Government Management

Brief to the Incoming Government 1987

VOLUME I

THE TREASURY

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Preface

'Government Management' is a review of the issues facing the incoming Minister of Finance in 1987. It was prepared by The Treasury as a briefing, to outline the nature of the issues and to put forward a framework for their analysis.These volumes do not go into detail or recommend proposals, instead they canvass broad approaches to policy.

The book includes background theoretical sections, as well as the more policy oriented chapters. This theoretical analysis is included for completeness, in order that the logical underpinnings of the ideas may be seen. These theoretical foundations include a theory of the state in Chapter 1, and a normative discussion of the ethics of policy in the Annex.

This first volume contains four policy oriented chapters. Chapter 2, on Public Sector Reform, reviews existing management systems in the public sector; it concludes that substantial change will be needed to improve incentives in the public sector, so that the Government's goals may be pursued more efficiently. The second part of that chapter suggests that the move to establish State Owned Enterprises should be continued and extended.

The chapter on social policy examines education, health, housing and income maintenance. All are reviewed in the light of the aim of promoting the well-being of people using social services. There is a general discussion of the options of universal or targeted social services, and also a discussion of social policies in a multicultural society.

Policies for economic management are examined in Chapter 4. Progress towards disinflation is reviewed, as well as the institutional arrangements for the management of monetary policy. There is a discussion of industry assistance and regulation. There is an analysis of labour market issues, and an analysis of tax.

In Chapter 5 there is a discussion of the Treaty of Waitangi. This is included because the Treaty is of considerable significance for the economy, but there has previously been little discussion of its effects.

After the policy oriented chapters, there is a review of the state of the economy. This review was prepared using information available up to early August 1987.

'Government Management' Volume II contains a detailed discussion of education issues.

Introduction

The Government's influence in the economy is pervasive and multi-faceted. It spends, it taxes, it legislates and it regulates. Major administrative resources are at its disposal to advise, to design and to implement its policies. Over the decades it has been a major influence over the institutional framework that surrounds New Zealand's markets.

Institutional arrangements have a major influence on economic outcomes. Individuals are constrained by legislative and regulatory rules. As a consequence these shape the incentives that drive people's decisions. Institutional arrangements affect income and wealth distribution. Ownership can affect the incentives to work. High taxation constrains individual spending power and reduces the incentives to work and save. Planning controls can limit land use and the extent to which businesses may pollute.

A key concern for policy makers is whether a different regulatory rule or institutional arrangement would yield better outcomes. In this sense the purpose of economic analysis and the function of policy advice is to compare different institutional arrangements in order to find the best mix of legislative and regulatory rules, and institutional and marker arrangements. In other words, the task that faces the Government is a comparative systems one. What systemic option out of a wide range of possibilities is to be preferred? This is the comparative institutional approach which underlies much of the discussion in this book.

There are, however, a number of factors which limit our ability to organise ourselves in the way we would like. The main constraints are the general scarcity of resources, the effects that one person's actions might have on other people, the costliness of acquiring all the information desired, uncertainty (these last two both impose limits on the extent to which we can make fully rational decisions) and the nature of incentives facing individuals and their ability to respond opportunistically.

The Importance of Incentives

Incentives matter. People will pursue their own ends, and their own interests. This is not to deny that many people act altruistically for much of the time. But if even only a relative few act opportunistically all the time, and most act so occasionally, then the problem remains. Various policies will generate incentives which will encourage individuals to see their interests in different ways. Well designed policies will align the interests and actions of individuals with those of the nation. They will encourage greater efficiency, equity or liberty.

The importance of incentives can be seen in the way that the new set of incentives, created by the recent moves to deregulate the economy, have created powerful and dynamic forces which generally are encouraging productivity, innovation and more outward looking approaches. Throughout the chapters which follow, we draw attention to the way in which various government interventions have created incentives-favourably or adversely. For example:

— high levels of assistance to manufacturing industries through import licensing and high tariffs have encouraged a flow of resources into some of our least efficient indusuies;

— the floating of the exchange rate has created a strong incentive for better economic management because poor management will be quickly reflected in a depreciating exchange rate;

— imposing clearer accountability on public sector managers in respect of the state's main commercial operations, with the prospect of sanctions for unsatisfactory performance, has greatly improved the incentives for better management in these areas.

Designing Better Government Interventions

Making the right choices about the nature and form of government intervention is the key to effective economic and social management. The issues in each case are always complex: it is necessary to take a very broad view of interventions in order to capture all the effects and costs. Health, for instance, must be seen more as a function of lifestyle and not of illness. Nor is the issue one of a choice between public and private provision. The issue concerns the mix.

Where the Government makes an intervention in some area it is important that it be done well. The design of efficient and effective institutions is difficult. Careful consideration must be given to the specification of objectives (to avoid ambiguous or conflicting objectives), to the scope of the authority given to managers (it must be sufficient to allow the manager to manage effectively), to effective lines of accountability, an effective way of assessing performance (which is not easy if the institution's shares are not publicly traded), and above all else to the way in which incentives can be designed to ensure that the objectives of managers and other employees are aligned with the institution's objectives. All these aspects are ueated more fully in Chapter 2.

The problems that give rise to difficulties for markets are equally problematical for government solutions. In addition to this the Government, because of its ability to redistribute, will come under pressure from interest groups. Public sector advisors should not be assumed to have better information or be best placed to make decisions. In this sense government failure can be every bit as real as market failure.

It is only sensible to organise economic and social activities in the form of a government department, state owned enterprise, education or health board, or whatever, if the particular form of organisation chosen enables these activities to be provided more cheaply, more effectively, or more equitably, in aggregate, than would provision through the market. This is an empirical matter. In most cases, there can be no *a* priori assumption that particular functions will always be best served through one form or another. The optimal organisational form may well change from time to time with technological developments or innovations in organisational arrangements such as the introduction of meals on wheels. In a market economy where competition between institutions themselves as well as with market place providers is encouraged, one would expect to see continual competition to find new ways of organising activities including co-operation between institutions and market providers, that is, contracting out, to enable them jointly to deliver services more cost effectively. The benefits to be derived from conscious competition between institutions and markets, however, will obviously depend upon how efficiently our markets are operating.

Improving the Operation of Markets

The greater part of economic activity in our society is still conducted through voluntary transactions in markets of one sort or another. Government owned organisations may not need to be very efficient to compare favourably with markets that operate less efficiently than they could because they are heavily regulated (with entry barriers, unnecessary exit costs and other restrictions that create rigidities and interfere with the market clearing process). Accordingly, improving the operation of markets is itself an important function for government in the pursuit of efficiency.

The prices generated by a well functioning market serve to inform and to co-ordinate so as to guide resources into their highest valued uses. Prices convey with great economy precisely the additional information (on values or 'marginal rates of transformation') that constitute the minimum efficient statistics for economic decision-making. And they are statistics in the sense that they summarise large amounts of information about changes in tastes, technology, resource availability and so on. The price system is also much quicker in conveying information about changes in economic circumstances than any alternative collection system. A particular advantage of a market is that it co-ordinates activities even in the absence of any agreement on priorities or ends. Governments tend to rank their objectives or ends in a hierarchical order: markets do not. An exchange in the market place serves the different ends of each party to the exchange even though the end each has in mind is not known to the other. It is this characteristic that creates the essential affinity between a market economy and a pluralist society: market participants can co-operate harmoniously in the market place without any need to agree on ends or purposes.

Markets cannot be relied upon to provide appropriate price signals unless there is competition or the threat of competition. Many feel uneasy with the concept of competition: notions of excessive rivalry do not seem to fit comfortably with the ideals of co-operative endeavour and team work. This is based on a serious misunderstanding about the nature of competition. Competitive activity is, in essence, a discovery procedure—a continuous search to find better ways of meeting consumer needs or to use resources more efficiently. The competitive efforts of input suppliers results in a form of co-operation with their customers in which all parties jointly strive to reduce costs. Constraints on competitive behaviour will reduce the benefits to society which can flow from the innovations prompted by market place competition.

The case for encouraging the operation of relatively free markets does not rest on any contention that this will bring us any closer to the textbook conditions of perfect competition, nor is it dependent upon the existence of optimal conditions anywhere else. It rests simply on a comparison with any other way of organising economic activity to achieve the same purposes. In many situations, provided markets are allowed to operate efficiently, there is no superior alternative.

The Partnership between Government and Citizens

The task of managing economic and social activity can perhaps be best thought of as a partnership between the Government and its citizens. It is primarily the Government's responsibility to ensure the correct policy settings in areas such as the levels of government expenditure and taxation, monetary policy, and in establishing appropriate legislative frameworks and regulatory regimes. More fundamentally, however, economic and social outcomes depend upon social attitudes, social processes and the ways in which our society organises itself to get things done. In these areas the Government cannot act alone: it is reliant upon the co-operation of its citizens. Certainly there is a role for government in providing leadership, in explaining clearly the need for changes in many of our institutions and other social arrangements and in co-ordinating policies for change. In the final analysis, however, the responsibility of deciding whether to accept change and to proceed to the construction of new, superior societal arrangements lies with individuals.

For example, attitudes to risk and to uncertainty, particularly about the future, are of central importance in influencing society's willingness and capacity to cope with change. A society that is willing to take risks, and to organise itself accordingly, is more likely to be innovative and more ready and able to seize and exploit the opportunities thrown its way by chance and circumstance. On the other hand, a society that is excessively risk averse, that tries to protect and insulate its members from all the adverse consequences of a changing external environment or changing technology is unlikely to adapt constructively to change and is much less likely to take up the opportunities that could provide additional jobs and higher incomes.

In this sense the task of adjustment and restructuring is also a shared responsibility. So it is important to participants in the private sector as well as to the successful performance of the public sector that the Government is able to distinguish clearly from the outset what the Government, by itself, can and cannot do well.

Some Current Key Policy Issues

Fiscal Policy

Successive governments over recent decades have emphasised their determination to curb the growth of government expenditure. Despite strenuous efforts over many years the outcome has been a relentless increase in outlays and a corresponding increase in the tax burden. How can this be explained? An explanation may lie not in an analysis of programme objectives and costs but in the nature of the incentives facing public sector managers and those that seek government assistance. The combination of a policy advisory function with regulatory or operational functions, for example, can lead to the phenomenon of regulatory or producer 'capture' of the agency, where the agency tends to take greater account of the interests of service providers or of the regulated sector than of the broader interests of society overall. Any lack of clarity or transparency in an agency's objectives can encourage attempts by the private sector to direct the employment of government policy instruments like tariffs and regulations in ways which will bring direct benefits to their firm or industry. The absence of clear lines of accountability in government owned agencies diffuses responsibility for management decisions and permits the development of an environment in which poor management practices will thrive. The rigid structure of the public sector labour market makes it very difficult to employ professionals with the technical skills required in many areas of modern management. The list could go on. Clearly it is the way in which institutional arrangements and rules have been designed that has created many of the impediments to improved economic performance in the public sector.

Inflation

Inflation imposes major efficiency and equity costs on the economy. Despite the best endeavours of successive administrations inflation has proved extremely difficult to control in New Zealand. For decades our rate of inflation has exceeded that of our trading partners. Again most of the blame can be ascribed to poorly designed government interventions. Some, such as the high levels of industry assistance which have nurtured a large sheltered sector, account for the pressures which are placed on the Government to inflate; others can be more directly attributed to the mechanisms and institutions through which monetary policy is implemented. As explained in some detail in the section on Liquidity Management the current arrangements impose dual and somewhat conflicting objectives on the Reserve Bank in its quite separate roles as the. Government's banker and as monetary authority. This duality can affect not only the effective operation of monetary policy but also discourage effective cash management within the public service.

Unemployment

Unemployment is a fundamental equity issue in the management of the economy. Unemployed people are effectively deprived of the opportunity to contribute to their own well-being by an unfair distribution of work opportunities. The fact that the economy is composed of individuals pursuing their own interests, and that the inevitable constraints on exchange prevent the full achievement of social goals, means that it is inevitable that some will have more opportunity in the workforce than others. However, the behaviour of the Government can affect the distribution of opportunity. Where the Government tends to protect the positions of various vested interests the result will be inequity elsewhere, and unemployment is one manifestation of that.

Regulations which protect weak industries through import licensing protect the jobs of people in those industries at the expense of employment elsewhere. Laws which require the payment of minimum wages protect the pay and conditions of those in employment at the expense of reduced job opportunities for the unemployed. Policies and practices which pander to employee groups or other lobbies by maintaining inefficient government expenditure make it more difficult to control inflation; inflation erodes investment and undermines potential job prospects.

The fact that these basically inequitable forms of behaviour are endemic in Government is symptomatic of a fundamental weakness in decision making and the delivery of policy. Though the Government ought to be fair and treat people equally, many actions tend to preserve the entrenched interests of relatively secure groups at the expense of the unemployed.

Social Policy and Redistribution

Income is the passport to participation in society. Access to social services like education and health are critical to personal well-being. The maintenance of a fair society by the redistribution of income to the poor and the protection of their access to social services is a fundamental equity issue facing the Government. Without government redistribution, some would be forced to lead mean and squalid lives.

Like all other activities the redistribution of income and the protection of access to education or health cannot be achieved without cost. The imposition of high taxes to pay for benefits and subsidies has a substantial impact on the efficiency of the economy. It tends to reduce total output and therefore national income. It is important therefore that taxes are spent carefully and directed to where the need is greatest.

The lion's share of income support and other social policies is in fact devoted to schemes that are not focused on those in need. The National Superannuation Scheme spends $4 billion annually, equivalent to an average income tax rate of about 8 percent. As well as assisting many low income people it provides money to many people in comfortable circumstances. Education and health spending are not targeted towards improving the access of low income people but instead are directed to the maintenance of major public sector monopolies.

A policy process which tends to protect the jobs of state employees and the incomes of middle income superannuitants has the effect of imposing the full efficiency costs of generous redistribution without achieving effective redistribution. Instead of empowering the poor, the programmes are disabling of taxpayers, restrict the choice of the users of social services and empower the public servants involved in their delivery.

Hospital boards and schools have confused objectives between the provision of services for society and the efficiency of production. The employment and management incentives on staff permit budget maximisation and job promotion rather than client satisfaction.

In essence the Government's management structures involved in social services and the decision making in income redistribution undermine the basic equitable goal behind these activities.

Conclusion

In each of the policy areas examined above we have suggested that the critical factor has been the quality of policy design. Government interventions that are well designed will be effective in meeting their objectives at minimal cost. Interventions that are badly designed can create costly distortions and consequential problems in other areas while failing to achieve their intended objectives.

Many of the existing interventions were not well conceived at the time they were introduced or no longer fit the changed economic environment. Many government institutions are not performing as effectively as desirable. The nature and form of many government interventions need rethinking and the operation of many core government departments and associated agencies should be reviewed, to assess the way institutional design and the current set of incentives influence the attainment of institutional goals.

The influence of the public sector is so pervasive and the impact on the rest of the economy through the size of the tax burden (and the consequential adverse effects on incentives to produce and work) so great that the reform of the public sector seems clearly the single most important item on the Government's agenda for the next three years.