PUBLIC SECTOR ADDED VALUE : CAN BUREAUCRACY DELIVER?

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Introduction

Today there is a search for a new understanding of the role and function of democratic government and along with it an answer to the question how best might the institutions of government add value to the services that they provide?

What is the source of the value added by government bureaucracies and are alternative forms of public sector supply superior sources of value added? These are the fundamental questions which lie at the heart of the contest between public sector bureaucratic supply and arms length decentralised market supply or, simply, hierarchy vs. markets. Answers to the fundamental questions focus upon two issues. First is the effective co-ordination of individual activities and the second is the control of opportunistic behaviour. Are decentralised markets, for example, better at solving these co-ordination and control problems? (Hayek, 1945).¹

These questions are a continuation of an agenda found in the works of Adam Smith, who advocated policies that were designed to maximise social welfare subject to the constraints of the administrative agencies of government which implemented the policies. Today much theoretical analysis is being directed at designing suitable incentives for public administration in order to relax the constraints on welfare improvements imposed by the administrative intermediaries of government. In other words, this analytical search is focused upon the optimal structure of government institutions. Central to this analysis are models based upon asymmetric information and agency in which contracts are incomplete as too are constitutions. This reflects the complexity of relationships that exist in the post-fordist and post-modern world of ambiguity and indeterminism. (Glennerster, 1995; Laffont 1999; Stiglitz 1994)

The purpose of this paper is to take stock of our understanding of the “architecture” of public sector resource allocation mechanisms. In particular, the relative efficiency and effectiveness of alternative architectures. This is a speculative venture and a framework rather than a precise theoretical model will be sketched out whilst engaging in a search for the frontiers of understanding by identifying unresolved problems. The vehicle that

will be used is a consideration of the success or otherwise of some recently implemented public sector management reforms along with the proposed changes recently announced by the incoming UK Labour Government of 1997. Specifically, the question which will be addressed is whether or not public sector bureaucracy can deliver value for money.

The search for improved designs in fiscal systems and the institutions of government is as old as Plato's *Republic*. The modernist search for efficient institutional forms of government is based upon some rather old propositions. The first proposition originates in the Scottish moralists and is represented in Adam Smith's contention that economic decentralisation, especially via market exchange, is more efficient than centralised decision making. The second proposition is found in the French Enlightenment claim that human happiness can be engineered by changing the social order.²

Market Failure vs. Government Failure

To what extent is it possible to rely upon arguments of market failure or government failure to decide upon the institutional design of resource allocation mechanisms? Whilst there is no complete agreement, nevertheless, a significantly large group of economists are now firmly of the view that the extreme positions that government should be responsible for all economic activity or that government should do nothing cannot be sustained (Wolf 1988). Government bureaucracies simply do not have the information processing capacity of markets - they are unable to solve the co-ordination problem nor can they successfully mimic the incentives established in markets. Markets, however, are also deficient in important and significant respects. They are not efficient except under very restrictive and special conditions. Moreover, they produce welfare distributions that are not socially just.

There is, therefore, the need to find a balance; a "third way", which is a mixed economy of the best features of market and bureaucratic designs. Giddens (1998) the architect of the "third way" explains it as, "the restructuring of government should follow the ecological principle of 'getting more from less', understood not as downsizing but as improved delivered value" (p74). Clearly then there will be a continued role for bureaucratic supply of public services. But what form will that role take and will public sector agencies be more heavily regulated? (Halpern and Mikosz 1998).

The first and second theorems of welfare economics establish the simple propositions that individuals acting in their own self interest will produce collective outcomes that are Pareto efficient and that such results will be produced by perfectly competitive markets. Real market systems, however, fail for a variety of reasons in the sense that they result in resource allocations which depart from the Pareto ideal. Non constant returns to scale; externalities and public goods have been analysed as important causes of market failure. It was, however, never made clear how significant these market failures were and whether government intervention through the use of taxes, subsidies, regulations or the direct provision of public services could bring the economy closer to the Pareto efficient ideal and at what cost. The benefits arising from public sector activity were much more of an article of faith than was often supposed.

Modern economic approaches to market failure are now much deeper and emphasise information failures (Arrow, 1970 and Stiglitz, 1994), especially those arising from moral hazard and adverse selection problems. There is now a better understanding that the information required to run markets efficiently is much greater than was originally thought. In addition, there is the problem of missing markets. Markets will fail to exist because the information required for markets, as in the case of many futures markets, does not exist and/or because the transactions costs of establishing these markets are prohibitively high. Missing markets, by definition, cannot contribute to the solution of the co-ordination problem and it is in circumstances such as these that government intervention can be justified. Thus, in addition to the standard market failure problems of dealing with externalities and public goods, governments will intervene and provide social insurance because private financial markets will fail to provide these activities. In developing and transitional economies missing markets also give a strong rationale for government activity at that stage of the development process.

Today's economists recognise that market failure is much more widespread than was traditionally thought to be the case. Because of the extensive scope of market failures the government could intervene in almost every sphere of life. Not all market failures are, however, of equal empirical or social significance. Market failure is a necessary but not sufficient argument for government intervention. Given the failures of central planning and other forms of government activity a judgement has to be made about

which market failures call for intervention and what form the intervention will take. Where will government intervention have the biggest impact? No amount of logical analysis will provide answers to these questions. It is an empirical issue which requires an appraisal of the benefits, costs, and effectiveness of alternative policies. This information is sadly lacking in the majority of cases.

The justification for government intervention goes well beyond the modern analysis of market failure. Questions about the distributive justice of market outcomes give a role to government to redistribute income. Economists tend to evaluate social justice in terms of equality of opportunities rather than equality of outcomes. This, however, presupposes an inclusive society which offers everyone equality of access to opportunities.

Government also has a role in establishing and maintaining the institutional infrastructure which defines the rules of the game for a civil society: in particular a legal system which will define and enforce property rights and contracts, and a regulatory regime, which will encourage competition.

The Public Choice school, as represented especially by Buchanan and Tullock, has been critical of government intervention. They drew attention to the costs of government intervention and the sources of government failure. Part of their argument was that voluntary private actions, such as bargaining to solve externality problems (Coase, 1960), were superior to government interventions. These results depended, however, upon highly restrictive assumptions, such as a complete specification of property rights; perfect information, low transactions costs and a small number of individuals (Farrell, 1987). Moreover, government has powers that voluntary arrangements can never secure, in particular the power to enforce contracts.

Public Choice writers (Downs, Niskanen, etc.) drew attention to the theoretical possibilities of "government failure" originating in the opportunistic rent seeking behaviour of politicians and bureaucrats, who would make decisions which result in an over expansion of public services and hence public expenditures.³ Vote maximising politicians, it was hypothesised, would also prefer deficit spending to taxation and would adjust macroeconomic variables over the political business cycle (Buchanan and Wagner, 1977).

The alleged consequences of political failure were many. Expanded public sector budgets, it was claimed, choked off resources required for economic growth. Large public sector deficits raised interest rates. Increased tax bills to pay for the enlarged public expenditure were thought to create disincentive effects which would inhibit the supply of work effort; savings; investment and risk taking. The political business cycle caused economic instability, raising inflation and unemployment.

Despite these criticisms of the Public Choice school it is wholly inappropriate to assume that government is all knowing and benevolent as did the naive market failure arguments favouring government intervention. Whilst government can use its coercive taxation powers to redistribute income it is not necessarily the case that the engineered outcome for the distribution of income will be closer to that which is regarded as socially just.

In addition to these critiques there were others. The public sector was seen to be captured by large professional monopoly groups who dictated to users what level and quality of service would be provided. Operational managers were not empowered to be effective and service standards were measured by reference to inputs and throughputs. Strategy or policy making was often separated from considerations of operations and implementation. Taken together, it was claimed, these resulted in large amounts of X-inefficiency.

What can be concluded from this discussion? Empirical evidence about the absolute benefits and costs associated with public services and the distribution of net benefits is extremely thin. It, therefore, follows that comparisons of the relative efficiency and effectiveness of private vs. public sector supply are very weak. There is, never-the-less, an overwhelming case in support of government intervention in the modern capitalist systems of developed, developing and transitional economies. This is based upon informational failures, the pursuit of distributive justice and the need to solve the co-ordination problem.⁴ Substituting market solutions for public sector bureaucratic supply is no guarantee of enhancing the efficiency of an economy. Whatever tasks are assigned to the public sector they must be conducted efficiently and effectively. How this might be achieved remains the subject of enquiry.

Public Sector Reforms

By the mid 1970s the general public's attitudes towards the public sector had reached a low. There was a loss of confidence in the public sector's abilities to deliver public services of the quality that was expected; to manage the economy; to solve social problems; or to be prudent with the public finances.

The Thatcher reforms, which began in 1979, had their intellectual foundations in the American Public Choice theorists' notions of public sector failure plus the ideas of Milton Friedman in America and the Institute for Economic Affairs in London. These reforms were based upon theories that had never been adequately subjected to empirical testing. They had nothing other than the status of working hypotheses. The deep seated ideology was that the discipline of market forces would drive out X-inefficiency; restore public expenditure to its optimal level and return choice back to the consumer.

The catalogue of reforms is now quite extensive and includes; devolved budgeting; the Financial Management Initiative; Value for Money Auditing; privatisation; contracting out; quasi (internal) markets; performance monitoring; the importation of best practice from the private sector and the fostering of managerialism within public services. There was much more (see Flynn, 1997; Jackson and Price, 1994; Lawton and Rose, 1994 and Walsh, 1995). The National Performance Review in the USA, which resulted in the Gore Report (1993), introduced incentives for improved public sector management.

Many of these reforms can be summarised with the assistance of Figure 1. Along the horizontal of the matrix the degree of competition is shown. The vertical shows the allocation of control rights - i.e. an indication of who has the right to make controlling decisions.

Traditional central and local bureaucracy is located in the bottom right square. Control rights reside within the political process and there is no competition. The Next Steps Agencies do not face competition but their management does have control rights. Quasi markets confront competitive forces and their managers have control rights whilst for contracting out the control rights remain within the public sector but competition is active.

In all of these settings ownership remains with the public sector and control rights have been delegated.

Contracting out is found in the NHS; local authorities etc. and will either involve the outsourcing of the complete provision of a service or the letting of a contract to manage a service.

Quasi or internal markets have been established in the NHS; education; social services and social rented housing.

Central to quasi markets and contracting out is the separation of purchasing from supply - i.e. the "purchaser / provider" split. The purchaser "buys" on behalf of a group of users within a geographical area, and is located within, for example, a local authority. The supplier competes for a contract and the supplier can come from within the authority or from outside. Whilst there is competition amongst suppliers there is no competition amongst purchasers. Some purchasers might be more efficient and effective than others. Privatisation lies outside of this framework since it involves a change in ownership. The framework is also embedded within various regulatory regimes which control providers' performance against target.

The general trend during the 1980s up to the mid 1990s was to decant more and more activities from bureaucracy into the other categories. This is shown from the direction of the arrows in Figure 1.

In 1997 the incoming Labour Government halted and in many areas of public service supply reversed the trend, which had been set by the previous Conservative Governments, of moving from hierarchy to markets. New Labour's policies shifted the emphasis from markets back to hierarchy. This was not, however, a return to unfettered hierarchy. Rather, the 1997 reforms, whilst making a relatively greater use of bureaucratic supply, recognised the need for a greater degree of regulation of bureaucracy.

The local government "Best Value" initiative replaced compulsory competitive tendering, no longer making competitive tendering compulsory. Instead, local authorities will be expected to engage in market testing and will be required to demonstrate that their performance (as reflected in a variety of standards) is as good as that of external suppliers. This will necessarily involve auditing as demonstration and proof of "best value" and service reviews to ensure continuous improvement.

In other areas of public service supply there has also been change. The annual contracts between NHS purchasers and providers have been replaced by three year contracts. General public spending targets are now set three years in advance. Grant maintained schools have been renamed “foundation” schools and the proposed nursery school voucher scheme was abolished.

Lessons from the Reforms

What have we learned from these reforms? Has the performance of the public sector improved?

First, has increased competition eliminated X-inefficiency and improved consumer choice? Despite general opinion to the contrary there is no strong theoretical analysis to support the case that competition is good. Adam Smith [1776] made a vague claim about the virtues of competition, "monopoly ... is a great enemy to good management" (p165). Recently a leading industrial economist Richard Caves (1980) having reviewed the evidence concluded that economists, "... have a vague suspicion that competition is the enemy of sloth". Even more recently Nickell (1996) argued that the "... general belief in the efficacy of competition exists despite the fact that it is not supported either by any strong theoretical foundation or by a large corpus of hard empirical evidence in its favour" (p725).

Our knowledge of the competitive process and how it causes a search for cost containment and reduction is meagre. In concluding his empirical study Nickell writes, "... I find that there are some theoretical reasons for thinking that competition might improve performance, but they are not overwhelming. I also see that there exists some empirical evidence in favour of this view, but again it is not overwhelming". (p746).

Analysis originating within the industrial economics and strategy literature is also informative. Empirical studies have sought to find out how much industrial structure matters when it comes to explaining differences in the relative performance (profitability) of different market based companies. In this case industrial structure (monopoly; perfect competition or oligopoly) is a surrogate for the intensity of competition. Rumelt's (1991) study produced some very interesting results, which are of significance for the discussion in this paper. He found that industry (i.e. competition)

did not matter. Industry effects only accounted for 8.3% of the explanation for the variation in the performance of private sector companies. Ownership effects were even smaller, 0.8%.

Given this background it would be surprising to find significant productivity improvements as a result of moving activities out of the bureaucracy into the other quadrants of Figure 1 or indeed, through privatisation (ownership effects) to another domain completely. My own review of the empirical work, which has searched for efficiency (cost savings) improvements following the introduction of contracting out or quasi markets, concludes that there is very little support for the proposition that privatisation or contracting out has increased efficiency and effectiveness. In some of these cases where support has been found in favour of the proposition there is a question mark over the methodology used (Jackson 1994 and 1997 (a) and (b)). Operational efficiency gains, if found, have been usually one off and small in magnitude. They do not appear to be sustained over the long run. Others who share this view include Walsh (1995); Davey (1996); Gold (1995) and Boyne (1998). In Davey's study of urban management in developed and developing countries, whilst there was some weak support in some cases for the claim that private sector involvement results in performance improvements, nevertheless, the overall results of the study did not give unambiguous or overwhelming support. Gold (1995) found in the USA that attempts to privatise brought some small *promises* of reduced costs as did attempts to restructure and re-invent. But there was no quick fix that would produce big pay-offs.

Finally, in a very carefully conducted study Domberger, Hall, and Li (1995) the impact of competitive tendering on price and quality was examined. The conclusions of this study were that competition had a significant (*but small*) impact upon price and quality. Quality was maintained following the introduction of competition and in some instances improved.

It is not only the existence of competition which is potentially important it is also the *force* of the competition. How powerful are these forces? Evidence suggests that they have not been very powerful. On many occasions very few alternative suppliers have bid for public sector contracts - in some cases none. In other cases the public sector has

faced very powerful suppliers who have eliminated the internal provider in the short run just to re-contract at higher prices in the longer run.

Perhaps it is not necessary to have actual competition. The theory of contestable markets (see Baumol, Panzar and Willig, 1982) suggests that a credible threat of competition will be sufficient to keep internal suppliers of public services searching for improvements in the cost and quality of services. The unanswered questions are how credible is the threat and how powerful is this competitive force?

What then is the purpose of competition? It protects against monopoly. But how effective is this protection in practice? Not very - that is why it is necessary to have regulatory regimes. Competition and regulation are substitutes; but not perfect substitutes. Regulation can of course be distortionary in so far as it introduces adverse incentives but monopoly is distortionary also. As in all policy matters the world of the first best is elusive. It is only the second best that is available to us and as such there is the danger that implementing first best solutions will move the system further away from the first best.

Quasi markets also suffer from traditional market failures - incomplete information; incomplete contracts (uncertainty); externalities; transactions costs and non constant returns to scale. Which then is worse? The market failures or the political failures? Unfortunately we have little (any?) useful empirical evidence to make such a comparison. This is confirmed by the most recent set of papers reviewing the quasi market reforms - see Bartlett, Roberts, and Le Grand (1998) - "It is too early in the experiment for a comprehensive appraisal of the social costs and benefits of quasi-markets to be undertaken. Given the state of flux that exists evaluation will also be difficult". (p287).

Given that many activities, which were organised through the public sector, were located there because of the failure of markets to allocate them effectively and given our understanding of what markets cannot do then it is a bit strange to believe that the problems of bureaucracy could be solved by taking these services out of the traditional bureaucracy and confronting them with greater amounts of competition and managerial control. This was an article of faith which has been found to be wanting.

Empirical studies of the impact of privatisation upon economic performance do not give much support to the proposition that privatised companies perform significantly better than nationalised utilities. Millward (1982); Millward and Parker (1983); Bishop and Kay (1989); Estrin and Perotin (1987); Hartley and Parker (1991); and Hutchinson (1991) in their empirical studies could find no significant improvements in efficiency following privatisation. Changes in ownership are not the key to efficiency improvements. Bishop and Kay's (1989) study of the prices, profits, outputs and productivity of the newly privatised firms between 1979 and 1988 revealed that improvements in performance were not related to privatisation, "the privatised industries have tended to be faster growing and more profitable, but it seems that the causation runs from rapid growth and profitability, rather than the other way round" (pp 40/41). Burn's and Weyman-Jone's (1994) examination of electricity distribution companies could not establish a significant relationship between privatisation and productivity change. Similar results are reported by Haskel and Szymanski (1991, 1992, 1993 (a) and (b)). Finally, Martin and Parker (1995) examined 11 organisations which had been privatised during the 1980s. Productivity growth fell after privatisation in the case of British Airways, British Gas, Rolls-Royce and the British Airports Authority - see also Parker and Martin (1996) and Martin and Parker (1997).

The performance of the public sector is not only judged in terms of efficiency - in particular the narrow concept of cost. Many public services were also judged in terms of their contribution to achievement of equity - who receives the services and in what quantity and with what effect upon the distribution of incomes (welfare)? Whilst markets produce a distribution as an outcome they are not designed to bring about desirable distributions unaided. Leaving it to the market can, therefore, result in government losing control over the means of achieving one of its primary objectives (distributive justice) and it needing to re-invent itself to achieve this.

There are other considerations that need to be taken into account when judging the recent reforms. Most commentators refer to the increasing centralisation of power. The adage that it is necessary to "centralise in order to decentralise" has only been partly true. Central government undoubtedly centralised power mainly at the expense of local government. But whilst it devolved decision making to agencies; intermediate

organisations; hospital trusts etc. it retained powers to control and regulate those activities that had been devolved.

The Architecture of the Public Sector

The 1980s and 90s has seen the hybridisation of the public sector in terms of the emergent mosaic of organisational forms contained within Figure 1. One useful way of analysing this phenomenon is to use the concept of “organisational architecture”, which was introduced by Sah and Stiglitz (1986). Borrowing from information sciences and the team approach to the study of organisation systems, (Marschak, 1955), they regarded architecture to mean the internal structure of an organisation, i.e.

“... how the constituent decision making units are arranged together in a system, how the decision-making authority and ability is distributed within a system, who gathers what information and who communicates what to whom” (Sah and Stiglitz, 1986, p716). Their thesis is that the relative performance of different economic organisations (this might be a single firm or an entire economic system) depends upon their architectures. It is architecture which influences the quality of decision making and hence performance.

Architecture is a primitive concept. Few have adopted the Sah and Stiglitz approach despite its richness (Jackson, 1998). Effective decision making depends upon ensuring that relevant information is available to the right person, at the right time and in the right format. There must, however, be appropriate incentives to ensure that decision makers will use information to create value. The architecture of markets relies upon the incentive of self interest for the effective use of information but when that fails market outcomes are not efficient. Information might not exist or it might be too costly to acquire. This is the decision environment, which those who deal with “wicked problems”, have to confront. In these cases a collective, co-operative non-market solution which requires a different architecture may produce a more efficient outcome. This is the basis of current research which is exploring the use of networks as an alternative governance structure lying between markets and hierarchies (see Jackson, 1999; Kickert et. al. 1997, and Rhodes 1996).

Architecture is a structure of relationships.⁵ Alternative shapes and forms of organisations arise from the holism of these relational configurations. To understand the effectiveness of alternative architectures focus needs to be placed upon the precise nature of the relational contracts and the way in which they relate to one another within a network. Organisational architecture shapes organisational space and defines organisational context and can, therefore, empower or constrain. It is much more than simply organisation structure and transcends the transactions cost view of organisations as a “nexus of contracts”, which can result in a confusion of where the boundaries of the organisation are located. Architecture is holistic - it takes into consideration the unique coherent pattern of its elements. Moreover, architecture is embedded in a wider social context which will also give it shape (Granovetter, 1985).

Topics like architecture and computer science use a design science perspective (Simon, 1969; Churchman, 1971) in the sense that, “the hypotheses of design science are not generalisations about current behaviour but are assertions that new levels of performance can be attained and diffused under the right conditions” (Miller, 1987). The search for improvements in the performance, i.e. the amount of value added, by public service bureaucracies is a search for the right conditions. These conditions are most likely to be found within the network of relational contracts.

Following Kay (1995) architecture is defined as, "a distinctive collection of relational contracts. The benefits of architecture typically rest in the development of organisational knowledge, flexibility in response, and information exchange within or between organisations" (p371).

An architecture incorporates:

- relationships with employees
- relationships with suppliers
- relationships with customers
- relationships with other organisations (networks)

Architecture tends to emerge in the sense that there is a constant search for that particular constellation of relationships that results in “excellence”. The precise set of relationships that produce high performance is "discovered" through the testing out of hypotheses in the process of managing. In the case of private sector organisations the

search is for a unique non-imitable architecture that will give a sustainable competitive advantage.

This approach invites us to think in similar terms when considering the performance of public sector organisations. The search is for an efficient and effective architecture i.e. that which adds maximum value. It is not a one off strategic design problem. Rather it is an act of discovery, which will involve experimentation.

Architecture takes us well beyond the simple dichotomy of the alternative governance structures embodied in the markets vs. hierarchy literature. Lying between markets and hierarchies there are alternative combinations of contractual relationships and authority relationships. These have a variety of names - networks; relational contracts and relational linkages and incorporate vertical hybrids such as franchising and subcontracting and horizontal hybrids such as joint ventures and strategic alliances. These architectures define the external boundaries of the organisation. There is also the internal architecture to be considered.

In terms of the governance structures of competition and hierarchy these are alternative means of achieving the *co-ordination* of activities. When the market works effectively (i.e. minimal market failure) then activities are located there but as Coase (1937) and Williamson (1975) have demonstrated when markets fail because of uncertainty; externalities; transactions costs etc. then hierarchy replaces impersonal exchange.

There is, however, a third form of governance that is under explored. That is *co-operation*. In this case the bureaucracy will act as a “broker” in a network of contractual relations, bringing together public and private sector organisations; public service organisations and voluntary agencies; etc. This general architecture is not far removed from the implicit objectives of the current public sector reforms. Government acting as broker is a role that is assuming increasing significance but very little is known about it.

Co-operation is not a soft alternative to competition. It can be shown (Shapiro, 1989) that co-operation works because of competition. Those who co-operate implicitly agree that if one party deviates then punishment will take the form of cut throat competition. Not all co-operative arrangements derive from the credible threat of competition, nor should co-operation be confused with collusion. Co-operation aims to increase added value to consumers by searching for synergies on the production side. Collusion need

not add value by rather tends to result in the expropriation of value from consumers by producers. Following Richardson (1972) co-operation is a highly efficient form of economic organisation. Co-operation, for example, enables the transfer of knowledge and the co-ordination of investment plans across firms. Architecture details the way in which activities are co-ordinated. This is characterised by a description of the knowledge available: to whom the knowledge is available; the communication networks between individuals and the time pattern (for example, sequence) of decisions.

The challenge facing us is to find that architecture which will deliver operational efficiency; effectiveness and also dynamic efficiency. This means comparing the relative benefits of different architectures. Table 1 lists some of the expectations that are held about what the architecture of the public sector has to do.

Table 1 Some Problems That Any Architecture Has To Solve

- deliver operational efficiency
- deliver effectiveness
- deliver dynamic efficiency
- identify problems
- deal with “wicked” problems
- enable organisational learning and build knowledge
- obtain information on user preferences
- reconcile the conflicts between preferences
- enable co-operation and co-ordination
- establish appropriate incentives
- deal with incomplete contracts problems
 moral hazard problems
 adverse selection problems
- re-establish confidence and trust

The specification in Table 1 addresses the critique of the present architecture. It emphasises dimensions of performance that were ignored by earlier reformers. First, dynamic efficiency, is a Schumpeterian idea that transcends the static ideas of economy and efficiency. In order to achieve dynamic efficiency the architecture must provide a capacity to enhance information flows; to respond to external change and to be innovative over time. That is it must fill Jervis and Richard's deficits.

Second, dynamic efficiency requires co-operation between the different elements within the system. It demands an holistic approach which transcends turf wars. The sharing of problems and the sharing of information increases the probability of finding agreeable solutions to "wicked problems". The challenge is the search for and discovery of new solutions to problems. This can be thought of as social technical progress.

In order to judge the relative performance of alternative architectures it is necessary to be more precise than we have been in the past about efficiency. Already the notion of dynamic efficiency has been introduced but there needs to be an appreciation that efficiency is much more than just operational or x-efficiency i.e. waste elimination and cost containment. Allocative efficiency requires that the system produces those services that individual users value and in the quantity and the quality that they prefer. This means ensuring that the architecture gives service users "voice" and enables this information to play a decisive role. Architecture must incorporate decentralised local government because local government is efficient government.

Participation encompasses many activities - voice (expressing opinion); voting; providing advice and providing feedback. Participation gives decision makers a better understanding of local values, knowledge and experience. It aids conflict resolution and wins support for the decisions taken which in turn fosters community assistance in local implementation as well as legitimisation (World Bank 1992).

Participation, therefore, enhances allocative efficiency; increases the chances of effectiveness, by using local knowledge in the implementation process; improves equity because the ability and willingness to pay are better assessed at the local level; and enhances accountability because local people have a strong demand for transparency.

Participation acts like a control mechanism. It promotes external accountability rather than the more traditional internal, vertical, bureaucratic accountability.

However, enabling mechanisms to foster participation must be created. Participation is not spontaneous or automatic. Decentralisation and participation need to be designed into the architecture. They imply a sharing of power and this is a challenge which has not been met in the past.

Participatory mechanisms include local neighbourhood associations; consultations with the public; referenda; annual service reviews etc. Whilst participation and local democracy have benefits they also have costs. Participatory mechanisms are costly to operate and can result in delays in decision making and lost opportunities. The search for optimal degrees of decentralisation, and hence optimal local government, involves discovery of the margins where these costs and benefits are in balance.

The Creation of Value

Whilst the new public sector management has searched for the delivery of value for money very little effort has gone into evaluating the reforms in terms of whether or not value has indeed been created. This is not a trivial exercise not least because value measures are difficult to obtain and it would be necessary to know how much value had been created under the old regime as opposed to the new.

Moreover, do we know what creates value? Up to a point yes. We certainly know how to reduce costs: but costs are not value. They are only one side of the equation. The objective is to enhance delivered value to the users of public services but little is known about how much value is actually delivered.

Success, or superior performance, is ideally measured in terms of value added. The fundamental purpose of management is to add value. When we ask, "why are some public sector organisations more successful than others?" we are attempting to find why some add more value than others. In terms of the reasoning adopted so far value is created by: managing production and costs; and choosing an appropriate architecture.

Managing to create value by reducing costs is, however, only one means of adding value. How do we improve benefits? Like any organisation this is done by adding value to the existing services through product and service developments and by ensuring that the services which are supplied are what consumers demand. This does not mean giving consumers more of the same but adding quality to what they already receive. It implies

creating a responsive organisation that listens to its clients and service users and responds with innovative policies thereby securing improvements in Schumpeterian dynamic efficiency.

How then is sustainable added value to be created? This is considered in the next section.

A Framework to Proceed

Whilst the reforms of the 1980s/90s referred to as the new Public Sector Management provided some small one off benefits they were by no means necessarily complete nor were the operational efficiency gains necessarily sustainable. The new Labour Government reforms offer an opportunity to revisit these problems. Already, policy initiatives such as “Best Value” have been advocated. Local authorities will choose whether or not to contract out services against the background threat that if they fail to deliver best value then they may be forced to contract out services or the existing management may be replaced by a “master class” hit squad. These threats in some respects replicate those of the private sector market for corporate control, which are effected through capital markets.

How then are we to proceed?

The internal management of public services is also part of the problem. How well are managers able to manage the changes introduced by the various reforms? This is not meant as an ill informed attack on public sector managers, who have been the butt of unfair criticism. Rather it is a recognition that change has to be managed; that organisation cultures have to be changed; and that new skills and competencies have to be learned and acquired if public services are to deliver the benefits that their users expect (Colville, Dalton and Tomkins, 1993).

Introducing new management systems and techniques such as benchmarking; TQM; devolved budgeting; performance measurement and contracting out are necessary but not sufficient for improvements in performance. The devil is in the detail of the implementation of these techniques and in the abilities and competencies of managers to manage the changes that they bring. Managerial effectiveness, it is hypothesised, is an area that needs to be given much greater attention if the factors that determine the

absolute and relative effectiveness of public service organisations are to be better understood. How effective are public sector managers at drawing up and monitoring contracts; implementing TQM; learning from the information generated by benchmarking and performance indicators; and regulating contractors? Too much emphasis has been given to techniques and managerialism and not enough to the processes of effective management. This more encompassing approach to the management of performance has been proposed by writers such as Jackson (1982, 1986).

Managerial effectiveness is not independent of context. Insufficient attention has been given to the decision environment within which public service management is conducted. An extremely useful vehicle for discussing this decision environment is Jervis and Richards's "three deficits" of public management. In a significant set of papers Jervis and Richards (1996 and 1997) reveal some of the fault lines that have emerged from previous public service. They describe these in the context of three deficits:

- * *the democratic deficit* - the emergence of intermediate forms of organisation which deliver public services (networks etc.); the development of opted out schools; the establishment of NHS Trusts etc. Whilst these new forms of organisation are accountable to central government (and that accountability is often weak) they are not directly locally accountable to those whom they serve. John Stewart (1992) amongst others has drawn attention to the weakening of participation and democratic accountability which are valued in their own right.

- * *the design deficit* - whilst existing public service organisations are equipped to deal with standard problems which are well defined, unambiguous and amenable to the application of traditional management techniques they are inadequately designed to identify and define "wicked problems" i.e. those problems that are complex; ambiguous and intractable. Also, they are not well equipped to solve them.

- * *the development deficit* - there is a failure of public sector organisations to develop new strategies to tackle "wicked problems".

These deficits along with the notion of "wicked problems" are another way of expressing the extreme forms of market failure set out earlier. The public sector is

charged with solving problems that markets are simply unable to deal with. It is, therefore, illogical to suppose that market solutions are simply waiting to be found. Asking the public sector to find solutions is setting it a daunting challenge. Indeed, overcoming public sector failure and searching for improvements in public sector efficiency are themselves wicked problems.

Can we improve on the present architecture? To answer these questions some of the things that we need to pay attention to include:

- defining a brokering role for government
- giving a greater emphasis to strategic thinking in the public sector
- paying greater attention to managing relational contracts and incentives
- performance monitoring

Brokering for Best Value

The brokering role of government has already been touched upon and is defined as the search for that architecture which will maximise added value. In order that it can judge the efficiency and effectiveness of its relationships public sector managers require a clear understanding of “value” and “value for money” and hence best value. After all, if the Audit Commission and the Accounts Commission are to pass judgement on whether or not local authorities are delivering best value then they need a precise definition. Value is neither price nor is it cost. It is a subjective concept being the total amount that someone would be prepared to pay for public output. This value is derived from its use and has been called, since the time of Adam Smith, “use value”. Value for money is, however, a more complex concept. It incorporates perceived use value and also the perceived price. The latter will include the implicit “tax” price plus the costs incurred by the consumer in using the service. In the case of public services this will include access costs and the costs of waiting. Best value, like value for money, is difficult to operationalise because,

- value is subjective
- value as perceived by individuals and will vary according to individuals’ tastes
- some individuals will not use public services - do they have a perceived use value?

- different individuals will have different access costs
- implicit tax prices will vary from person to person
- perceptions of value for money will be influenced by ability to pay

This reduces to the age old question - given the heterogeneity of users preferences and ability to pay, whose value is to count when making best value judgements?

The performance of any team is greater than the sum of its parts. This is usually referred to as synergy. When it comes to managing the set of relationships that make up an organisation's architecture the successful organisation is that which creates more synergy than others i.e. it adds more value. In its brokerage role government searches for and establishes such synergies. Public sector managers have very little information about benefits and costs nor do they have any idea about the value created through synergies. In this case comparatively superior architectures are more likely to emerge and be discovered rather than rationally planned *a priori*.

If the value of an organisation is simply the value of its inputs then value and cost are the same. The management of a successful organisation adds value to its resources.

The brokerage role of government is to put together an architecture which adds maximum value i.e. it provides the best value or, put more weakly, better value. Value will be added by managing relationships with suppliers; users; employees etc.

Contract Management and Incentives

The architecture of any organisation is a set of relations established not only through explicit but also implicit contracts. These contracts have to be managed and this involves understanding the nature of the incentive mechanisms that are built into the contracts. Much has to be learned from the principal/agent and incomplete contracts literatures which were touched upon by Jackson (1982) but which have developed considerably since then.

The problems which face the public sector are:

- outputs are hard to quantify and measure
- agencies have multiple goals - how are they to be weighted?
- heterogeneity of tastes
- accountability to a variety of constituencies which have differing objectives

- public employees are often motivated by social concerns

It is generally established in the literature (Dixit, (1997), Tirole, (1989)) that where there are multiple tasks which are observable with different degrees of accuracy then the strong incentives placed on the measurable will draw effort away from those activities that are less measurable. The result is that the overall *average* performance will fall.

The same problem arises if there is a common agency with multiple principals.

Weak incentives can result in gridlock and indecision. If these pathologies are to be avoided then attention needs to be given to the design of incentives.

Another problem facing the public sector is time inconsistency. This arises in a number of forms. First, there is the issue of the length of the contracts that are let. If they are short term and the climate is adversarial then suppliers will either tend not to bid for such contracts or if they do accept a contract they will probably under invest because there is always the threat that the contract will not be renewed in the future. Second, there are problems that arise in regulatory regimes. If there is a fear that the regulator will renege and change the regulatory regime in the future then this too will result in under investment. Cost cutting investments would produce gains which the regulator attempts to obtain by changing the regime.

These time inconsistency issues can be alleviated by governments establishing reputations that they will not renege and by promoting long term co-operative contractual relationships. Central to most co-operative relationships is “trust”, which greatly reduces transactions costs.

Performance Monitoring

Much has been written on the use of performance indicators as part of the general approach to performance management (Jackson, 1995). Incentive problems also enter performance monitoring.

To what extent do the existing performance indicators adequately reflect value added and value for money? The result of many studies is very imperfect. Measurable elements of performance tend to drive out immeasurable activities with the result that average performance declines. In other words the measurement system contains adverse incentives. But there are other problems.

Consider the conflict between policy objectives. A job training scheme has the objectives that it be directed at those who can benefit from it and those who are in most need. These are two distinct objectives which exist side by side because of a compromise that was struck between competing constituencies. The performance standards against which the success of the job training scheme will be judged are:

- the number of trainees in employment three months after the trainee leaves the programme
- the wage rate and earnings of the trainee after three months

An incentive scheme exists. Those job training offices that perform well will receive a bonus. These bonuses will be paid into departmental funds but cannot be used to top up salaries. This will clearly dampen individuals' personal incentives to improve results.

In an ideal world the performance of a job training office would be judged in terms of social value added net of costs. This would require working out the counterfactual - what would have happened to the individual without the job training. Would he/she have obtained a job and what would the individual's earnings have been. The counterfactual, however, is unobservable. Moreover, ideally we would want to know what happens to individuals in the long term, not just after three months.

What would probably happen in practice is that, given the explicit performance standards, employment and earnings after three months are used as performance indicators rather than long run value added.

These performance measures do, however, have adverse incentives built in. First, there is the problem of cream skinning or adverse selection. When selecting those to join a training programme there is an incentive to choose those who have a high probability of obtaining a well paid job at the completion of the training, not necessarily those in greatest need. Not only is added value reduced but the equity objective of the programme is also violated. There is also evidence of adverse selection in opted out schools and the NHS. Schools wishing to improve their position in the league tables will only wish to accept the brightest of students. Likewise G.P. fund holders will not wish too many sick patients on their books.

Second, the problem of moral hazard arises when managers engage in strategic gaming behaviour or play incentive schemes in an attempt to maximise their personal rewards.

This arises because of information asymmetry in favour of the managers and also because, in the case of multiple objectives, they can play off one objective against another. Effort is adjusted to ensure that measured performance is maximised and as has already been pointed out this usually means that average performance falls.

Few public service objectives are sufficiently verifiable to be useful for performance incentives contracts. When goals are vague and when job descriptions cannot be easily written down then the behaviour of public sector employees is usually defined by ideology, attitudes and the standards set by external agencies such as professional groups.

Other factors cloud the issue. Suppose the service environment in one local authority is worse than that in another. The crime rate might be much higher. It requires more resources simply to stand still. On crude league table comparisons this point will be lost and even value added calculations will not pick this up.

Architecture

The search for effective architectures encompasses the language and conceptual frameworks of the economist. There are, however, complementary literatures which will fill in the richness of detail. In particular Rhode's (1997) meso large canvas agenda, which revolves around the themes of networks, governance, reflexivity and accountability, complements the architectural framework. In this work Rhodes, in assessing the appropriateness of the Westminster model, is critically reflecting upon the suitability of its architecture and comparing it with what he regards to be a more appropriate conception, namely centralisation co-existing with fragmentation and interdependence.

Organisation architecture provides a useful framework for identifying those areas which are the focus of further study. It is asserted that architecture complemented by Rhode's themes will provide a rich research agenda for those who are concerned to improve the efficiency and effectiveness of the institutions of government. Intergovernmental relations; power dependence; policy networks; and systems of governance are embedded within and contribute to the shaping of organisation architecture. Organisation

architecture is a metaphor rather than a model. It does not by itself provide explanation nor does it suggest specific hypotheses.

Changing public sector architectures, once a specific design has been chosen, is problematic. Reinventing government is no mean task. The recommendations of many previous attempts to search for improvements in government performance are now covered in decades of dust. Implementation is fraught with difficulties not least because reform normally meets the force of bureaucratic inertia. As one American commentator has remarked, "...reinvention can polish the surface without touching the soul", Kaufman (1994, p20). In order to translate the rhetoric of reform into reality it is necessary to pay close attention to the changes that must be made to the organisation's culture and the underlying incentive structure.

Reforming public sector architectures also surfaces a number of dilemmas. For example, it is generally regarded that those organisations which display relatively superior performance are those which are populated by empowered employees. How much discretion, however, is it feasible to grant public sector workers without compromising the demands of public accountability. For example, whilst it is acceptable to empower a public servant to improve the effectiveness of the process by which a social security cheque is paid it would not be regarded as acceptable if that person was empowered to determine how much should be paid. Not only must empowerment be constrained by the prevailing demands of accountability it must also be recognised that the checks and balances of accountability exist because individuals inherently do not trust government.

Conclusions

Where should the boundaries of the State be drawn? How should bureaucracy be shaped? There are age old questions but they remain on today's policy agenda. They are difficult questions to answer analytically and are equally difficult to answer empirically.

Such general questions, however, are not confined to the public sector. The horizontal and vertical boundaries of private sector organisations have been changing radically in recent years as firms have reconfigured their value chains. There has been a move towards a variety of forms of partnering through the formation of networks; strategic alliances; joint ventures and franchising. These new organisational forms are designed to achieve competitive advantage through collaboration and co-operation. Similar changing forms are also to be found in the public sector.

One of the current questions that modern policy analysis seeks to answer is how best might governments add value to the services that they provide? Can bureaucracy deliver value for money? The evidence reviewed in this paper suggests that there is no reason *a priori* to believe that it cannot. The pay off to the market reforms, measured by efficiency gains, have been both ambiguous and weak. In terms of the market vs hierarchy (bureaucracy) debate the issues are more complex than the simplistic treatments of the problem suppose.

To analyse these problems considerable potential is promised by the economics literature on asymmetric information; moral hazard; adverse selection and architecture. This approach focuses upon the structure of relationships within and between organisations, but in a new and refreshing way. Adopting this perspective should enable an analytical appraisal of the rag bag of managerialist reforms that have been proposed for, and in some instances implemented in the public sector; total quality management; contracting out; performance monitoring and reinventing government (Osborne and Gaebler, 1992). Few, if any, of these ideas had been adequately tested empirically or validated analytically prior to their introduction.

Can public sector bureaucracies deliver added value and provide value for money? The answer is, potentially yes but for public sector managers to be confident in doing so will require much more information and understanding than currently exists about

distribution of information and the design of incentives within the public sector's architecture of relationships. This in turn requires knowledge about the empirical magnitudes of the incentive and disincentive effects embedded within these relationships

- knowledge which currently does not exist.

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ENDNOTES

1. The debate is, “what are the proper roles, in economic organisation, of planning and of competition?” When should the co-ordinating mechanism of the market be used and when should activities be co-ordinated through a set of coherent instructions issued by a central authority? This is an old debate, but one which is not resolved - see Richardson (1971).
2. Montesquieu, Condorcet, Sir James Steuart, Thomas Paine, and David Hume all argued that the expansion of the market would mitigate against the excesses of the Sovereign (government) whilst also being a strong civilising force. Rousseau rebelled against this view arguing that commerce undermined the moral foundations of society. Later the “utopian socialists” Marx, Engels, and Lange believed that socialism, in the form of centralised economic planning systems, could deliver the best results of perfectly competitive markets but with a greatly improved distributive justice. Others believed in less centralism and advocated democratic market socialism - Schumpeter, Marschak and Lerner.
3. non public choice critics of public sector services made similar claims e.g. Illich (1975) and McKnight (1995) who argues that public sector management is iatrogenic i.e. management is as much of a cause of the problem as it is a solution.
4. this gives renewed vigour to Musgrave’s (1959) classification of the roles of government into the allocative, stabilisation and distributional branches. At the heart of each branch lies an information and co-ordination failure.
5. the notion of “architecture” has slipped casually into a number of presentations and publications. A report on Mr Camdessus’ speech to the Council of Europe 1998 was presented under the heading “Asian Crisis Intensifies Need for a New Global Architecture”. Hennessy (1998) refers to “.... deliberate rebuilding of the

constitutional architecture”, (p4) and Dunleavy (1989) discusses the “architecture of the British State”.