
Why Most Developing Countries Should Not Try New Zealand's Reforms

Allen Schick

During the past decade New Zealand has introduced far-reaching reforms in the structure and operation of government departments and agencies. This model has attracted interest in developing countries because it promises significant gains in operational efficiency. But developing countries, which are dominated by informal markets, are risky candidates for applying the New Zealand model. The author suggests that basic reforms to strengthen rule-based government and pave the way for robust markets should be undertaken first.

Developing and transitional countries have an understandable desire to accelerate public sector reform by adopting the most advanced innovations devised by industrial countries. This 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 model; 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, although 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 system, but it is much too early to gauge how far they will go in embracing its basic tenets. On the whole, industrial and developing countries have not implemented such reforms because the reforms are beyond their reach or do not fit their current needs.

I draw this conclusion despite New Zealand's enormous contribution to the theory and practice of public management. Not only has the menu of reform possibilities been greatly expanded, but New Zealand has brought its public management much more closely into line with institutional economics and with contemporary business practices. And the rigor with which the model has been applied is impressive. 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 ideas were applied with full fidelity to their internal logic. But I do not accept the view that New Zealand offers practical guidance on how developing countries should surmount deficiencies in public management.

I believe that there are important preconditions for successfully implementing the new public management approach and that these should not be ignored by countries striving to correct decades of mismanagement. In contrast to those who take the position that managerial deficiencies should be the driving factor in determining the suitability of these type reforms, I argue that they should be deterring factors. The greater the shortcomings in a country's established management practices, the less suitable the reforms.

The New Zealand Model: Government by Contract

Since 1988, New Zealand has implemented an enormous number of management reforms that 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 the implicit or relational contracts that characterize traditional public administration.¹ Contracts convert the budget from an understanding between 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 to decouple 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 the Defense Forces, which carry out assigned operations). Under the new system, ministers 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 tax on goods and services 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 as well, 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 that, 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 assessing whether the New Zealand model is appropriate for developing countries, it is necessary to consider its effectiveness at home. In my view, organizational performance has been significantly enhanced. But this favorable assessment carries certain caveats, some of which were discussed in my report commissioned by the New Zealand Government (Schick 1996).

- The New Zealand 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.
- Robust contracting depends on voluntary, self-interested action. Sometimes, however, self-interest defeats the government's collective interest. In the early years of reform, for example, efforts to establish a senior executive service were undermined by managers who preferred to contract on an individual basis.
- 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."
- 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 that is essential to the effectiveness and enforcement of private contracts.
- Chief executives, senior managers, and others attribute most of the improvement in government performance to the discretion given to managers rather than to formal contracts. Managers differ on how much value is added by contracts, but few think that they have been the main contributor to higher operational efficiency.
- Contracting is not costless. Negotiating and enforcing contracts entails enormous transaction costs that have not been systematically studied, although they take a deep bite out of operating budgets, especially those of small departments.

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. Rather, the contracts 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 as it was under pre-reform management. My own sense is that while some gain may come from mimicking markets, anything less than the real thing denies government the full benefits of vigorous competition and economic redress.

The Informal Public Sector

In New Zealand, formal contracts and internal markets were feasible because the country had a robust market sector and established mechanisms for enforcing contracts—conditions that are often absent in developing countries, which tend to have an informal economy with 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, de Soto (1989, p. 12) emphasized informality as the distinctive condition of the Peruvian economy. Characterizing it “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,” de Soto found that the informal economy supplied more housing to Peruvians than did the government, was the main source of public transportation, and enabled entrepreneurs to start businesses when they were blocked by government regulations. He also concluded that the informal economy was inefficient, bred corruption, denied home and business owners access to capital, and retarded 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 does the dead hand of overregulation and the eagerness of government officials to look the other way in exchange for favors. 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 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 eligi-

bility 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, although 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 that is presented to the parliament and the real one that 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 macroeconomic stability by not making some of the expenditures approved by the 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 unachievable. 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 are high; 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 operated under 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 diminish 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) that 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 the development of robust public institutions. Singapore and Chile are countries in which economic development and modernization of public management have proceeded in tandem.

Formalizing the market sector does not ensure reciprocal changes in public institutions, however. Informality is as much a matter of culture as of practice; it defines social roles, relationships, and legitimate and expected behavior, and it persists even when the underlying conditions that gave rise to it vanish. There are quite a few countries in which the development of the public sector has not kept pace with economic changes. These countries typically have a competitive sector that is open, formal, and lightly regulated, as well as a heavily regulated sector that depends on informal contracts, embedded traditions, and government 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 external controls, as described above. 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. It gives managers the skills to manage on their own, builds trust between central controllers and line managers and confidence between citizens and government, and 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.

This process, however, 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 public employees are given opportunities to acquire new skills and advance professionally. 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 the parliament must be one that can be implemented, 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 then does it make sense to convert the budget into an explicit contract.

Third, politicians and officials must concentrate on the basic process of public management. They must be able to control inputs before they are called upon 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.

Once the basics have been mastered, the public sector should be organized according to the principles of internal control. External control and New Zealand-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; 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.

Singapore illustrates the progression from external to internal controls and thence to New Zealand-type arrangements. On gaining independence and for many years afterward, Singapore had a line-item budget that specified the positions to be filled and the items to be purchased. During the 1980s block budgets were adopted that shifted the government from external to internal control, and in the mid-1990s a "budgeting for results" system was adopted 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 short-cuts that turn into dead ends.

Notes

Allen Schick is a consultant in the Public Sector Group, Poverty Reduction and Economic Management, of the World Bank. He wrote this article while on assignment to the Economic Development Institute.

1. The term is taken from Davis, Sullivan, and Yeatman (1997). See especially Matheson (1997) in that volume.

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