for enforcing contracts. These conditions often are rare in developing countries which tend to have an informal economy and relatively weak specification of property rights and other formal processes to regulate economic activity.

Informality is not a new concept; shortly before New Zealand embarked on its reforms, Hernando de Soto emphasized informality as the distinctive condition of the Peruvian economy in The Other Path, a book that had considerable currency in the years immediately following publication and that still warrants close reading. De Soto characterized the informal sector "as a gray area which has a long frontier with the legal world and in which individuals take refuge when the cost of obeying the law outweighs the benefits."³ De Soto found that the informal economy supplied more housing to Peruvians than official government progress did, was the main source of public transportation, and enabled entrepreneurs to start businesses when they were blocked by governmental regulation. He also concluded that the informal economy is inefficient, breeds corruption, denies home and business owners access to capital, and retards economic development.

De Soto and others have focused on informality in the market economy. I believe that informality is as pronounced in the culture of government as it is in the marketplace. In fact, the parallel incidence of informality in the public and private sectors is not happenstance. Norms, practices, and ideas migrate from one sector to the other, as do the dead hand of overregulation, and the eagerness of government officials to look the other way in exchange for favors and the acceptance of informality as the way things get done.

³ Hernando de Soto, The Other Path: The Invisible Revolution in the Third World, paperback Edition, Harper & Row, 1989, p. 12.

The emergence of open, robust markets is as much a precondition for modernizing the public sector as it is for developing the private economy. It is highly unlikely that government will operate by the book when rules and regulations are routinely breached in private transactions.

If New Zealand-style contracts are at one end of the spectrum, then informality is at the other end. And if contracts and the rule of law are underdeveloped in business relations, it is highly improbable that they can be safely or effectively applied in the conduct of the government's business. It would be foolhardy to entrust public managers with complete freedom over resources when they have not yet internalized the habit of spending public money according to prescribed rules. Many developing countries have formal management control systems that prescribe how government should operate. These systems are overseen by powerful central agencies such as the finance ministry, the civil service board, and the procurement agency. On paper, everything is done according to rule. The civil service system is based on a detailed classification of positions and ranks, each with its own job descriptions, skill and experience requirements, eligibility rules, and pay scale. In this formal control process, operating units must obtain advance approval from the civil service agency (and sometimes from the finance ministry as well) before they can fill vacant positions. Formal rules dictate every step in the hiring process: announcing the position, establishing eligibility qualifications, processing applications, appointing the winning candidate, and setting each employee's pay and grade levels. Each step is monitored by a central agency to assure compliance with the rules.

Where informality flourishes, however, this is not the way many civil servants get their jobs. They are hired because they know the right person or have contributed to some organization or cause. Because official pay levels are low, they may be assigned to one position but be paid for another. Many may be ghost workers who appear on the payroll but not at work; some may hold two or more positions, and those who show up on the job may put in less than a day's work because the official salary scale is a lot less than a day's reasonable pay. Thus there are two coexisting civil service systems -- one based on formal rules, the other on actual practices. To say that there is an informal system is not to conclude that the rules always are ignored or that corruption always flourishes, though these pathologies may occur. Rather, it is to argue that the informality contributes to public order; in the case of the civil service, it enables the government to recruit and retain skilled persons.

Informality also reigns in the budget arena. The government has two budgets: the public one which is tabled in parliament and the real one which determines which bills are paid and how much is actually spent. The formal budget promises spending that exceeds the government's fiscal capacity; the informal budget facilitates macro-economic stability by not making some of the expenditures approved by parliament. The formal budget is known in advance, the informal one after the spending occurs. Because there are two budgets, the temptation is for the formal document to be unrealistic and unimplementable. The process thus feeds on itself. Inasmuch as the official budget will not be implemented, why not cram into it spending that will not be made? This behavior leads to cash flow budgeting, in which the amounts actually spent are determined more

by cash payments than by the amounts authorized by law. It also breeds repetitive budgeting, in which the government “rebudgets” several times during the year to align disbursements and resources.

Informality is a mixed blessing. On the one hand, it cuts through red tape, unresponsive bureaucracies, and bad policies; on the other hand, it opens the door to (and sometimes institutionalizes) corruption and inefficiency. The positive side of informality in public management includes the maintenance of fiscal discipline despite unrealistic budgets and the provision of public services despite rigid rules and controls. But the costs of informality are high in the public sector. They include widespread evasion of civil service rules and other controls, the time and resources spent in beating the system, distrust of government, routinized corruption, and inattention to the outputs and results of public programs and the performance of government agencies and officials. It would not be surprising if some of the most esteemed and productive civil servants in developing countries are those who use their entrepreneurial and managerial skills to outwit the formal controls. But when bureaucrats are valued for their verve in operating informally, it is easy for them and others trapped in the system to lose sight of the public purposes they are serving and the outputs they are supposed to produce. It is only a short step from disabling the controls to bending the rules for dishonorable purposes.

It is a much longer step for them to adopt New Zealand style reforms, and a much riskier one. No country should move directly from an informal public sector to one in which managers are accorded enormous discretion to hire and spend as they see fit. New Zealand did not make this leap, and neither should other countries. Before reform, New Zealand had budgets that controlled spending and corresponded to actual transactions; it also had a civil service system that governed how public employees were hired and paid. In other words, it had a formal public sector. This is an essential precondition for adopting elements of the New Zealand model.

The Logic of Development

If contract-based public management is beyond reach and informality is an unsatisfactory state of affairs, what can developing countries do to improve government operations. In my view, significant progress can be made through a logical sequence of steps that diminishes the scope of informality while building managerial capacity, confidence, and experience. This concluding section outlines some of the key steps.

First, progress in the public sector requires parallel advances in the market sector. As long as the economy operates according to informal norms and property rights are defined more by practice than by contract, the government is not likely to make much headway in installing rule-based public management. There may be special situations (in colonial regimes for example) which enable a developing country to establish a skilled civil service system, modern financial management, and other trappings of formal public management even though the market sector is lagging behind. But the much more typical situation is one in which market development precedes or coincides with development of robust public institutions. Singapore and Chile are countries in which economic development and modernization of public management have proceeded in tandem.

There is no assurance, however, that formalizing the market sector will induce reciprocal changes in public institutions. Informality is as much a matter of culture as of practice; it defines social roles and relationships, and what is legitimate and expected behavior, and it persists even when underlying conditions that gave rise to it vanish. There are quite a few countries in which development of the public sector has not kept pace with economic changes. These countries typically have a competitive sector that is open, lightly regulated and formal, as well as a heavily regulated sector that depends on informal contracts, embedded traditions, and governmental protection. The two cultures can operate independently of one another for an extended period, but sooner or later they will be driven by scandal, financial mismanagement, or citizen pressure to modernize the public sector.

Second, modernizing the public sector means establishing reliable, workable, external controls. As described earlier, these controls require that operating units receive advance approval before taking personnel, spending, or procurement actions. As old fashioned as external controls may seem to be, they are building blocks for a formal, rule-based, honest public sector. Operating in an externally-controlled environment is an essential phase in the development process for it (a) gives managers the skills to operate - that is, to manage on their own, (b) builds trust between central controllers and line managers and confidence between citizens and government, and (c) encourages managers to internalize a public ethic of proper behavior. As these basic conditions of formal management take root, it should be possible for central controllers to ease the regulations by giving line managers broader discretion in operating their programs.

However, this learning and formalizing process can bear fruit only if the controls are exercised in a fair and realistic manner. In the case of civil service rules, this means that pay levels rise as the economy develops, the number of ghost positions declines, and opportunities are provided public employees to enhance their skills and advance. If these conditions are absent, learning will take place, but it will be pathological: how to beat the system, how to outmaneuver the controllers, how to get paid without really working, and so on. Realism must also pervade budgeting, another arena that often is infected by pervasive informality. The budget presented to Parliament must be capable of implementation, not a political wish list that promises more than the government intends to spend. Moreover, agencies must inculcate the habits and ethic of spending according to the plans laid out in the budget. In other words, the budget must be treated as an implicit contract. Only after this occurs does it make sense to convert the budget into an explicit contract.

Third, in the process of developing skills, confidence, trust, and public-regarding values, politicians and officials must concentrate on the basic process of public management. They must be able to control inputs before they are called upon (as in the NZ model) to control outputs; they must be able to account for cash before they are asked to account for cost; they must abide by uniform rules before they are authorized to make their own rules; they must operate in integrated, centralized departments before being authorized to go it alone in autonomous agencies. These are some of the basics they must satisfy in order for the public sector to develop.

Finally, once the basics have been mastered, the public sector should be organized according to the principles of internal control. External control and NZ-type managerial discretion are not the only options for organizing governmental operations. Internal control is a third possibility. In a formal sense, internal control refers to the systems and procedures used by agencies to assure compliance with rules and to safeguard public assets. In a behavioral sense, internal control means that the rules are accepted as fair, workable, and legitimate. Without this normative underpinning, no system of internal control can be effective.

In practice, internal control gives managers broader discretion in managing their affairs. It shifts the focus from ex ante control to ex post audit, from control of individual actions to control within a broad band, from reviewing specific actions to reviewing systems. It means, for example, that civil service rules dictate the total number of positions or the total within broad employment categories, and that operating departments make their own hiring decisions subject to oversight by central agencies. In the financial sphere, it means that if funds are available, agencies can make purchases, authorize travel, and take other spending actions without obtaining prior approval.

The Singapore Government illustrates the progression from external to internal controls to NZ-type arrangements. On gaining independence and for many years afterwards, Singapore had a line item budget which specified the positions to be filled and things to be purchased. During the 1980s, Singapore adopted block budgets which shifted the government from external to internal control, and in the mid 1990s, it adopted a "budgeting for results" system that implements several elements of the New Zealand model.

Singapore provides another lesson for countries seeking to advance to the first rank of developing countries. The process of development does not have to stretch out over generations. If development proceeds in a logical order, progress can be rapid, especially if modernization of public institutions advances apace with modernization of the market sector. To many developing countries, New Zealand is at the cutting edge in public management, but they will not get there by taking shortcuts that turn into dead ends.

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