

**Institute for International Research**

**Efficiency and Accountability  
in the Private Sector**

**WHAT CAN WE LEARN?**

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## **EFFICIENCY AND ACCOUNTABILITY IN THE PRIVATE SECTOR**

### **WHAT CAN WE LEARN?**

#### **Introduction**

Over the years, larger and larger shares of New Zealand's resources have come to be absorbed or directed by the state. Few people seem to associate this with any corresponding increase in social well-being or in the sense of satisfaction of the average citizen.

Government expenditure was 28.4 percent of GDP in 1974-75. By 1989-90, that figure had risen to over 40 percent. This sharp upward trend was unplanned. Throughout that period, most governments would have claimed that they were trying to hold each year's expenditure at roughly the same levels in relation to GDP. In other words, the single most important structural change in the economy in the past 15 years was largely unintended. The ever-rising tax burden, especially in the last five years, has undermined the growth potential of the market sector and sapped business confidence.

Transfer payments accounted for a large part of the spending growth, as did assistance to industry in the early part of the period. In recent years spending has mushroomed in areas such as education, health and government administration. The overall trend reveals the power of interest groups in obtaining political support for spending programmes which often benefit them rather than the wider community. It also exposes the weak disciplines on government employees to manage and control resources efficiently.

#### **Incentives for Efficiency in the Private Sector**

In the private sector, success and survival is firmly anchored to the disciplines of making a profit by meeting consumers' needs. The disciplines apply to sole traders, partnerships, and private and public companies alike.

Those forms of organisation have evolved over a prolonged period of time through competition with other forms of organisation. The listed company, for example, is a successful method of organising many kinds of economic activity because it allows for management by specialists and risk-sharing by a diverse group of shareholders who take no part in the detail of the organisation's business affairs.

The separation of company control from ownership makes it imperative to align the interests of managers with the interests of the shareholders. This is best achieved by allowing unrestricted transferability of ownership.

At a higher level, the interest of private firms is aligned with the interests of society as a whole by requiring them to operate without protection or privileges in a competitive environment. Within that framework, their objectives will not be

achieved unless they put the customer first and, in doing so, organise themselves to use resources efficiently.

When those are the ground rules, private firms may make bad investment decisions or perform poorly, but the market checks on sustained poor performance are the strongest available. Since sustained poor performance is precisely the problem that public sector organisations are most prone to, it is important to understand how, on average and over the long haul, the private sector achieves superior results.

In all cases the answer comes down to effective incentives and disciplines. For example, the ability to transfer ownership in a company by means of the sharemarket has a powerful influence on the attitudes and behaviour of management. Poor quality management and inefficient resource use opens an opportunity for new owners to take over the company, replace the management, achieve more efficient resource use, and realise a gain on their investment. This motivates continuous monitoring for cases of poor performance. Even if a poorly performing company is not taken over, investors may dump their shares and the end result may be much the same. Debt holders also take a close interest in the performance of businesses to which they lend.

The market for corporate control and the market for managers are two of the most important markets in the economy. For both directors and management, reputation and future prospects are linked with the performance of the company and directly affected by the information generated by the sharemarket. There is little point in trying to withhold information from the market. Investment analysts nowadays are professional and vigilant. They mark up companies that openly disclose the bad news as well as the good and mark down those that appear to have something to hide.

None of these mechanisms is perfect, and poor performance can sometimes go hidden or uncorrected for a long time. But it cannot go on forever. The ultimate check on poor performance in the private sector is bankruptcy. This check is virtually non-existent in the public sector. No New Zealand government in recent history has let a public sector organisation fail. In the past 12 months, two more have been bailed out.

It is this set of mechanisms - competitive markets, the discipline of profits and losses, and the incentives for monitoring - that underwrite the efficiency of the private sector and the accountability of its decision makers. This point is poorly understood. It is often assumed that the public sector would work better if only it were run by more capable managers. But the private sector is not efficient because by chance it has been endowed with superior managers. It has better managers *because* competitive markets provide the filter mechanisms required to make sure that only managers making the correct decisions survive and prosper. Appointing top flight managers to run factories in the Soviet Union or hospitals in New Zealand would have a minimal pay-off in the longer run unless the systems in which they have to operate are changed.

The relative efficiency of the private sector in relation to the public sector does not mean that there are no cases of poor performance in the private sector nor cases of

good performance in the public sector. Of course mistakes are made in the private sector; indeed successful entrepreneurship involves taking risks, accepting a number of mistakes and learning from them. The difference is that the discipline of having to make a profit ensures that bad decisions are not enshrined in open-ended, ongoing investments. Successful managers have to make more good decisions than bad ones. In the public sector, by contrast, bad decisions may not be transparent, politicians have incentives to conceal them, and good money is often thrown after bad when things turn sour.

Nor can private sector efficiency be guaranteed when markets are not open to entry and firms are not subject to competition or the threat of it. There is no reason to expect that in a sheltered environment private firms will behave much differently from public sector organisations. We have seen much evidence of that in protected industries in New Zealand in the past.

The changes in Eastern Europe and the Soviet Union have now convinced most people that, at the level of whole economies, political and bureaucratic systems work less well than competitive market systems, if indeed they work at all. But this lesson has not yet been fully absorbed in relation to major parts of OECD-type economies. For example, Americans are puzzled and frustrated that their superior performance in industry relative to the Soviet Union is not matched by the superior performance of their schools. Commentators have pointed out that this should be no real surprise: in both countries schools are largely run by the public sector. Although the notion is still fiercely resisted, it is unlikely that education performance will increase markedly until competition, pressures from owners and consumers, and private initiative are introduced into the education system.

### **The State-Owned Enterprise Reforms**

The reforms adopted for state-owned business enterprises in recent years have deliberately aimed to replicate as far as possible a set of private sector incentives and sanctions to improve business performance. Enormous advances have been achieved in SOE efficiency. The Electricity Corporation has reduced the average wholesale price of electricity by 16 per cent in real terms over the past four years while total real unit costs are down by 29 percent. At the same time profits have gone up from \$140 million to around \$400 million and returns are now approaching commercial norms. Current Airways charges for a Boeing 737 from Auckland to Wellington are only a little over a third of their 1987 level. The combined costs of Telecom toll calls and local services for a range of businesses have gone down between 32 percent and 48 percent in real terms in the past 4 years, and people no longer spend months waiting for new telephones. New Zealand Post has held postage rates for ordinary mail constant for over three years.

The evidence of waste and mismanagement has conclusively disposed of the arguments of those in the State Services Commission and Public Service Association who saw no need for the reforms. It was pleasing to hear the new minister for state-owned enterprises, Mr Kidd, say recently:

"We are by no means at the end of the corporatisation process. There are more government departments, and even more activities within departments,

which could be turned into State-Owned Enterprises. The Housing Corporation has already been flagged by this government as a potential SOE. The answer isn't for government to build or buy more, but to make sure that people who need housing assistance get it."

Even in the business areas of government activity, however, corporatisation is not enough. The limitations of the SOE model were succinctly summarised in a Treasury paper written as long ago as September 1987. Corporatisation, the paper said, had undoubted advantages over previous organisation forms for government trading activity. But it went on to point out that:

"In the absence of contestable ownership and control, however, the incentives for SOE directors' interests to coincide with those of a wealth maximising owner are blunted... There are difficulties in monitoring the performance of SOE boards and in applying sanctions..."

"For SOE directors to be held responsible for performance, they must have the freedom to make commercial decisions. But there is also evidence from history that the more independence they are given, the more likely it will be that over time they will substitute non-commercial objectives because of the lack of commercial incentives that would normally occur with contestable control..."

"The fundamental conflict between avoiding political interference in SOEs and ensuring that SOEs are operated in the commercial interests of shareholding Ministers remains."

In other words, privatisation is a fundamentally better option than corporatisation for the economy and society in the longer run. Mr Kidd acknowledged that in his 8 February speech, when he said that he intended to recommend a resumption of asset sales, subject to the state of the market and the condition of the business - and after all regulatory, monopoly, social and Treaty of Waitangi issues have been properly resolved. The lengthy list of reservations may be sound in principle, but it can also prove very costly if it is applied with excessive caution. Recent experience with the Bank of New Zealand and the Government Property Services Corporation has demonstrated that the sooner exposure to business risks is reduced the better.

The prime motives for sale, as stated by the new National government, will be efficiency and risk avoidance. No business venture is risk free - not even the biggest trading bank in the country. Moreover, without privatisation, the growth of many state-owned businesses would remain hostage to other priorities for government funds. Their development might well be stunted for lack of capital. This could hinder the growth of the economy as a whole.

### **Structural Solutions to Public Sector Management Problems**

There is ultimately no satisfactory solution to the problem of monitoring public sector performance. That is why it is important to shrink the public sector as far as possible while seeking to achieve further improvements in accountability.

The principles underlying corporatisation and privatisation must be extended as widely as possible through the public sector. Allowing unreformed departments to levy user-pays charges on a full cost-recovery basis without any real competitive pressure on them is a licence for waste. Many commercial and net-funded activities undertaken by departments should be set up as state-owned companies. Wherever possible, privatisation should follow to complete the process.

Where privatisation is not feasible - perhaps because of the requirements of foreign governments as may be the case with MAF meat inspection services - the organisation could be split into two or more competing units or the function could be contracted out. Greater contestability is feasible and desirable in departments as diverse as Social Welfare, Labour and Justice, as well as universities and hospitals.

Funding should be split wherever possible from decisions about who produces goods and services. This separation is what frees the government to buy on a basis of best value for money, instead of buying as a matter of principle only from some other government organisation. The proposal of the minister of broadcasting to put the publicly-funded programmes of Radio New Zealand out to tender is a sound application of this approach.

Comparable problems continue to occur where a single organisation is responsible for both policy advice and major departmental operations. Housing Corporation advice on housing has consistently favoured spending more money through the Housing Corporation. MAF has advised Federated Farmers on how to make a case for disaster relief; it has then advised the government on the proposals made by Federated Farmers; and finally it has received a percentage of the funding granted for the administration of the subsequent relief programme! While I agree with those who say that the principle of splitting functions should not be pushed beyond reasonable limits, it has a lot going for it.

It is not enough to exhort civil servants to be objective, and to put the public interest first. Nobody can be objective under those conditions. That is why client capture has been such a frequent occurrence in the past. The Ministry of Transport typically argued Air New Zealand's case to the government; it did not put the interests of consumers in lower fares first. Trade and Industry aligned itself with the Manufacturers Federation in promoting protection and subsidies for industry. The Department of Social Welfare came to think of beneficiaries as clients to whom it should deliver the highest possible level of benefits. Fairness to clients dominated considerations of fairness to the taxpaying public. The only satisfactory answer to such problems is structural change.

### **The Core State Sector**

The State Services Act and the Public Finance Act laid a foundation for a much more efficient public service. Departmental chief executives are now on contract. An annual contract between the CEO and the minister spells out the government's goals and priorities for the year, and agrees the resources which will be provided in order to achieve them. The CEO's performance is to be judged in terms of departmental outputs against that contract.

CEOs can be appointed from anywhere. They have power to hire and fire, choosing staff from inside or outside sources. For the fixing of pay and conditions, each department is regarded as an enterprise. Negotiations can be based on departmental circumstances rather than on nationwide occupational classes. CEOs are no longer bound to give preference to other departments in buying their inputs.

Those are large changes of fundamental importance. Yet in the core public service departments, as both the prime minister and the minister of state services have publicly stated, surprisingly little has changed. Their comments indicate that the papers coming forward to the government are still, in many cases, woefully inadequate and that Crown assets continue to be poorly managed. In many areas, expenditure creep remains the norm. The fact of the matter is that, by the best private sector standards, management in the core state sector remains seriously deficient.

Currently there is a danger of drawing the wrong conclusions from this experience and going back to a system of centralised controls. There have already been indications of such thinking in respect of wages, accommodation and computing. This would fly in the face of ongoing trends in private sector management practice towards decentralised decision making with accountability being exercised through budgets and results. Past problems of control agencies and ministers running departments and confused accountability for performance are too easily forgotten. In my view the new structures provide a much better basis for achieving government objectives, but they must be made to work. The focus should now be on matching greater managerial freedom with greater accountability for performance and on remedial action where performance falls short.

People in the private sector find it difficult to understand, for example, why those responsible for the botched implementation of the Picot reforms were not brought to account, or why there have been no apparent sanctions on those responsible for this year's blow-out in the education budget. What is the accountability of managers in the Department of Justice for the mess that has been made of commercial law reform in recent years, or in the Department of Labour for their steadfast opposition to necessary labour market reform? Who in the Ministry for the Environment was responsible for the incompetent handling of the resource management review which has had to be revisited by the present government, or in the Law Commission for the low quality exercise on accident compensation which is also having to be reworked? Ministers may have had some responsibility in some of these cases, but they appear to raise large questions about public sector management performance.

Three years down the track from the State Sector Act, a number of potential improvements have yet to be realised. The evidence is clear that many ministers have a limited understanding of their role in the new system, and how to play that role effectively. Of the first 23 CEOs appointed as heads of departments under the new contract system, only 4 came from outside the public service. Although management talent is in short supply in the country at large, the State Services Commission has not yet been successful in significantly widening the pool it draws on.

The new system, however, needs a new mix of skills to make it work properly. Some top jobs in the public sector have large responsibilities compared with many in the

private sector. There is no point in quibbling over remuneration for such positions. Management skill is an internationally traded commodity. The cost to the country of paying cut rates for inadequate talent is far higher than meeting the market. Individuals can make a difference, as experience in Telecom and the Electricity Corporation has shown.

The State Services Commission is responsible, subject to government policy directions, for setting the framework within which performance agreements are made and ministerial assessment occurs. It plays a key role in finding the right people, advising on appointments, helping ministers to monitor performance, and advising on what to do in cases of inadequate performance. A power of dismissal exists now. Despite some visibly inadequate performances, it has not been used. While that continues to remain the case, many will doubt the seriousness of the SSC and the government in seeking to use all the tools at their disposal to achieve maximum departmental efficiency.

It is, of course, impossible to know precisely why top departmental positions continue to fail to attract top applicants from the private sector. The intrusion into individual privacy of forced disclosure of salaries is one negative factor. Very probably, private sector CEOs continue to lack confidence that politicians would be content to set clear objectives and let the department get on with the business of achieving them efficiently. It is also important to ensure that CEO positions are properly specified. DSIR, for example, recently managed to bias the choice of CEO for that department by placing virtually an exclusive emphasis in the job specification on the need for scientific standing and ability to relate to the scientific community. There is no excuse for allowing such manoeuvring to go unchallenged and become the basis on which an appointment is finally made.

The SOE programme was successful precisely because exceptionally capable chairmen and directors were appointed to run the various businesses largely free from ministerial interference. There are signs that this is changing, and that the life of the SOE model may have run its course. There has already been one directive under the SOE Act to prevent a corporation from taking decisions it regarded as commercially sound, and there are reports of a much higher level of interest in the day-to-day running of SOEs. The inevitability of a re-emergence of political control constitutes one of the strongest arguments for privatisation.

In the case of core government departments, ministers in the past have tried to become the chief executive themselves or allowed themselves to be captured by departments which had already been captured by their clients. In one or two cases, distrusting the department, they tried to run policy out of their own offices by way of decree.

The fact is that this new system cannot work properly unless ministers understand that their role is that of the board of directors, not the chief executive. Who helps ministers to come to terms with these problems? So far, we do not have any answer which is good enough. Ministers need to recognise collectively the requirement for skills and training in running a large organisation, setting its objectives, and determining which priorities ought to have precedence over others.

A variety of options exist which might fill the gap. It is clearly possible to appoint an advisor or two with real professional clout to the offices of ministers to provide assistance of this kind. Another option may be to appoint appropriate outside people as boards of directors for core public sector agencies - either like the SOE Steering Committee on an advisory basis or as a more direct counterpart to the boards of directors of SOEs. In the case of onerous tasks such as Social Welfare or Health, particularly where major organisational change is involved, there may be a case for appointing an establishment board or commission to supervise an effective reconstruction and find or support a chief executive with skills that fit the new requirements of the job. A third option could be modelled on the advisory board used by the Debt Management Office of the Treasury, which uses experienced outsiders as a sounding board to help monitor market conditions and plan debt management strategy.

Whatever the options adopted, they should of course preserve and reinforce the improved accountability which the new system has established for CEOs.

### **Health and Education**

Health and Education are among the largest businesses in the country. In most respects, the job of improving the way they run has not yet seriously begun. The previous government's attempted decentralisation of education was, in the event, compromised profoundly by education bureaucrats at every level. This was one of the more notable cases in recent years of sound proposals being captured by the providers, and turned to their advantage.

The education reform process needs to go back to the original Picot concept and involve a real decentralisation of control to local school boards. Indeed it needs to go further, as a flaw in the Picot thinking was the belief that satisfying consumer interests in education meant that parents had to become involved in running schools. This is analogous to the proposition that to improve the quality of beer, consumers need to get involved in running a brewery. Parental involvement in schools has merits, especially where educational choices are limited, but a far more potent force for raising educational standards is competition. Means need to be found to fund students, whether on a per pupil basis or by direct vouchers, instead of funding the providers. Without this, there can be no satisfactory parent/pupil discipline on the quality of education. Public and private schools should compete in the education market. Like their private sector school counterparts, the boards of public schools should be able to set the pay and conditions of teachers, and hire and fire, in line with the terms of the new Employment Contracts Bill. Until we have a system of this kind, educationalists will continue to defend the inadequacies of a system which has turned far too many children out into the world without the skills they need to cope in today's job market.

The new government appears to be heading in the right direction in the case of schools, and in tertiary education. Corporatisation of tertiary institutions will be a dramatic improvement on the present situation. It will be necessary to appoint boards with the right skills to assess performance, not just in commercial and asset management, but also academic excellence, teaching and research in order to achieve international standards. An element of private tertiary provision should be

welcomed, not feared. Competition is important to force the pace in providing higher quality education.

As with the SOEs, fresh appointments should be made to chief executive positions. Present CEOs should obviously be able to apply, but they should have to compete to hold their positions. New terms of appointment are required, not just for them but for all tertiary education staff. The international market for academic skills should determine terms and conditions. In some areas that may cost more than at present. In others, it will undoubtedly cost less. There is no shortage of skilled people in some disciplines, and where this is the case terms of employment should reflect it.

In the health area, the Hospitals Task Force headed by Alan Gibbs set out some initial steps that should have been taken three years ago. The crucial first step is to separate funding from provision. Both public and private providers should be placed on an equal footing to compete. What matters is not whether provision comes from a public or privately owned facility, but whether it offers the public the best value for money.

The Wellington Area Health Board's Wellbank proposal moves in the right direction. Unfortunately, our present system provides no incentives to area health boards other than a politicised process where outcomes are largely determined by interest group pressures. Health care will continue to be grossly wasteful and grossly unfair to disadvantaged people as long as that system persists.

The following steps should focus on how to fund health care. Traditionally we have funded health care out of taxation revenue. People have paid on the same basis, regardless of how well or how badly they chose to look after their own personal health and the health of their families. Nothing in the system of funding health insurance gave them any particular incentive to adopt a healthy lifestyle or placed any penalty on those who failed to do so, thereby imposing higher costs on others.

The evidence of the Hospitals Task Force was that the present system has been wasteful in the extreme. Large numbers of people, most often the disadvantaged, have been deprived of timely health care as a result. We need an improved set of incentives and sanctions at every level: for the funders, the providers, and the people whose health the system is supposed to look after. The present approach to state funding has been disintegrating under the weight of its own inefficiencies for many years. A better structured mix of public and private funding has become a necessity for the future.

## **Conclusion**

I began by referring to the growth in the public sector share in the economy in the last two decades. One way of measuring it is by looking at what has happened to Tax Freedom Day. This is the day on which New Zealanders effectively start working for themselves. Until that point in the year, all of their earnings go to the government in tax.

Government expenditure is the best measure of the true tax burden. When the government share in the economy was around 30 percent, Tax Freedom Day fell

around now. Today it takes about 150 days or another 5 weeks of the year - close to the end of May - before New Zealanders earn income for themselves.

I applaud the aim of the minister of finance to bring Tax Freedom Day back to around mid-April. Reducing the tax burden in this way would give a real impetus to the economy. To achieve this aim will require the utmost discipline on the part of governments. In respect of transfer payments, many more hard decisions on rates and eligibility criteria for state assistance will need to be made. In respect of government provision of goods and services, a rigorous application of the principles I have been discussing is called for.

To summarise, I have argued:

- \* First, that while it is not immune from making poor decisions, the private sector - provided it operates in a competitive environment - is subject to strong checks on poor decision making which encourage efficient performance;
- \* Second, that these checks are almost impossible to replicate in the public sector. Hence the most important requirement is a structural one: to shrink the public sector as far as possible, so that ministers and other elected representatives can concentrate their energies on those functions that cannot be handled satisfactorily in the market sector;
- \* Third, that this implies a need for privatisation of all government activities that can be run as businesses;
- \* Fourth, that where the government is properly engaged in funding services such as health and education, it does not automatically follow that it should be the provider. It should explore the scope for funding the recipients of such services where appropriate, allowing competition between the public and private sectors and scaling back its role as a provider over time;
- \* Finally, that there is a real problem of monitoring, rewarding and disciplining management performance in the core state sector which has not been overcome. The temptation to revert to centralised controls should be firmly resisted but ways of strengthening current standards of accountability need to be found. Control agencies and ministers should be much more rigorous in correcting problems, including dismissal of non-performing managers.

I might add that much the same analysis applies to the local government sector.

If we take these principles to heart, I believe that there is a real possibility that if this conference is held on the same date in the year 2000, we could be celebrating the occasion of Tax Freedom Day.