

**MODERNIZING THE STATE
RESTRUCTURING CHINA'S PSUs
AND DELIVERING PUBLIC SERVICES**

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INTRODUCTION

China is a special case. Its vast size, rapid development, and distinctive amalgam of political and economic institutions have propelled modernization along a somewhat different course from that taken by most Western countries. China also is special in that it has more than one million public service units (PSUs) that operate at all levels of government (state, province, prefecture, county and township) and employ approximately 30 million people. The scale of these service entities far surpasses those of any other country. China's PSUs operate local schools, hospitals, athletic clubs, and other community facilities. They are active in agriculture, science and technology, media and communications, and many other government programs. Although most countries have service delivery agencies, within or outside the departmental (or ministerial) structure, none approaches China in the number of these entities or in the scope of activities.

Yet, as different as it is, China faces development and management challenges that are similar to those that Western countries have confronted. As they developed, these countries had to expand and improve public services to satisfy the rising expectations of citizens. All had to reorganize and modernize public administration to accommodate significantly broadened governmental responsibilities. Every country had to devise new institutions that both connect and separate markets and government; they had to apportion government resources and authority among the central government and regional or local units; they had to attract skilled people to public service by competing against private employers for the best and the brightest; they had to produce increasing amounts of revenue to finance the escalating costs of government; and they had to incorporate new technologies into government operations and to develop more efficient means of service delivery. Moreover, they had to satisfy the mass of people who want more from government and more freedom from government. In sum, they had to be more efficient, more responsive and more accountable. Similar challenges confront China as it considers the future structure, roles and financing of PSUs, but it must resolve these questions in a much more compressed period than Western countries had.

Modernizing the PSUs is an essential step in the country's development. These entities may have been satisfactory when the economy was centrally managed; they do not suit a country that has dismantled much of its central planning apparatus and strives to be an efficient producer of public and private services. It is highly likely that the process of development will itself impel changes in PSUs. China will have fewer PSUs in the future, but it is not yet possible to foretell whether those that survive will resemble government agencies or businesslike organizations. At this point, one can envision radically different futures for China's PSUs. One scenario would have many (perhaps most) operate as firms that receive most of their income from the sale of services (user fees) and compete against other service providers. Alternatively, most might be financed through government budgets and would have a near-monopoly on particular services. Between these extremes lie a large number of arrangements that combine governments and markets in various ways.

Sorting out the various possibilities requires a clear understanding of the PSU issue. This is done in Section 1, which argues that PSUs have been erroneously compared to the independent agencies that have recently been established in some Western countries. It is important to keep in mind that PSUs began as administrative instruments of a centrally managed economy, not as freestanding agencies with broad operating discretion. Defining PSUs solely as an organizational issue ignores a far more important question: the role of the state in financing and providing public services. This issue needs to be addressed in any restructuring of PSUs.

Section 2 considers PSUs as an administrative issue. Key questions pertain to the relationship between political officers and public managers, and to the means of coordinating agencies that have operating independently but share public objectives. The discussion shows that practice has evolved in some Western countries, which once preferred integrated departments, but now vest service responsibility in freestanding agencies. The concluding section turns the spotlight on China and discusses the implications of alternative organizational and service delivery arrangements for the country's development. The risks are high because flawed reforms may damage China's political and economic institutions.

I. DEFINING THE PSU PROBLEM

The PSU issue is less about the organization of government than about the financing of government, less about how public services should be structured and more about who should pay for them. In fact, PSUs are a priority concern principally because they are a huge financial burden. During the past 20 years, efforts to modernize PSUs have aimed at reducing the budgetary costs of these operations. The cost of public services has impeded efforts to rationalize fiscal relations between the center and subnational governments, and is one of the main reasons why the central governments obtains a declining share of tax revenue.

Organizational and service delivery issues also are important because many PSUs are reputed to be inefficiently run. However, defining the PSU issue in organizational terms, has led, inappropriately, I believe, to comparing these units to the autonomous agencies that have been established during the past 15 years in some Western countries. It also has led to reforms that purport to reduce the cost of public services by recasting the PSUs into business-like units that subsist on income from services. Treating PSUs as independent agencies attributes more managerial capacity to them than most have; forming them into business units impels PSUs to take financial (and other) risks that may be imprudent for government and to shop for customers who are willing to pay for services. Both are inappropriate strategies that are likely to create serious downstream problems for the central government and service providers. One should not be surprised if the course PSU reform is taking leads to a buildup of financial liabilities in the years

ahead. Such obligations inevitably will become implicit or explicit liabilities of the central or provincial governments. Moreover, as PSUs convert into business units, the income and service gaps between rich and poor communities will widen, as will the gap between wealthy and poor citizens. In reforming PSUs, the Government has distinguished among different types of units, especially between those that provide commercial services and should be structured as enterprises, and those that provide public goods that should be provided by public entities. Nevertheless, all PSUs, including those that supply basic public services, face pressure to generate a large portion of their revenue through the sale of services.

To effectively reform the PSUs, it is necessary to understand why they exist and occupy such a prominent niche, why there are so many of them, and why they ballooned into a huge financial burden. The short answer is that they are leftovers from the centrally planned economy of the past. Most PSUs were established during the era of central economic management, when human and physical resources were allocated through multiyear plans among sectors and from the central government to local units. Because the country's vast size, centralized planning was combined with decentralized operations. China's schools, hospitals, farms, community centers, and myriad other facilities could not be managed from the center though, presumably, policies were centrally established and resources were allocated by central authorities. The PSUs, which were modeled after the Soviet system, enabled China to have a highly centralized policy and resource allocation apparatus and a highly decentralized operating mode.

China's PSUs are operational arms of the State or its political subdivisions; they are not intended to be independent entities. PSU architects sought compliance with national policy, not operating freedom from service providers. Most PSUs were placed at the bottom of the administrative chain of command, at country or township level. Human and other physical resources were apportioned to them based on normative rules that were supposed to be applied uniformly across the country. For example, national plans (or their offshoots) might have been allocated one teacher, 20 square meters of classroom space, and 120 textbooks for each 35 students. Other rules prescribed the number of hospital beds, the ratio of nurses to patients, and so on. In contrast to Western practice, schools and other end-users of public resources did not bid for money through a public budgetary process. The allocations did not depend on local circumstances, though various "need" factors were incorporated into the formulas, and were not based on a review of how well each unit was operating. Service agencies received the prescribed amounts whether they performed well or poorly. One side effect of formula-based allocations was the proliferation of PSUs, because they were entitled to the staff and physical resources indicated by the rules. Nothing was gained by combining PSUs into larger units. In fact, PSUs developed close ties to the communities in which they were situated, and these relationships often were more important than those with the central or provincial government.

Very little cash was allocated to PSUs, for the allocations were of physical resources, principally employees, facilities, and certain supplies. Over time, many PSUs

devised means of augmenting their cash by running “side businesses,” such as renting out the school or selling certain products. The additional money gave PSUs some operating freedom and eased their financial predicament when allocations were insufficient. The large number of PSUs, their ties to local governments, and geographical distance from the center, all contributed to the development of PSU operating discretion.

Viewed in this light, PSUs were very different from administrative agencies in Western countries. They were regimented, not self-governed, units. They were formally controlled, though many had substantial informal freedom. They had little incentive to be efficient because resources were determined by uniform rules, which did not take into account performance. The physical resources given to PSUs were free goods, they were not exchangeable with other resources, and were not paid for out of a pool of money. In a planned economy, it was deemed costless to overstaff PSUs.

There is another side to the PSU story that has complicated the task of restructuring them. The government allocated physical resources because it had an immature tax system that produced much less revenue than is common in Western countries. China’s centrally planned economy had a large public sector (relative to the overall economy and to countries at a comparable stage of development), but little of it was financed through tax revenue. Moreover, some taxes were collected by the provinces, with a portion of the money remitted to the central government. In dismantling the planned economy and reforming the public sector, China faced three difficult challenges: to establish a modern tax system, to forge a fair, workable relationship with provinces and other sub-national governments, and to improve efficiency in the delivery of public services. The three challenges are intertwined, and all pivot on relations between the center and provinces. China has been grappling with these issues for approximately two decades, and has not yet found a stable division of money and responsibility among the various levels of government. The PSU issue involves the tax system, intergovernmental relations, and the delivery of services. Resolving only one or two of these issues will not bring closure to China’s PSU problem.

The fundamental issue, then, pertains to the boundaries of the state and the division of authority and resources between the center and subnational governments. Efforts to resolve the boundary problem by shrinking the state or by ignoring center-local relationships have a meager chance of success. The reform of PSUs entails nothing less than defining the role of the modern state and providing it with financial and managerial resources to govern effectively.

When the Government of China dismantled central planning, it did not take down the structures that central planners had created. For this paper, the most relevant structures are the million-plus PSUs that reach into every community. It could not discard these entities because they are responsible for most of the services received from government. Nevertheless, GOC has severe, ongoing difficulty in financing these entities and the services they provide. For one thing, GOC still is dependent on the provinces for collecting some major taxes. In fact, the share of tax revenue going to the central

government has declined over the past decade. At the same time, pressure to improve public services has impelled GOC to impose unfunded mandates on provinces and subnational governments. As a consequence, a declining portion of PSU revenue comes from the central budget; a rising portion derives from self-generated activities. GOC does a weak job collecting taxes and has little say in how PSUs operate. However, it does have a large voice in policy pronouncements that tend to add to the financial stresses of government.

China's reform strategy makes sense if the issue is defined solely in financial terms, without taking into account the social services provided by PSUs. The strategy has two main prongs: one is to commercialize those PSUs, which have marketable goods and services. Many science and technology PSUs fall into this category, and some have already been disbanded, converted into firms, or restructured as state enterprises. But even if all such entities were privatized or transformed into state enterprises, China still will have hundreds of thousands of PSUs that carry out public activities and are not appropriate candidates for marketization. This has led to the second prong of reform, which is to encourage PSUs to charge for services, thereby reducing their dependence on public budgets. In contrast to the first strategy, these will remain public units, but they will operate in a business-like manner, pruning payroll if income is insufficient to cover expenses and seeking opportunities to generate income-producing services. This strategy has penetrated the education and health sectors, both of which have experienced a decline in the portion of their budgets covered by public funds. We have been told that some hospitals receive as little of five percent of total revenue in direct subvention from government; the rest is earned through various fees for services. This trend has bred a great deal of covert cross-subsidization. For example, the typical hospital loses money on routine medical care, but makes up the deficit by dispensing drugs. The arrangement gives hospitals a strong incentive to over-prescribe drugs and to seek out patients who can pay for services. Local schools have similarly distorted incentives, for their financial condition improves if they take in more fee-paying students.

If financial pressure were sustained, China would have fewer PSUs, the public sector would shrink, many costs would be shifted from taxpayers to customers, and, at least in the short term, the Government's finances would be on a sounder basis. But it is also likely that venturesome PSUs would take financial risks by creating joint ventures, seeking private capital, and taking steps to explain their activities so as to capture a larger share of the market, introduce new technologies, and take other steps.

THE STATE AND THE MARKET. It is understandable that GOC regards the market as an efficient alternative to the state for financing and delivering public services. For one thing, marketizing commercial activities has greatly enhanced the material wellbeing of the country within an extraordinarily short period of time; for another, reliance on markets would ease pressure on government finances. Markets would give citizens choice in purchasing services, and PSUs (or their successors) incentive to operate more efficiently. Marketization would be compatible with encouraging voluntary groups to form and serve those who lack income to pay for services, and it would permit a residual

role for government in financing certain services.

The notion that markets and the state are alternative forms of socioeconomic organization seems sensible. One provides services through collective choice, the other through individual choice. One is a voluntary exchange; the other is prescribed by law. One is financed by taxes extracted from citizens and firms, the other by transactions between willing buyers and sellers. It is easy to conclude that where the state thrives markets wither, and that for markets to flourish, the state must have a minimalist role. However, this conclusion flies in the face of Western experience. In the West, development during the past century has been fueled by massive increases in the scale of both the market sector and the public sector. Rather than one institution being a substitute for the other, both have thrived. In fact, a strong argument can be made that one could not have grown so large and powerful without support from the other.

A few key statistics show that the development which characterized Western economies during the past century was accompanied by both state and market growth. The sustained growth rate is unprecedented in world history, and it has brought material wellbeing to the citizens of these countries that could not even be imagined a century ago. According to estimates compiled by Angus Maddison for the OECD, real GDP was 10 times larger in 12 Western European countries in 2000, than it had been a century earlier.¹ Growth was even greater in four other Western countries (Australia, Canada, New Zealand and the United States): real GDP in these countries was 26 times greater at the close of the 20th century than it had been at the start.² Of course, much of the GDP growth was due to population increases and enlargement of the labor force, yet, even adjusting for population change, economic output soared during the century. Real per capita GDP was approximately six times greater in the 12 European highly developed countries in 2000 than it had been a century earlier, and almost 7 times greater than the four other Western Countries.³ The comparable growth rate was barely half this level in seven East European countries. Tables 1 and 2 provide detailed estimates for particular countries; Table 3 provides summary data for certain regions and types of countries.

From the vantage point of 1900, not only was massive economic growth not foreseen, neither was the enormous expansion of the state. If one had envisioned market growth a century ago, the facile assumption would have been that the state would become smaller, if not in absolute terms, at least relative to the overall economy. Of course, from the perspective of the 21st century, we know that exactly the opposite occurred.

¹ Angus Maddison, *The World Economy: Historical Statistics*, Table 1b. The 12 countries are Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom.

² *Ibid*, Table 2b.

³ *Ibid*, Tables 1c and 2c.

According to Maddison, total government spending in six advanced countries (France, Germany, Japan, Netherlands, the United Kingdom, and the United States) average only 11.7 percent of GDP in 1913, but 42.0 percent in 1999.⁴ When one considers that this was a period of economic growth, the expansion in government is truly extraordinary. Data assembled by Tanzi and Schuknecht (as presented in Table 4) differ slightly from Maddison's, but tell a similar story. They show that general government expenditure in 13 developed countries escalated from about 13 percent of GDP in 1913 to 45 percent in 1996.⁵ Most of the public sector growth has been concentrated in social programs, particularly income transfers, but most all government activities are now significantly larger than they were a century ago.

Table 5 decomposes expenditure trends by sector. It shows that spending on defense and investment peaked in the pre-World War II period and has trended downward since then. However, spending has soared in all the social sectors reported here. Public expenditure on health was a miniscule 0.3 percent of GDP in 1913, but now exceeds 6 percent. Education spending has followed a similar course, rising from 1.3 percent of GDP to 6.1 percent. The growth rate has been even greater for pensions, which were only 0.4 percent of GDP early in the last century, but now are close to 10 percent.

The data show a fundamental transformation in the role of the state in Western countries. Where the State once had "watchman" responsibilities – protecting against outside threat, maintaining law and order, and carrying out housekeeping services – nowadays, the state is defined in terms of the financial security it provides individuals and the life opportunities it provides them through enhanced education and health services. This transformation has begun to move eastward, but it is not as yet fully embraced in Asia, especially in societies which are anchored in Confucian values of family responsibility. In the high spending welfare states of Northern Europe, government has supplanted the family as the protector of the individual against financial adversity; it is not certain at this point that various Asian countries will move as sharply in this direction.

The enlarged state required significantly more public revenue to pay for income support schemes and enhanced public services. Table 6 shows revenue trends in 13 industrial countries. In every country, revenue was a much higher proportion of GDP near the end of the 20th century than it was early in the century. Some of the increases are truly astounding. Government revenue in Sweden soared almost tenfold, from 6.7 percent of GDP at the eve of World War I to more than 60 percent near century's end. The rise was not as steep in other countries, but everywhere public revenue was much greater than it once had been.

To generate such a vast amount of revenue, Western countries modernized their

⁴ Angus Maddison, The World Economy: A Millennial Perspective (OECD, 2001) Table 3-9.

⁵ Vito Tanzi and Ludger Schuknecht, Public Spending in the 10th Century, Cambridge University Press, 2000, Table 1.1

tax systems. European countries generally shifted to consumption taxes, while the United States relied principally on income taxes. But regardless of the form of taxation, governments had to achieve a much higher degree of efficiency in revenue collection, and they also had to persuade voters that taxes were reasonably fair and that the services provided by government were worth the cost. Without these conditions, democratic governments could not sustain a high revenue regime.

The concurrent growth of the market and government is no longer regarded as happenstance. It has long been recognized that a strong state is essential to underpin markets by protecting property rights, enforcing contracts, providing legal due process, and establishing conditions that encourage capital flows and other transactions. But recent economic analysis goes beyond these basic watchman functions of the state to link economic performance and the social role of the state. One of the most powerful arguments was published in a 2004 book, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century* by Peter H. Lindert. Basing his findings on a wealth of data from developed countries, Lindert concludes that the growth of government has not degraded economic performance. Two of his provocative findings are relevant for countries at the cusp of development:

The net national costs of social transfers, and the taxes that finance them, are essentially zero.... No Darwinian mechanism has punished the bigger spenders.⁶

and

Two general principles seem to explain why the welfare state does no net damage to GDP per capita and why welfare states will not collapse. The first is that high budget democracies show more care in choosing the design of taxes and transfers so as to avoid compromising growth. The second is that broad universalism in taxes and entitlements fosters growth better than low budget countries' preference for strict means testing and complicated tax compromises.⁷

There are many explanations of the congruence of state and economic growth. The one that I find most persuasive pertains to the role of both markets and the state in empowering the individual, the state by bequeathing individuals with rights and sheltering them against critical adversities, the market by giving them choice and opportunity. In all developed countries, the state and the market also are rivals for the sentiments of individuals, and the boundaries between them are unsettled and go through continuous adjustment. In all developed countries, some social services, such as primary education and health services are financed or provided through market activity, but most are

⁶ Peter H. Lindert, *Growing Public: Social Spending and Economic Growth Since the Eighteenth Century*, Cambridge University Press, 2004, p. 21.

⁷ *Ibid.*

provided or financed through governmental organs and programs. Developed countries differ greatly in the extent to which various services are provided by voluntary organizations. All have a voluntary sector, composed of community groups or groups affiliated with a religious movement. As important as they are, the aggregate activity of voluntary groups pales by comparison with that of the state. A fair conclusion is that these groups have a niche role, reaching to some constituencies not adequately served, but that they do not substitute for the state. Some governments have an important role in promoting the voluntary sector through direct subventions or tax subsidies, but for the most part these groups form because like-minded people are motivated to act in the collective interest.

CHINA'S UNIQUE SITUATION. All Western countries have followed a similar development path, though they differ in the relative size of the state and market, and in the role of the public sector. But China (and some other transitional countries) are likely to take a different course. In contrast to Western countries, which had a small state when markets were under-developed, China already has a large state that is laden with PSUs and other carryovers from a planned economy. China does not have the option of growing the state in tandem with developing the market. Moreover, the composition and financing of China's large state sector differs from that of Western countries in two important matters. First, China has a weak tax base, making it difficult to finance the state; second, its social sector is relatively undeveloped, especially as regards income support and transfers. China cannot deal with inadequacies in social services and support unless it first comes to grips with the financing of the state.

The course favored by China has been influenced not only by the success of market-opening initiatives, but also by a critical shift in Western sentiment away from growing the state to relying more on markets. About the time that China launched its historic switch from a planned to a market economy (in the early 1980s); growth of the state sector in OECD countries had come to a virtual halt. In most OECD countries, the public sector is approximately the same share of GDP today as it was two or so decades ago.⁸ There is a pervasive sense that the state is about as big as it should be or too big. In some (if not most) OECD countries, this shift has been marked by greater reliance on public-private partnerships, outsourcing, privatization, fees for public services, and other arrangements that have bolstered the market's role in public services. It is hard to gauge the extent to which this trend has influenced Chinese policy, but it is probable that China's course of development would have been different if it had been initiated during a period of rapid state growth in the West.

In defining its own path, China is seeking to create a new type of non-profit, market-oriented entity that is uncommon in the West. It is hoped that these hybrids will fuse the efficiency of markets with public-oriented norms of the state and the voluntary sector. While this combination does occur in Western countries, it is relatively rare, for as

⁸ OECD, Historical Statistics, Table 6.8.

Table 7 shows, the three types of social institutions (the state, markets, and voluntary associations) differ in the services they provide, the beneficiaries and norms of service, and financing. China will be breaking new ground if it succeeds in large-scale establishment of these hybrids as substitutes for social service PSUs. If China succeeds, the West will learn a great deal from its innovations.

II. MANAGING THE STATE

In the West, growth of the state was fueled by the maturation of public administration, that is, by the widespread acceptance and application of various norms and practices that gave the enlarged state legitimacy and enabled it to operate at an acceptable level of efficiency. In this regard, too, the PSUs differ from Western experience.

For governments to be 20-40 times larger in 2000 than they were a century earlier, it was necessary that they modernize public administration. Key steps were the introduction of meritocratic civil service systems, in which public employees were recruited, paid and promoted based on uniform rules and criteria. Civil service systems replaced the cronyism, patronage and clientilism that had been breeding grounds for corruption, and enabled the modern state to carry out greatly enlarged responsibilities in an effective manner. The enlarged state also required modern budget systems, which provided for each administrative entity to bid annually for resources, to have its bid and activities reviewed by central authorities, and to control the amount it spent each year. Budget capacity enabled the state to grow within its financial means, and for the demands of spending units to be disciplined by the resources available to government. Budgeting and related financial management systems also bred adherence to controls and compliance with rules, and reinforced the hierarchical structure of modern public administration. Schools, hospitals, and the many other field units providing public services operated with a degree of uniformity that probably exceeded that in centrally managed economies.

The budget also served as an engine of government expansion, as new programs were funded or existing ones expanded in response to demands from spending agencies, legislators, or interest groups. During the early growth period, in the 19th century, the typical practice in most developed countries was to entrust the expanding roster of governmental responsibilities to new agencies. The result, of course, was a proliferation of freestanding agencies, each with its particular organizational structure and activities. But these arrangements were justified by the prevailing doctrine that public administration is more efficient when it is walled off from political influence. However, as government expansion accelerated, the large number of agencies spawned several serious problems. (1) Government had an over-extended span of control; (2) the activities of many agencies were not effectively coordinated, even when they operated in the same sector or had similar or interdependent objectives; and (3) the numerous agencies lacked uniform procedures for handling common administrative tasks such as

purchasing goods and services, managing their finances, and recruiting employees.

Span of control, the first of these deficiencies refers to the number of entities (or subordinates) for which a government leader is responsible. It came to be accepted that administrative oversight is ineffective if the span of control is too broad. The proliferation of agencies significantly widened the span of control and made it difficult for political leaders and senior managers to supervise government activities. Agencies had excessive freedom because those at the center of government could not oversee so many of them. Coordination was obstructed by the number of agencies dealing with similar or overlapping matters, each with its own organizational culture and sphere of operation. Finally, agencies tended to set their own administrative rules and practices, especially in areas that cut across all of government, such as procurement, civil service and financial management.

These problems gave rise in the late 19th and early 20th century to a counter-movement, that merged previously separate entities into functionally integrated departments, such as agriculture, transport, education and health. When it departmentalized, a government combined dozens or hundreds of separate agencies into 15-20 large organizations. In some cases, agencies retained distinct identities as bureaus within departments; in other cases, they were reorganized out of existence. In all cases, administrative authority was transferred from independent units to departmental headquarters.

Functional integration normally was accompanied by several other reforms, as noted above, that promoted administrative efficiency, such as a merit-based civil service, standardized accounts, a comprehensive budget system, and centralized procurement of goods and services. The common element in these reforms is that they brought uniformity and integration to the operation of government. An inevitable side effect was to curtail the managerial freedom of administrative subunits.

Functional integration of government was paralleled and strongly influenced by vertical integration in business organizations. Vertical integration internalizes within the firm the production and assembly of the various components that go into the final product; functional integration internalizes within the department the various activities contributing to the same objective. For example, a vertically integrated automobile firm produces the engine, chassis, brakes and many other components that are assembled into cars; a functionally integrated department combines air, rail, roads, and other means of movement into a transport ministry.

Functional integration places policy makers and service providers in the same ministry or department. Typically, policy makers are at the top of the chain of command, service providers near or at the bottom. It was assumed that rules and policies would flow downward, information would move upward. Subordinates would do the bidding of superiors, and services would be provided according to the established policies of

government. In the heyday of functional integration, during approximately the first three-quarters of the past century, this elongated, hierarchical chain of command was regarded as highly efficient because it narrowed the span of control (especially at the top), eased coordination by having related activities performed in the same organization, and gave political leaders, managers, and service providers shared values and perspectives. Functional integration also was thought to reduce administrative costs and friction, facilitate oversight by headquarters staff, reduce the number of managers reporting to political leaders, and promote uniformity in the provision of goods and services. Recently, however, some governments that have created autonomous agencies have viewed functional integration as inefficient because it values compliance over performance and uniformity over initiative. But, for the better part of a century, functional departmentalization held sway. There were a few notable exceptions, such as Sweden, which long ago organized public administration along agency lines, and maintained small departments that have responsibility for policy, but do not themselves operate programs or deliver services.

In functionally integrated departments, policy and administrative functions are joined in the same organization, yet they are also separated. One form of separation is political, with ministerial and senior sub-ministerial posts held by elected persons or political appointees, with the managerial ranks staffed by career officials. In some countries, political operatives are found only at the very highest levels, such as the minister and secretary of state; all subordinate positions, including director generals, are held by career persons. The British model follows this pattern, with the permanent secretary (who is a career official) serving as a bridge between political and managerial realms. In other countries, political appointees may reach three or four echelons down into the bureaucracy, and few important matters are resolved by careerists. The boundary between political and managerial depends on country-specific characteristics, such as history, tradition, culture, and law.

Though they are atop functionally integrated departments, political leaders are constrained by procedural rules governing virtually all administrative routines. Rules specify how civil service positions are to be filled, travel authorized, space leased, contracts executed, and so on, to ensure that public administration is a politics-free zone. However, the actual effect of these rules depends as much on behavioral norms as on legal constraints. Within each country's political-administrative culture, there are informal understandings of the real boundaries, how they are enforced, when and how politicians may intervene in administrative affairs, how contact between the two spheres is handled. In all countries, the wall between politics and administration is breached; is some rarely, in others, it is hardly maintained at all.

To realize the full benefits of functional integration, it does not suffice that politics and administration be separated; they also must be linked. In design, the relationship is supposed to work fluidly by having policy guidance and procedural rules flow downward, and information on activities and results flow upward. Policymakers would tell administrators what to do (and not to do), and would provide the financial and

organizational resources needed to carry out assigned tasks, while administrators would report on what they have done and how they have complied with the policies and rules handed them. Audits would check the reliability and accuracy of reported information, and evaluations would assess the accomplishments of programs. In this ideal world, administration would be free of politics, but driven by policy.

In reality, the relationship between politics and administration in a functionally integrated structure is more interdependent and less hierarchical. Administrators frequently advise on policy and politicians often dictate how authorized activities are to be managed. When interaction is ongoing and close, it is likely to generate both friction and cooperation. Politicians and managers fight on some matters and agree on others, and there are zones of indifference – matters on which some prevail because they have a strong interest and others do not – which enable the two cultures to coexist in relative harmony. Formally, political leaders have the upper hand when interests collide; in fact, administrators often have the advantage because they can withhold or manipulate information, thereby undermining or capturing their political masters.

FROM INTEGRATED DEPARTMENTS TO INDEPENDENT AGENCIES. Even during the prime of functional integration, most governments had an assortment of agencies that operated outside the departmental structure. Some agencies had legal or regulatory functions; others had strong political supporters who protected them against integration. Some just did not fit well within the departmental structure; others were given independence to invest their work with high priority. Yet, despite the messiness of these agencies, the bulk of national government activities were carried out within departments.

During the last decades of the 20th century, however, a number of countries moved away from the departmental model for the delivery of public services. The most influential move was taken by the United Kingdom, which launched its “Next Steps” reform in the late 1980s, creating approximately 140 executive agencies, which are responsible for operating most public services and employ three-quarters of the central government’s civil servants. Agencies have been created in advanced countries (e.g., the Netherlands), transitional countries (e.g., Latvia), emerging market countries (e.g., Singapore), and in quite a few underdeveloped countries.

This movement has come to be known as “agencification.” In contrast to the occasional practice during the era of functional integration, when individual agencies were established for their own purposes, agencification is a movement that aims to restructure and transform the administrative machinery of government so as to improve efficiency, quality, access, and responsiveness in the provision of public services. Although the creation of agencies has received much notice in contemporary public management, it must be noted that (1) the movement still is concentrated in a small number of countries. Germany, Japan, France, the United States, and other countries have not moved to the agency model.

The countries that have agencified have done so for various reasons. Sweden, as already noted, has a long tradition of agency-based public management on the ground that administrative actions should be neutral and free of political influence. New Zealand decoupled policy from services and operations because of concern that policy makers were captured by service providers. The United Kingdom acted for the opposite reason, concern that policy makers were ignoring service delivery.

Underlying the different rationales is a conviction that emerged in the late 20th century that large, integrated organizations are inefficient. Just as vertical integration is no longer regarded as an unalloyed virtue in the business sector; functional integration is increasingly viewed as a liability in government. In both the business and public sectors, outsourcing has become more prevalent in recent decades, as has the breaking up of integrated entities into relatively small, quasi-autonomous units. In government, this form of organization is associated with new public management (NPM), an approach that has gained support mostly in British Commonwealth and Scandinavian countries. NPM proponents argue that the efficiency and quality of public services improve when managers are given operating discretion and are held accountable for results. Discretion and accountability tend to be weak in integrated organizations, which operate through command and control mechanisms and diffuse responsibility through multiple layers of hierarchy and multiple, often conflicting, objectives. Entrusting operational independence to agencies is only one of NPM's innovations, but it has received the most attention because it runs counter to the century-long practice of integrating public services in large departments.

The case for independent management rests on a series of arguments of which the following are most often voiced.

- Trends in Business practice. Ideas and practice developed in the business sector often migrate to government. Just as functional integration in government was influenced by vertical integration in firms, outsourcing and devolved management in business has spurred some governments to adopt similar practices.
- Opportunistic agents. Hierarchies are organized on the premise that subordinates carry out the instructions given by superiors. Institutional economists argue, however, that information asymmetries – agents know more about what they are doing than their bosses – enable agents to behave opportunistically, promoting their self-interest rather than that of the organization. This opportunism increases as bureaucracies become more layered and take on multiple tasks.
- Bureaucratic Inefficiency. Hierarchical, centrally managed organizations tend to lack initiative, are slow to respond to changing conditions, and often are unresponsive to those they serve. These organizations favor uniformity and

compliance over performance and results. They bear heavy dead-weight costs of maintaining and enforcing centrally imposed controls.

- Lack of Managerial Capacity. Integrated organizations inhibit managers from applying their professional skill, experience and judgment to improve performance. Managers are recruited and promoted because they follow rules, not because they take initiative.
- Weak Accountability. Integrated organizations, which, by definition, have a large, diverse portfolio of responsibilities, generally have weak accountability. When they are doing many things, it is hard to pin down exactly how well they are doing.

In sum, the arguments for breaking up large organizations into discrete units rests on the expectation that

- performance improves when: managers are given clear signals as to what is expected of them and results are measured against these expectations;
- performance improves when each entity has a specific mission and is made responsible for specified activities;
- performance improves when managers have flexibility in carrying out assigned responsibilities;
- performance improves when the provision of services is organizationally decoupled from policy advice;
- performance improves when operational authority is devolved from headquarters and central agencies to regional or local authorities;
- performance improves when program and resource decisions are based on outputs and outcomes, rather than on inputs and procedures; and
- performance improves when managers are accountable for costs and results.

Proponents of the agency model argue that these performance-enhancing qualities should impel governments to favor agency rather than integrated forms of organization.

MANAGERIAL VERSUS MARKET-BASED AGENCIES. The agency model has branched off in two directions, one emphasizing market-type mechanisms such as competition, prices, and formal contracts, the other relying more on the capacity and public service ethic of managers. To clarify the two approaches, it may be convenient to label the first “marketization” and the second “managerialism.” The first is often identified with the New Zealand approach to public sector reform, the second with Britain’s modernization efforts. Both approaches seek to decouple policy from operations by establishing quasi-autonomous agencies, but they do so for different reasons and go about the process in different ways. In practice, governments tend to have elements of both models, though to varying degrees. Nevertheless, it is useful to

distinguish market and manager-based models because their differences are relevant to the question of whether and how government should be organized around departments or agencies.

Marketization is rooted in basic ideas of institutional economics, which views the relationship of politicians and managers in principal-agent terms. An agent is any person who is supposed to carry out tasks, policies or instructions prescribed by another person. A person may be an agent in one relationship and a principal in another. For example, a senior manager is an agent in relation to elected leaders and a principal in relation to junior managers.

By definition, a principal is superior to an agent. Institutional economists argue, however, that in practice, principals often are “captured” by their agents. They draw this conclusion from two assumptions: (1) Agents are self-interested persons who opportunistically exploit the relationship to get their way; and (2) agents can pursue their self-interest by withholding or manipulating the information needed by principals to supervise their performance. This information asymmetry gives agents many opportunities to shape the outlook, expectations, and policies of their superiors. The Permanent Secretary in the popular British books and television program “Yes, Minister” is an entertaining example of this relationship.

The agency problem is at the intellectual roots of the movement away from integrated organizations. According to this view, the principal-agency problem is unavoidable in integrated firms and departments. In vertically integrated firms, the corporation purchases all the output of its divisions at fixed or negotiated prices. Because the price is not set by market competition, it may be too high, in which case the firm will be an inefficient producer; or too low, in which case subordinate units might be unable to produce the required output. There is a conflict of interest inherent within the firm, for corporate managers (the principals) want a low price and production managers (the agents) prefer a high price. In negotiating prices, the advantage lies with the production division because it controls critical information on costs, production rates, output per worker, and other relevant variables.

This illustrates why vertical integration has been discredited in some circles and is being replaced by outsourcing. Contracting out establishes, it is hoped, a competitive, arms-length relationship between a firm and its suppliers. The price is set by the market, not by opportunistic agents.

Institutional economists see a parallel situation in functionally integrated departments. Policy makers at the top of government are captured by service providers who determine the cost of outputs and require the government to cover the costs in the budget. Moreover, they control much of the information that shapes policy and (it is argued) thwart efforts by political leaders to change the way the organization operates. Separating policy functions at the ministerial (or senior departmental) level from service

or operational levels has the same logic as outsourcing. It purports to enable policy makers to establish an arms-length relationship with suppliers, and to have alternative sources of both outputs and advice. This was the explicit rationale for decoupling services from policy in New Zealand and (less explicitly) it influenced British reforms.

Managerialists come to the same conclusion about integrated organizations, but from opposite premises. They view managers and career civil servants as persons who have an interest in performing well, but have been blocked by rigid rules and a culture that values compliance more than results. Rather than being concerned that agents will capture principals, the concern is that principals will suppress agents, deterring them from effectively managing their organizations. For managers to produce robust results, it does not suffice to ease some of the central, ex ante controls that restrict them, for they still will lack the freedom and motivation to apply their skills and judgment. What is required is extensive freedom that empowers them to be productive managers of public resources. One way of giving managers the essential freedom to operate is to transfer responsibility for particular services to quasi-autonomous agencies that are outside the departmental structure.

Not only do the market and managerial approaches come to similar conclusions on the advantages of agencies, they also converge on some of the key instruments suitable for improving agency performance. These include performance targets and reports, employment contracts and term appointments for senior managers, and audited financial and performance reports. The main difference between the two is in reliance on competition to select suppliers and to set prices.

HOW AGENCIES ARE ESTABLISHED. Given agencies freedom is easy; getting them to perform is much more difficult. It is essential to keep in mind that agencies do not have freedom to disregard government policies or rules, to spend money on unauthorized purposes, or to act against the public interest. The term used in this paper to describe the status of agencies is “quasi-autonomous”; this is a clumsy, vague phrase that combines freedom to operate with responsibility to higher authorities. No national government could be truly accountable to citizens if independent agencies did what they wanted. The key to a successful agency strategy is to balance operational freedom and accountability. This balance has to be forged before agencies are established and maintained when they operate. In countries that have well performing agencies, this balance is defined and monitored by the department to which each agency is responsible, by central agencies (such as the finance ministry) or by both.

It is essential that each agency be made the clear responsibility of a department or ministry and that the relationship between these organizations is specified in advance. Equally important, the department (or ministry) must be willing and prepared to oversee the agencies in its jurisdiction. If it is uninterested in this responsibility, agency performance is likely to slip. It is a mistake, therefore, to assume that once agencies are given autonomy the relevant department must withdraw. In fact, the department’s role should be transformed from controlling inputs and delivering services to setting policy

and managing the accountability process. The successful agency-based government depends as much on the performance of the parent departments as on the activities of the agencies themselves. There should be a continuing involvement of the parent department in establishing performance targets, selecting key managers, deciding on resources, and overseeing the fulfillment of government objectives.

Either formally or implicitly, departments have a contractual relationship with their agencies. They have to negotiate resource and budget issues, performance objectives, the framework in which the agency will operate, and more. True, they do not intervene in operational matters, but they still must know enough about the activities of agencies to make sound policy judgments and to take corrective action if matters go awry. It may be difficult to specify the exact division of responsibility between departments and agencies – the line is likely to be drawn differently in each country. Inevitably, however, if activities of agencies become public controversies, ministers or senior managers cannot avoid getting involved.

Central government controllers have been greatly affected by the emergence of agencies. Where the agency model works best, the finance ministry has a lead role in promoting managerial reform and encouraging agencies (and other administrative units) to improve their performance. It must do so without maintaining excessive controls that rob agencies of incentive and opportunity to perform better. Good performance does not just happen in government; it has to be promoted and defined at the center of government. In most countries, the finance ministry (or its budget department) has an ongoing involvement in management, but there is some dispute as to whether its preoccupation with financial matters deters it from giving sufficient attention to operations.

In countries that have purposefully shifted from departments to agencies, the manner in which an agency is launched has a vital bearing on its subsequent performance. The United Kingdom has probably invested more care in establishing agencies than any other country. The process outlined below is quite demanding, and has been replicated in few other countries. However, it is worth reviewing the steps to show what a comprehensive process might look like.

1. The Government identifies candidate agencies. This is a formal step that sets required reviews into motion.
2. The Treasury or Cabinet Office (which has government-wide responsibility for public management) reviews options for carrying out the agency's missions. This "prior options" review may conclude that the activity should be privatized or kept within a department.
3. The Government examines the relationship of the proposed agency and the department to which it is responsible. The key issue here is whether the department is adequately prepared to supervise the agency.

4. The agency and Government negotiate a framework document that specifies the matters on which the agency may exercise discretion, reporting requirements and other operational matters. The framework document serves as the legal or contractual basis for each agency.
5. The Government recruits a chief executive, often from outside the civil service, and gives the person a fixed term contract. The contract specifies performance expectations of the chief executive.
6. The Government decides each agency's budget annually, along with performance targets for the year. This entails much discussion and negotiation between the parent department and agency.
7. Each agency reports annually on its finances and performance targets. In some years, the government publishes performance results against these targets.
8. Periodically (every 3-6 years) each agency is evaluated and the government reconsiders its status and framework.

Behind this sequence of activities is the idea that an agency must be capable of self-management before it is entrusted with public money and responsibility. Self-management means that the agency has reliable internal controls, departments oversee their agencies, and measures are taken to assure transparency and accountability. In Britain, as in most countries that have recently embraced the agency model, there is heightened focus on performance and results. Nevertheless, as valuable as these are, they depend on an agency being able to manage itself.

THE FUNDAMENTAL ROLE OF DEPARTMENTS. This paper has portrayed agencies and departments as rival forms of organization for performing the tasks of government. From this perspective, greater reliance on agencies means less recourse to departments. The success of agencies in the United Kingdom and other countries should, therefore, spell the relative decline of departments and ministries. This, however, is an incomplete view that does not properly recognize the enduring importance of departments in the operation of government.

It is highly relevant that when a firm switches from vertical integration to outsourcing, the corporation does not disappear. Rather, it takes on a different, equally important role in giving the firm strategic direction, guiding and overseeing the various components, and forging them into a productive and profitable enterprise. Similarly, in the government, departments are transformed, not eliminated, when agencies are given operational autonomy. In fact, the British model, which is so often cited as justifying the proliferation of agencies, has another side, which deserves much more attention than it has received in the literature on public management. When the Labour Government took

office in 1997 after 18 consecutive years of Conservative Party rule, it continued the agencies, but gave much more priority to the policy and coordination role of parent departments and central agencies (in particular the Treasury and Cabinet Offices). In effect, it subordinated agencies and the work they perform to the functions and responsibilities of departments.

The Labor Government had an ambitious agenda to modernize British Government. It wanted to improve education and health, two vital areas where Britain had lagged significantly behind other European countries, and was willing to spend more money for these purposes. To accomplish its objectives, the Government needed integration rather than fragmentation, and it needed to join rather than separate operations from policy. After all, the Government would be politically responsible to voters for the performance of schools and hospitals (as well as other public services), and it needed assurance that the additional funds it was providing would be spent on its priorities. This political imperative led it to bolster the role of departments, which are under the Government's purview, at the expense of agency independence.

Within a year after taking office, the Government issued a *Modernizing Government White Paper* that did not even mention independent agencies. Rather than take services out of departments, which was a key objective for creating separate agencies, it made better service the primary measure of departmental performance. The White Paper insisted that departments have a “new focus on delivery – asking every Permanent Secretary to ensure that their department has the capacity to drive through achievement of the key government targets and to take a personal responsibility for ensuring that this happens.”⁹

Excessive administrative autonomy, the new view suggested, gets in the way of policy cohesion and service integration. This theme is strongly implied in *Wiring Up Government*, a manifesto on integrated service delivery issued by the Cabinet Office in 2000.¹⁰ Revealingly subtitled, “*Whitehall's Management of Cross-Cutting Policies and Services*”, this report recommended stronger leadership from Ministers and senior civil servants, as well as a more active role by central agencies (the Prime Minister's Office, Treasury, and Cabinet Offices) “to lead the drive to more effective cross-cutting approaches, wherever they are needed.”¹¹

⁹ Modernizing Government, Cm4310, March 1999, p. 6.

¹⁰ *Wiring It Up*, Prime Minister's Strategy Unit, January 2000, *Wiring It Up* examined how current accountability arrangements and incentive systems can be reformed to facilitate joined-up policy-making and delivery, for example by promoting achievement of joint objectives which require co-operation between departments. For the full report, go to <http://www.strategy.gov.uk/files/pdf/coiwire.pdf>.

¹¹ A summary of the report and its outcomes can be found in the *Making a Difference report* (updated annually). <http://www.strategy.gov.uk/files/pdf/impactspdf.pdf>

While Britain's agency model promoted the breakup of the civil service into separate organizational enclaves, each with its own salary structure and work arrangements, *Wiring Up Government* demanded that public employees work across organizational boundaries because key governmental objectives, such as improving educational performance and reducing poverty, depend on the coordinated effort of many public organizations.

To promote its integrated strategy, the British Government retained the independent agencies, but issued new instructions for assessing their effectiveness to "to ensure that the right structures for these bodies are put in place, so that they deliver the Government's agenda effectively, and work in an efficient and integrated way." Moreover, periodic evaluations should take account that "agencies do not exist in isolation from the rest of Government, and so greater emphasis will be placed on considering the performance of agencies in the context of their contributions to wider Departmental and Governmental objectives."¹²

Many of these objectives have been articulated in an important innovation of the Labor Government. The Government's expenditure review process has been expanded into means by which departments negotiate formal, published agreements on exactly what they will accomplish in the next three years. These public service agreements (PSAs), which are agreed by the Treasury, link resources and results by specifying the targets each agency commits itself to achieve. For example, the PSAs for 2001-2004, set out approximately 160 specific performance milestones. These are regarded by the Government as "transparent commitments which the Government can be held accountable for, and all departments will report on every year"¹³ As in other recent British managerial innovations, PSAs have redefined the role of agencies in terms of contributing to departmental – rather than their own – performance. Pursuant to this departments also publish service delivery agreements (SDAs) that specify the concrete actions they will take to improve services. SDAs inherently deal with the things agencies are responsible for. Yet, according to official guidelines, "some agencies will be involved directly with these SDAs. However, in many cases, high level performance targets will be cascaded to agencies to fulfill their attainment."¹⁴ In other words, the responsibility of agencies in the current top-down process is not to define their own targets, but to take the actions needed to achieve departmental objectives.

From a strictly legal point of view, little has been changed. Departments are still accountable for policy guidance, coordination, and service results; and agencies are still accountable for their operations. However, the fact that departmental performance is emphasized inevitably eats into agency autonomy. Agencies must do their department's bidding, even if it means doing things the department's way, rather than their own.

¹² Executive Agencies 1999 Report, p. 10

¹³ *2000 Spending Review: Public Services Agreements*, Cm 4808, "Introduction."

¹⁴ Executive Agencies 1999 Report, p. 10

Nowadays, departments and agencies coexist in Britain. While the British experience has some distinctive features that arise out of the country's long political tradition, in fact, agencies were established by government decision, not by legislation, so changing their status (or even abolishing them) does not require new law. But as special as the British case is, it holds an important lesson for China and other countries that have or are considering agencies. Although departments and agencies have been rival forms of government organization, in contemporary times, they are likely to coexist. A government that relies on agencies to provide services to all its citizens must have strong, effective, vigilant departments. If, as likely, China retains PSUs for key public services, it will have to strengthen central and provincial departments to assure that government priorities and policies dictate the actions of PSUs, especially their use of public resources. Indeed, the more that a country relies on agencies, the greater will its investment in upgrading departmental monitoring capacity be.

NEW ZEALAND: GOVERNMENT BY CONTRACT. At about the same time as the UK as moving to establish independent agencies, New Zealand was modernizing its public management by separating the policy functions of government from the delivery of services, and linking these two fundamental roles through a network of contracts. Although it is as small as China is big, New Zealand offers some relevant lessons regarding the place of independent administrative organizations in contemporary public management. In fact the "New Zealand model" has been one of the strongest influences on new public management, especially with regard to using internal contracts within government to link policy and operations and to bolster accountability for public performance. Although few countries have adopted the full New Zealand model – Mongolia is reputed to be one of the countries that has – parts of its approach have been applied elsewhere.

Because it aimed for a complete restructuring of government, New Zealand acted via legislation. Two key laws were the State Sector Act (1988)¹⁵ which replaced permanent department heads with chief executives recruited on a competitive basis and employed under fixed term contracts for up to five years, and the Public Finance Act (1989)¹⁶ which transformed the annual budget the appropriations from inputs (salaries, supplies, travel expenses, etc.) to outputs (the goods and services produced by government entities). The first law gave chief executives virtually complete authority in running their departments, including the power to set wages and most working conditions; the second sought to make the budget and related documents into implicit contracts for

¹⁵ Effective 1 April 1988, The State Sector Act: An Act (a) to ensure that employees in the State service are imbued with the spirit of service to the community”
http://www.legislation.govt.nz/browse_vw.asp?content-set=pal_statutes

¹⁶ Effective 1 July 1989, The Public Finance Act 1989: An act to amend the law governing the use of public finance resources and to that end to, (a) provide a framework for Parliamentary scrutiny of the Government's management of the Crown's assets and liabilities, including expenditure proposals, ...”
http://www.legislation.govt.nz/browse_vw.asp?content-set=pal_statutes

performing specified tasks. The combined effect of these and other New Zealand reforms has been to separate the policy role of Ministers from the operational responsibilities of chief executives and other managers. Essentially, the New Zealand government was split into two separate compartments: the political realm which controls resources and sets policy; and the managerial realm which operates government departments and programs.

From this perspective, New Zealand's restructured departments, like the UK's independent agencies are empowered, self managed organizations that operate pursuant to policies and resources supplied by government. The parallel is not fully warranted, however, because Britain's agencies have sharply defined missions, while most New Zealand departments have a portfolio of somewhat diverse responsibilities. New Zealand has fewer than 40 departments, less than one-third the number of British agencies. But New Zealand also has a large number of Crown entities – such as regulatory boards that are outside the departmental structure. For example, each public school is a separate entity, with its own board of directors and some operating freedom. Crown entities also run the nation's health care system that consumes a big part of the national budget. The role, structure and responsibility of these entities has generally been less defined and more troublesome than that of the regular departments.

The New Zealand model relies on a web of personal and organizational contracts. One key contract is a “purchase agreement” that is negotiated between a chief executive and the Minister responsible for the Department. It specifies the resources to be made available during the year and the outputs to be produced. A “performance agreement” between the State Services Commission (representing the Government) and each departmental chief executive specifies the key results expected during the year. There also are individual employment contracts for senior and middle managers, “statements of intent” prepared each year by Crown entities, and other contract-like arrangements. These contracts combine two features that may be of interest to China: (1) They give managers broad operational discretion in using resources and running their organizations; and (2) they establish the basis for holding managers accountable for their use of resources and the results produced. Operational independence is thus fused together with managerial accountability.

Can a government legitimately contract with itself? It is a basic tenet of law that a party cannot contract with itself. The parties to a contract have to be independent of one another; they must have an arms-length relationship, so that each is free to represent its own interests. In New Zealand, the following extraordinary steps have taken to establish conditions needed to negotiate and execute contracts within government.

- (1) Ministers and departments have been separated so that policy advice and operations are entrusted to independent entities. For example, New Zealand split the Ministry of Defense into two entities: the ministry which supplies policy advice to government; and New Zealand Defense Forces which operate military programs.

- (2) Appropriations are made to the Minister who has complete freedom to purchase services from within or outside government. In theory, all services are contestable. The Minister does not have to obtain them from the Government's own departments.
- (3) The chief executive has almost complete freedom in running the department, and has the freedom to negotiate the "prices" to be charged for the services it supplies to government.
- (4) The budget and associated documents, along with purchase agreements (mentioned earlier) specify the outputs to be "sold" to government by inside or outside suppliers.
- (5) Each department publishes an annual report of the outputs it has produced, and its use of financial resources.
- (6) The financial results and substantive performance are audited by an independent authority.

Despite these arrangements, it is appropriate to question whether the relationship between policy makers and departments is truly arms-length. Are the political and managerial realms sufficiently independent from one another that it is legitimate to regard these as genuine contracts? After all, it makes little sense to use to use contracts if the parties to the agreement do not have a realistic option of purchasing from alternative suppliers. For example, if the Ministry of Education must rely on public schools for teaching children, writing a contract that sets the price and output targets for schools will not do much to improve either performance or the Government's capacity to influence educational results. There is a big difference between theoretical and actual contestability (competition) in the provision of public services. It is one thing for Ministers to have the legal right to select alternative suppliers, quite another for them to go outside government for basic services. In fact, ministers still purchase most services from their own departments.

The main problem with these contracts is that although the government's purchasers (ministers) and providers (departments and Crown entities) may be organizationally and legally separate, they are locked into an interdependent relationship where each side is pressured to defer to the other side's interests. For one thing, the Minister and the Government bear much of the political cost if a department fails to perform according to the terms of the contract. To be specific, if schools do a poor job teaching children, politicians are likely to be blamed for the failure and it may be pressured to spend more rather than less on non-performing schools.

In contrast to contracts executed in real markets, government has little recourse for failure to perform. It does not gain much leverage by having the option of canceling the contract or stopping payment. The prospect of firing public employees may do more

damage to the political interests of Ministers than to the department that employs them. During negotiations, Ministers typically know much less about the outputs they are buying than managers know about what they are selling. In many New Zealand departments, the chief executive drafts the purchase agreement and presents it to the Minister, who signs it after making a few marginal adjustments, such as adding a minor task to the list of outputs.

To its credit, New Zealand has invested in independent assessments of its reforms.¹⁷ The most recent has been a “review of the centre,” carried out by an interdepartmental team. The State Services Commission which has had a leading role in managing the new system has been forthright in criticizing the contract model that underlies purchase agreements.

The model is that the marketplace: buyer and seller haggling over price against a backdrop of competitive supply, discriminating demand, efficient price, symmetrical information and minimum transaction costs. Experience has shown, however, that none of the model’s conditions can be reliably satisfied, even in a weak form, in the New Zealand Public Service. The market for NZPS inputs is characterized by monopoly supply, compliant demand, arbitrary price, asymmetry of information and time horizons, and significant transaction costs, many of which arise well after the transaction. The concept of an efficient market fundamentally misrepresents the nature of New Zealand public service’s production and exchange.¹⁸

Although they may not be bona fide contracts, these agreements may nevertheless help improve public management. In the view of New Zealand politicians and managers, the contracts have enhanced performance by providing opportunities to discuss matters of mutual interest. The process of negotiating a purchase agreement encourages the Minister and chief executive to discuss what they hope will be accomplished in the year ahead, to plan and agree changes in operations or objectives, and to deal with issues that may impede achievement of the Government’s goals. During the year, the parties to the agreement meet periodically to review progress and make appropriate adjustments. This impels Ministers to set aside time on their crowded calendars to oversee administrative matters that they might otherwise ignore. In sum, the contracts regularize and deepen the

¹⁷ In 2001 the Government established the Review of the Centre Advisory Committee to review the State sector. The report and recommendations of the Advisory Committee were released in December 2001. Published on 20 July 2004, was a briefing paper to the Minister of State Services on the Integrated Services Delivery Programme. See <http://www.ssc.govt.nz/display/document.asp?NavID=105&DocID=4050>

relationship between Ministers and managers, though neither side regards them as genuine contracts.

INTEGRATING THE NEW ZEALAND PUBLIC SECTOR. In New Zealand, as in the UK, the Government has had to consider the impact of reforms on overall policy, the linkages between politicians and managers, interdepartmental relations, and other coordination issues. In both countries, it has been easier to fragment public administration by setting up quasi-autonomous entities than to integrate public policy, and in both countries a second wave of reforms has concentrated on an integration strategy.

Because New Zealand's contracts link Ministers and managers, its innovations have been less centrifugal than Britain's. Moreover, in New Zealand, departments have generally retained a broad portfolio of responsibilities. Two fissures have been serious, however. One arises out of the weak capacity of the government to define national objectives and priorities, the other out of the proliferation of Crown Entities (CEs) and other non-departmental bodies. The first problem is not directly relevant to China's PSU situation is not considered here; the second is directly relevant.

Despite the emphasis the New Zealand model places on departments, these organizations account for significantly less than half of the money that flows through the State budget. Most public money is actually spent by the Crown Entities that are outside the departmental accountability structure. These entities have a number of important characteristics that impair governmental control. (1) They are not legally part of the State; they act in their own name. (2) They are typically governed by an independent board appointed by the Minister responsible for their operation. The Board, not the government, appoints the CE's chief executive. (3) Each CE is established by separate legislation; thus, the government's relation to CE's and control over their resources, is not standardized. (4) In contrast to departments, CEs do not have a common accountability system; some have acted as if they were totally independent of government.

Although they share a common label, the CEs are not homogeneous in either form or function. They differ in why they were established, why they are outside the departmental structure, how they relate to Ministers and departments, the extent to which they are dependent on the State budget or generate their own revenue, and other matters. Their only common feature is that they are not departments. Some are outside the departmental structure because they have regulatory functions, some because they were decoupled from departments in order to separate policy and operations, some because government wanted stakeholders to have a stronger voice in their operations, some because of historical accident, and so on.

Studies of the Crown Entities were undertaken by the State Services Commission and the Treasury in 1999 and 2000, more than a decade after the New Zealand reforms

were introduced.¹⁹ These studies identify a number of serious shortcomings that tend to be found in entities that have operating independence and weak accountability. The main deficiencies were (1) lack of a public service ethic, (2) extravagant spending, (3) inadequate and uneven monitoring by departments and lack of attention by Ministers to the Crown entities for which they were responsible, (4) no standard procedures for appointing board members, (5) disregard by Crown entities of government policies, (6) inadequate governance arrangements and confusion over the legal status of some entities, and (7) incomplete and inconsistent accountability arrangements.²⁰

Remedying these defects has been difficult because Crown entities are so disparate. It has been hard to devise a single approach that covers all or most entities. Pursuant to recommendations by the State Services Commission, Crown entities were classified into four distinct categories, with special accountability rules for each. (1) Crown companies are entities that carry out commercial activities; these would be governed by the Companies Act, which covers private firms, not by laws pertaining to State organizations. (2) Independent Crown entities carry out activities for which there is a compelling basis for freeing them from ministerial influence. New Zealand examples include the Electoral Commission, the Accounting Standards Review Board, and the Policy Complaints Authority. These entities are permitted to act without having regard for the government's policies. (3) Autonomous Crown entities are the appropriate form of organization when low political, strategic, or financial risk makes it prudent to delegate responsibility in respect to the activities undertaken by the entity. Examples include the Casino Control Authority and the Lotteries Commission. In these cases, the Responsible Minister retains authority to set performance expectations. (4) Crown agents are the agencies subject to a high degree of ministerial control. These agencies operate as agents of the Crown (government), even though they are legally independent. Agencies that fit this category include the Civil Aviation Authority and the Transport Safety Authority.

LESSONS FROM BRITAIN AND NEW ZEALAND. Although China's PSUs pose challenges that neither the UK or NZ has faced, it is appropriate to extract some lessons from it.

¹⁹ See Crown Entities: Roles of Ministers, Crown Entities and Departments, Occasional Paper No. 18, State Services Commission, September 1999, ISBN 0-478-08971-6, Crown copyright. Crown Entities: Organisational Design. Occasional Paper No. 21, September 1999. State Services Commission, September 1999, ISBN 0-478-08974-0, Crown copyright. Review of the Centre – Paper Three – Improving Alignment: Crown Entities – Power to Act (Published 9 December 2002, Authored by State Services Commission). Review of the Centre – Paper Three – Improving Alignment: Crown Entities (published 9 December 2002, Authored by the State Services Commission.) Review of the Centre – Paper Four – Departmental Accountability and Reporting Arrangements (published 9 December 2002, Authored by the Treasury). Schick, Allen: The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change, Report for the State Services Commission and the Treasury, 1996.

- (1) Both Britain and the NZ have tried to inject businesslike practices into the management of public agencies, the former through market testing and outsourcing, the latter through contracts and contestability in the purchase of goods and services. Yet, when managers and politicians are asked about the gains from the agency structure, they almost always point to the freedom it gives managers to apply their professional judgment and experience, not to competitive bidding or similar market-type innovations. It is the freedom to escape the bureaucratic command and control system that is valued most, along with reduction in compliance costs. For China, the plain but important implication is that the Government should be wary of stripping well-functioning PSUs of managerial discretion.
- (2) Agencies in the UK and NZ, like PSUs in China, cover a truly diverse range of situations and cannot, therefore, be subjected to the same arrangements. In the UK, many agencies which generate their own income have been converted into trading companies; others have varying types of relationships with the Government. In NZ, recent legislation divides agencies into different classifications, depending on the extent to which they are to be subjected to ministerial control. In China, no less than in these countries, commercialization will be an option for only some agencies. Most PSUs will remain within the governmental system, but even those that do will have different connections to government.
- (3) Agencies fragment government and complicate the task of political leaders in setting and implementing national policy. It is not accidental that having transferred Administrative control to self-managed agencies, both NZ and UK leaders found it urgent to retake some of the responsibilities they had yielded. It is significant, however, that neither NZ nor UK rolled back the agency-centered reforms. Instead they sought other means to achieve political-administrative integration. The vital lesson for China is that a well-governed country needs both strategic capacity at the center and managerial capacity in its service-providing organizations. Agencies are not a substitute for effective leadership, and an effective center does not itself resolve the problem of how to deliver public services.
- (4) Genuine accountability is an elusive objective, but one worth pursuing. Both NZ and UK invested in accountability systems, including specific performance targets, annual reports, and audited financial and performance statements. Britain relied more on periodic evaluations, New Zealand on annual contracts, but both countries recognized that it is risky to give managers autonomy unless they are given clear guidelines as to their responsibilities and are held to account for spending public money and providing public services. Inasmuch as China already has free-standing agencies, it faces a somewhat different situation. It must introduce accountability regimes into PSUs that have lacked them, and rather than broadening the operational autonomy of

agencies, it must decide whether the narrow the freedom that its PSUs already enjoy.

- (5) Finally, the succession of changes made in both the UK and NZ after the original reforms had been institutionalized suggests that there is no perfect or permanent arrangement for reconciling managerial freedom and political control. Although these imperatives pull in opposite directions, they must coexist in every government. Hence, the tendency to shift from one arrangement to another. On the basis of UK and NZ experience, one can be certain that the next round of PSU reforms will not be the last.

III. LESSONS FROM COUNTRIES IN TRANSITION

China is a country in transition. In fact, it is undergoing two parallel transitions, one from a centrally planned to an open, market-driven economy, the other from an underdeveloped to a developed country. Both transitions are proceeding rapidly, though both will take a number of years to complete. Although both processes are concentrated in the market sector, their impacts extend to governmental operations and spur efforts to modernize the public sector. In most transitional countries, modernization of government lags behind development of the economy. When this occurs, citizens tend to be dissatisfied with public services and government spending rises as a share of GDP. Government may also be ill prepared to handle the regulatory (and other) functions required for a rapidly developing economy.

China has no peers in the pace and scale of transition, but it may nevertheless be able to extract some lessons from other countries coping with the pressures and opportunities of social change. It would be useful to examine what other transitional countries have done in establishing or regulating agencies and other service-delivery organizations. For this purpose I have selected one country representative of each type of transition: Latvia, which like China has divested central planning; and Thailand, which like China has undergone rapid economic development. Both Latvia and Thailand have wrestled with the agency problem, and both have found that restructuring the public sector is a difficult task.

LATVIA: REGULATING PUBLIC AGENCIES. Latvia, like other countries in East/Central Europe has a hierarchical, Soviet-style public administration. Most of these countries have retained the inherited bureaucratic structures, some because they prefer that type of organization, others because they faced too many obstacles in dismantling it. The European Commission generally discouraged countries that were candidates for accession from establishing independent agencies. It has probably been strongly influenced by France and Germany, arguably its two most important Member countries, neither of which has adopted the agency model.

Latvia, however, was an exception. Without any overall plan, it established a slew of agencies, each one addressing a particular problem facing the country. Two of the most important were the Road Traffic Safety Directorate, which licenses automobile drivers, and the Health Insurance Agency, which operates the country's health care system. These agencies and others were self-financing; they had authority to charge fees that covered their cost of operations, thereby enabling them to bypass the budget system and other financial controls as well as civil service rules. In fact, one of the strongest incentives for establishing agencies is that they were not bound by civil service rules and were able to pay much higher salaries than were common in the public sector.

Although each agency was nominally under the jurisdiction of a ministry, ministerial supervision was inadequate. One problem was that agency staff was paid much more than those who worked in ministries. They also had better office accommodations, bigger expense accounts, and other benefits that flowed from being a self-financed agency. The proliferation of agencies in Latvia was associated with another trend – a marked increase in the portion of State revenues that were earmarked for particular purposes. By some estimates, 70 percent of these revenues were siphoned from the regular budget to a maze of special funds, many of which were controlled by newly-independent agencies. In effect, these agencies had their power to tax, for they had a monopoly on public services. For example, the road safety agency could charge what it wanted for drivers' licenses and the health insurance agency could adjust fees for its services. Because they were chartered under a law intended to deal with business firms, these agencies were only weakly regulated by their parent ministries.

The combination of organizational independence, self-generated revenue, and earmarked funds weakened the government and undermined fiscal discipline. Public accountability was degraded as the public sector was balkanized into a growing number of protected enclaves.

Remedying these problems was a complicated task, not only because of political pressure from agencies to retain their privileged status, but also because of the need to disentangle commercial and public activities. One key step was the Commerce Law adopted in 2001 that defined certain types of private and public commercial bodies and provided that entities not conforming to these characteristics had to be established, operated, supervised, and held accountable for their actions. It is, I believe the best legislative model, and with suitable adjustment, can be a template for other countries that have agencies or are considering them.

The law clearly establishes the principle that an agency is a public body under the supervision of a ministry, and that it is created pursuant to an edict by the Cabinet. It also authorizes agencies to charge fees for public services only, pursuant to Cabinet approval. It charges the minister responsible for an agency with a number of critical supervisory tasks, including nomination or dismissal of the agency director, evaluation of the agency performance, negotiation of a management agreement with the director, approval of medium-term performance and development strategies, the annual performance plan and

budget, and initiation of audits. These provisions make it clear that although it is operationally independent, an agency is beholden to the ministry in which it is located.

The Public Agencies Law has several novel provisions which reflect the influence of new public management. One of these is a management agreement that specifies quantitative and qualitative performance targets, financial targets for the year ahead, procedures and criteria for evaluating agency performance, and requirements for quarterly and annual performance reports. The management agreement covers at least three years, but may be amended as deemed appropriate by the minister and agency director. Another innovation is designation of an individual as a “responsible official” to assist the minister in his/her oversight functions. The official has broad authority to obtain and review information regarding the agency’s operation. In effect, the responsible minister performs two roles. One is to be a broker between the minister and the agency; the other is to maintain accountability for agency actions.

In 2002, the Parliament adopted another law, on State Administration Structure, which covers the entire public sector. Its guiding principle is that “State administration shall be organized in a single hierarchical system. No institution or administrative official may remain outside this system.” In tandem, the two laws seek to meld together, as the UK and NZ have, an integrated public administration and operational independence of service delivery units. These laws are not self-executing; their effectiveness depends on how they are implemented. While it is too early to draw firm conclusions, there have been several encouraging developments, such as promulgation by the Cabinet of criteria for assessing the suitability of agency status. These criteria pertain to the entity’s functions (regulatory, service delivery, policy, etc.), the feasibility of identifying outputs so as to assure managerial accountability, the ministry’s capacity to supervise the entity, and the scale of operations. These criteria and the new laws have slowed the rush to create agencies and have re-established a more integrated public administration.

THAILAND: THE HURDLES APPROACH. Thailand’s rapid growth in the 1980s and first half of the 1990s and its subsequent financial crisis exposed inadequacies in public governance. The country had a highly centralized management system which revolved around the budget process. The system had been designed when the economy and the public sector were much smaller, but it was ill suited for the enlarged role that the State acquired during the boom years. The government was organized to control small details of administration, but had little capacity to set strategic goals for the public sector. Spending units were chafing under the excessive controls, and Members of Parliament were restless.

The main problem was Thailand’s over-detailed line item budget which specified each of the items to be purchased during the year by spending unit. Not only was the budget prepared on this basis, but spending units had to receive approval from the Bureau of the Budget before funds were actually made available to them. This arrangement had one overriding advantage – it enabled the government to operate within its means.

Budget deficits, when they occurred, were modest, and the country seemed to be on a solid financial footing. But the central controls disabled the budget as a means of promoting social development and generated ongoing friction between the budget Bureau and spenders.

The solution devised by Thailand was to retain financial controls, but to transfer responsibility for them from the Budget Bureau to the spending agencies themselves. It was hoped that, given responsibility for their own resources, agencies would have an incentive to operate efficiently and to perform better. However, Thailand had to face up to the reality that many agencies were poorly managed and could not be entrusted with self-management. There was substantial risk, therefore, that transferring responsibility to spending units would undermine spending control. Thus, the Budget Bureau opted to yield spending control to agencies on a case by case basis. Each agency would have to demonstrate competence in seven areas of public management in order to be given authority to operate on its own. The seven criteria came to be known as “hurdles” that had to be surmounted before independence was granted. The seven hurdles pertain to budget planning, output costing, public sector procurement, budget and funds control, financial and performance reporting, asset management, and internal audit. Each hurdle had a detailed set of criteria to measure agency competence. Each agency that was a candidate for self-management underwent a “gaps analysis” that identified shortcomings in its management system and proposed steps to remedy them.

In design, the hurdles approach is a significant contribution to the inventory of tools for managing public agencies. It could be applied in other countries as a diagnostic to assess the preparedness of public entities for operational freedom. In practice, however, the hurdles scheme was not successfully implemented in Thailand and early in the new century it was largely superseded by other managerial reforms. To my knowledge, the government has not systematically examined this failure, but I believe it due to two principal causes, both of which are relevant to a country pursuing an agency strategy. One reason is that managerial reform was narrowly applied to budget-related tasks; it did not cover the full spectrum of management functions. Especially important is the complete absence of attention to human resources. In general, controls on personnel are a more important impediment to operational efficiency than financial controls because most operating funds go to pay the salaries of public employees. It is not practical to separate out budgeting from other core managerial activities and reform this aspect alone. In Thailand, the civil service is outside the boundaries of reform because it is outside the jurisdiction of the Budget Bureau. The Civil Service Board showed no inclination to reform, so this issue was left off the agenda.

The second reason is that some hurdles were set too high or placed on the wrong practice. In deciding whether to vest agencies with operating freedom, the key question is not whether they have adopted *avant garde* practices, but whether they carry out basic managerial responsibilities in a competent, efficient manner. Output pricing, one of the seven hurdles, is a recent innovation that has been successfully implemented in only a few countries. Each of the seven hurdles had sub-hurdles, criteria used to assess management

practices. Many of these were so demanding that even reasonably well run agencies could not meet them. When this occurs, agencies sidestep or circumvent the rules, for example, by getting Parliament to approve agency status even when basic criteria have not been met.

IMPLICATIONS FOR CHINA. Despite their very different approaches, Latvia and Thailand share one feature: both sought strong, effective government at the center, and efficient, performing agencies at the periphery. This is the same formula that the UK and NZ uses, with the important difference being that they began with fragmentation and moved to integration. A second common feature is that both Latvia and Thailand applied comprehensive criteria on a case by case basis. Even as they embraced the agency model, they recognized that not all public organizations are equally prepared to manage their own finances, personnel systems, and other administrative practices.

China, of course, already has agencies, so it cannot apply criteria ex ante, as Latvia and Thailand did. Nevertheless, China can devise standards for agency operation that would enable it to differentiate the competence and performance of PSUs and extend operating freedom only when it is prudent to do so.

Latvia and Thailand are not truly representative of countries in transition. Each has been highlighted here because it has pioneered significant managerial innovations that may be applicable in other venues. As a country that combines both Latvia's transition from central planning to a market economy, and Thailand's transition from underdeveloped to rapidly developing country, China can profitably borrow these practices.

Should it do so through legislation, as Latvia has done, or through administrative rules, which has been Thailand's preferred course? No simple answer suffices, for the approach must be consistent with a country's political culture and traditions. Legislation has one obvious advantage, however, for it remains in effect regardless of practice. But this can also be a shortcoming, for it is easier to adjust administrative rules than statutory requirements. A prudent course for China would be to innovate via administrative practices and to consider broad legislation only when it has sufficient experience with different modes of agencies to formulate a workable statute.

IV. WHICH MODEL IS SUITABLE FOR CHINA?

China faces difficult decisions in modernizing its PSUs. One set of choices deals with organizational structure, another with financial responsibility for public services. Western experience offers clear, but not necessarily relevant or applicable guidance on financing; it provides diverse options on reorganizing the PSUs. The problem for China

is that it has already diverged in significant ways from pattern of development in the West. In contrast to most Western countries, which had relatively small public sectors before their economies developed, China has a large public sector but is still relatively underdeveloped. In the West, government grew as the economy expanded; in China, it may be appropriate for some functions of government to shrink as the economy expands. Western countries established agencies as they expanded, China has to abolish or terminate some agencies as it expands. Western countries financed enlarged governments with the dividends of economic growth and higher tax burdens, China may have to finance existing programs and entities in part through efficiencies in public operations.

Pressure for efficiency leads straight to PSUs. Whether they are integrated in departments or continued as freestanding agencies, the number of these entities needs to be significantly reduced. The departmental option would fold PSUs into central or provincial governmental departments, stripping many of their organizational autonomy, which they now have. In effect, PSUs would become bureaus or field units within integrated departments. Many country-level PSUs would become regional offices, while township level PSUs might become administrative subdivisions. Reorganization along these lines is likely to be controversial, and would probably provoke opposition from local governments concerned with losing their special relationship with PSUs in their communities. Local PSUs would be at or near the bottom of a bureaucratic chain of command, though many would undoubtedly retain a substantial amount of operating freedom.

The form of reorganization would correspond to Western practice discussed earlier. China would have large, functionally integrated departments and relatively few independent agencies. It is important to note, however, that departmental integration does not itself assure greater operational efficiency. There is a risk that departments might end up with larger numbers on their payrolls than are now employed by PSUs, if only because managing an integrated bureaucracy and operating its administrative controls and processes can be labor intensive. Care must be taken, therefore, to realign operations when PSUs are absorbed into departments.

Departmentalization may contribute to equalization of public services across regions and economic classes. That is, once these units are dependent on parent departments for their budgets and other resources, the government would have greater capacity, if it wishes to exercise it, to narrow financial and service differentials between rich and poor areas. It also may have an easier time fine-tuning allocations to the particular needs and situations of each administrative unit.

Departmental integration would imply that the Government is responsible for the cost of operating these units. It therefore might be dependent on a significant increase in the taxing competence of the state. Obviously, this path would deviate from the strategy defined by China during two decades of efforts to reform the PSUs.

For this and other reasons, the probability is that China will not consolidate most PSUs within an integrated organization structure. Whatever difficulty the de facto independence of PSUs poses for China, independence facilitates transferring a large part of the cost of services from government to the PSUs and their clients. The more independent PSUs are from Government, the less obligated Government might be in paying their expenses. Retaining the current structure builds on the existing PSU system, facilitates decentralized public management, and may spur development of the market economy, including markets for some public services. But the Government still will have to face the issue of financing PSUs, especially in health and education services.

THE CHINA MODEL. As already emphasized, China's PSU problem has to do more with financing public services than with organizational structure. The thrust of some recent reforms suggests that the Government may be aiming for a small state by divesting or privatizing many public services and turning others over to non-profit organizations. It may also maintain price controls on certain basic services, such as prescription drugs and school fees.

This strategy entails a number of risks, to the financial position of government and to the quality of public services. Newly freed PSUs, imbued with a spirit of enterprise and opportunity, may be propelled to enter into risky financial arrangements in order to take advantage of their new status, to garner a larger market share, or to compete against other service providers. Some risks may be prudent, others might not be; some units may be favorably positioned to take risks, others might not be. In preparation of this paper, I (along with other mission members) visited an enterprising hospital that had significantly improved the quality and geographical reach of its services through merger with another hospital, joint ventures with one, a bond float, and other creative financing methods. The early evidence is that this hospital is thriving. It has upgraded medical technology, increased the patient population, and improved staff morale. However, this institution, which is located in a prosperous region, loses money on standard hospital services. It nevertheless is profitable because it makes money on dispensing drugs. Leaving aside the economic justification of cross-subsidization, extending this model to less affluent areas or to less well-run institutions, may lead to financial mishaps, as well as to oversupply of services in some areas and undersupply in others. As recent efforts by the government to constrain the over-prescription of drugs would indicate, reducing cash flows to newly liberated PSUs can have adverse financial consequences.

The rush to deregulate PSUs may occur without adequate consideration of their readiness for self-management, in particular the sturdiness of their internal control system. In deciding whether a PSU should operate in the market, it does not suffice to consider the types of goods and services it provides; it is also necessary to assess its managerial capacity, financial management systems, and the quality of staff.

MARKETIZING PSUS. Thus far, only a small fraction of PSUs have been converted into market-oriented entities, though a much larger portion of PSUs dabble in market like activities by conducting income generating activities that supplement the

stipend received from Government. This trend may accelerate if the share of total income derived from Government continues to decline.

At present, China does not have robust markets for various public services. Markets have to develop before the Government can successfully marketize public services. Forcing PSUs to fend on their own may spur the entry of private or not-for-profit providers into services previously monopolized by Government. But in the absence of genuine competition, fees charged by these entities will really be hidden taxes. They may be regressive and will price some recipients out of public services. In the absence of income support measures, they will widen the gap between rich and poor citizens. Marketization will improve access to and quality of services for those who can afford to pay the fees, and diminish it for those who cannot.

There is substantial risk that undue marketization will damage the public service ethic. Making money may displace providing public services as the dominant motive, with implications for Chinese society that go far beyond the financial condition of government. There also is danger that marketization will give rise to a bubble mentality with banks eager to finance the expansionary ambitions of newly privatized (or established) entities with easy credit.

In some quarters, there is an expectation that the diminished role of government in financing and delivering public services will be compensated by a big increase in the provision of services through voluntary, non-profit activity. China has experienced an increase in such activity during the past two decades, but the level still falls far short of what exists in some Western countries and far short of making up the gap between government and private financing. The Government may be able to stimulate voluntary flows of assistance by converting some public service units into not-for-profit organizations, but Western experience suggests that these entities take time to develop, differ greatly from country to country, and are not substitutes for government financing. Government can play a role in stimulating voluntary, collective action through tax subsidies and regularly policy, but the creation and operation of voluntary groups depends most of all on an engaged, caring civil society. The Government cannot itself will a robust voluntary sector into existence.

This conclusion assumes that China will follow the path of Western development, with government taking on an expanding role as economic conditions improve. Rather than relying on families or voluntary groups for income support, pensioners and other dependent people will turn to government for assistance. Perhaps, however, China will embrace “Asian values,” the notion that each family has a fundamental responsibility to care for its own. This is the path that Singapore has chosen, reflected in its 1996 Maintenance of Parents Act, which enables elderly parents to sue their adult children for failing to support them adequately. Shortly before this Act was passed, Singapore’s President Ong Teng Cheong asserted:

Developed countries in Europe, Australia, New Zealand and Canada once proudly called themselves welfare states. Now they have to revamp their welfare system in order to remedy the disastrous side effects of state welfare: weakened family bonds, diminished incentives to work, and impoverishment of the country's finances...Their problems confirm that we have chosen the right path.²¹

If Asian values prevailed, one would expect to have relatively smaller governments in various newly-industrialized countries such as Korea and Malaysia. In fact, these countries appear to have similarly-sized governments (relative to GDP) as most OECD countries had at comparable stages of development.²² Moreover, Japan which had a rather small welfare state in the post-World War II period greatly expanded social benefits when the economy boomed.

RECOMMENDATIONS. If neither the market nor the voluntary sector is a sufficient base for PSUs, it behooves Government to retain a lead role in financing and delivering public services. This does not mean that the existing PSU system should remain unchanged. In their current form, PSUs will get a declining share of their money from government, but will be a growing burden on public budgets. The following are seeds of ideas for how to go about rationalizing PSUs.

1. Define the issue in terms of developing society. It is a mistake to view development solely in economic terms. When an economy expands and the wellbeing of citizens improves, as has dramatically occurred in China during the past two decades, society undergoes significant transformation. Not only do citizens have more to spend on private goods, they also want better public goods. For example, the most advanced hospitals seek to obtain state-of-the-art medical imaging technology and other hospitals pressure government to get the same equipment. These demands cannot be deflected simply by turning responsibility over to private or voluntary sectors. For the economy and society to develop, the State must also develop. It must mature into a more efficient, responsive provider or financier of public services.
2. Develop the State by Enhancing Public Services. Despite the lively debate in Western countries over the role of the state and the form of delivery, one fact stands out: Everywhere, the state carries most of the burden of public services. What is public is defined differently in various countries, but the boundaries of the state have not been significantly shrunk by privatization

²¹ Quoted in Lindert, *op cit*, p. 220.

²² See Tanzi and Schuknecht, pp. 120-24.

(except in state-owned enterprises). Even if the state is not deemed the optimal provider of services, it retains huge financial responsibilities.

3. Modernize the Tax System. Rationalizing PSUs depends on a robust, revenue-producing tax system. China like most other transitional countries, entered the modern era without an adequate tax system. Establishing a modern tax system has been complicated by dependence on provinces for collecting certain taxes and by revenue-sharing arrangements that disadvantage the central government. The Government's market orientation indicates that it may be reluctant to move boldly on the tax front, but the need to finance public services may impel it to seek additional tax revenue.
4. Consolidate and Restructure PSUs that Remain Public Responsibilities. China has too many PSUs. As previously discussed, many may disappear through privatization of those that resemble enterprises. However, even when PSUs are pruned, China will need to consolidate the hundreds of thousands of remaining PSUs. This writer does not know enough about county and township governments and the ties they have with PSUs to offer useful advice. But, it is likely that consolidation would alter those relationships. Rather than being closely linked to local governments, PSUs would be more closely tethered to the hierarchies in which they are placed. Transforming PSUs from agencies into field units of central or provincial bureaucracies would facilitate reform of their budget and civil service systems.
5. Strengthen the Policy and Oversight Capacity of Ministries. Sooner or later, every country that relies on independent agencies to deliver public services comes to the conclusion that it needs to integrate policy at the center so that services fulfill the priorities and objectives of government. It is one thing to have agencies that are operationally independent, quite another to leave agencies to their own wills without adequate guidance or supervision. This recommendation flows directly from the four countries examined in this paper. The United Kingdom first gave agencies broad operating freedom; after a decade of experience, it concluded that while agencies were operating efficiently and should be continued, it would be prudent to tie them more closely to departmental policies and objectives through specific performance targets expressed in public service agreements. New Zealand gave its departments and Crown Entities operating freedom, but expressly made Ministers responsible for their performance. After more than a decade with this model, New Zealand found it appropriate to strengthen the center, so that the collective interest of government is better served. When it divested central planning, Latvia faced pressure to establish independent agencies. It responded by passing a law that clearly defines the responsibility of ministries to superintending

agencies. Finally, Thailand, devised a hurdles approach to review the preparedness of each entity for agency status. This approach assigned each department responsibility for assessing the competence of entities that were candidates to become agencies.

In China PSUs operate at several levels of government, making it appropriate that ministerial (or departmental) capacity be strengthened at each. It would be appropriate for departments to review the ways they oversee the PSUs in their jurisdiction, and to consider the following questions:

- Is any particular unit or person assigned oversight responsibility?
- What information does the department receive on an ongoing basis to check the activities of its PSUs?
- Does the department periodically evaluate PSU performance, including audit of its use of public funds?
- Does the department give performance targets to its PSUs?

Latvia's Public Agencies Law offers some useful concepts for strengthening PSU oversight. One is the notion of a management (or performance) agreement that sets out expectations and targets; another is the idea of designating a responsible official as the intermediary between the department and its agencies. While it would not be appropriate to recommend a specific approach for China, the basic concept of specifying performance in advance and assigning an official with oversight responsibility appears valid for it.

6. Review Capacity and Performance of Surviving PSUs. Because PSUs have existed for an extended period, China does not have Britain's option of reviewing each entity before entrusting it with operational responsibility, nor can it apply Latvia's criteria for agencies that already exist. Nevertheless, it behooves China to assess each existing PSU to identify and remedy gaps in its operational capacity. The key question should be: does this entity have robust internal controls and management practices that enable it to manage itself in an efficient manner? Along the lines devised by Thailand, it should devise criteria for assessing internal capacity and the steps needed to close identified gaps. Toward this end, central and provincial ministries should promulgate standards for the PSUs in their jurisdiction.

7. Introduce Basic Performance Targets for PSUs. There is substantial evidence that giving government agencies advance notice of what is expected of them tends to improve operational performance. It is important, however, that the targets be realistic, that is, they can be achieved with the resources and capacities at hand – but that they also be challenging – that they impel PSUs to improve their performance. Ideally, the targets should be selected through negotiation or consultation between the parent ministry and the affected PSU. Unilateral demands can have a negative effect, leading PSUs to conclude that their situation and needs are not being adequately considered.

The targets should deal with basic operations, not with *avant garde* measures of outputs or outcomes. In my view there would be significant gains in specifying workload and efficiency targets. There may be some advantage to encapsulating the targets in a formal agreement, such as is applied in New Zealand and Latvia. But what is most important is not the formalism itself, but the opportunity for dialogue between the PSU and the ministry.

8. Reform Center-Provincial Fiscal Relations. Viewed from the vantage point of central government, it is tempting to resolve the PSU problem by transferring responsibility to subnational governments; viewed from the perspective of local governments, it is tempting to resolve the same problem by wresting more money from the central government. The clashing interests of those who finance and those who deliver these services points to the need to negotiate a new system of fiscal and administrative decentralization. This will be a difficult task, as past, contentious negotiations show, but it may be impossible without a significant boost in tax revenue.
9. PSU Reform should be Accompanied by Modification of Budget Allocation. The origins of the PSU problem lie in normative rules for allocating financial and human resources to these units. The steps suggested thus far should make it feasible to introduce a modern budget system that uses annual allocations of money to review the activities and operations of the departments (or other organizations) into which PSUs were consolidated. Government would not assign staff to PSUs, though the budget would specify maximum staffing levels for departments or other organizations.
10. Modernize the Civil Service System. There is reason to believe that many PSUs are overstaffed, that staff training and morale are deficient in many of these units, and that some PSUs have been used as refuges to absorb employees discharged by SOEs. The quality of services delivered by PSUs depends on the performance of the staff who works in these units. It

is essential that service providers have a freer hand in staffing their organizations and that (within staffing limits mentioned in the previous point) they be able to decide on employment levels.

It is anomalous that the Government may be willing to give marketized PSUs total freedom in staffing and other operational matters, but give PSUs within the public sector very little flexibility. This double standard is strong incentive for some PSUs to migrate from the public to the market or non-profit sector.

In conclusion, PSU reform is not simply a matter of classifying these units into their respective categories: enterprise, public, etc. Many PSUs are hybrids that combine elements of enterprises and public services. The position taken in this paper is that reform should be defined in terms of state-building and providing public services, not in terms of shifting costs from government to citizens or from the central to subnational governments.

APPENDIX

TABLES

- Table 1. REAL GDP GROWTH: 16 WESTERN COUNTRIES, SELECTED YEARS 1900-1994
- Table 2. PER CAPITA GDP IN 16 WESTERN COUNTRIES, SELECTED YEARS 1900-2000
- Table 3. PER CAPITA GDP GROWTH BY REGION OR TYPE OF COUNTRY, 1900-2000
- Table 4. GENERAL GOVERNMENT EXPENDITURE AS PERCENT OF GDP, SELECTED YEARS, 1913-1996
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- Table 6. GENERAL GOVERNMENT REVENUE AS PERCENT OF GDP, SELECTED YEARS, 1870-1997
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Table 1
REAL GDP GROWTH: 16 WESTERN COUNTRIES,
SELECTED YEARS 1900-1994
(1913=100)

	1900	1920	1940	1960	1980	1994
Australia	61	102	158	331	764	1,161
Austria	73	66	113	196	444	586
Belgium	78	93	118	196	436	547
Canada	46	97	180	458	1,185	1,661
Denmark	66	111	168	346	669	894
Finland	69	91	186	432	978	1,207
France	81	87	115	239	564	728
Germany	68	79	167	323	652	879
Italy	63	101	163	311	791	1,021
Netherlands	75	116	172	381	833	1,084
New Zealand	60	121	178	388	677	898
Norway	71	120	199	422	1,010	1,430
Sweden	75	95	177	373	713	845
Switzerland	72	102	164	405	727	901
United Kingdom	82	95	147	209	336	448
United States	60	115	180	390	803	1,140

Source: Angus Maddison, Monitoring the World Economy: 1820-1992, Organization for Economic Cooperation and Development, 1995, Table B-10a

Note: Each Country is individually indexed to 1913

Table 2
PER CAPITA GDP IN 16 WESTERN COUNTRIES, SELECTED YEARS 1900-
2000
(In 1990 “International Dollars”)

	1900	1920	1940	1960	1980	2000
Australia	4,013	4,766	6,166	8,791	14,412	21,540
Austria	2,882	2,412	3,959	6,519	13,759	20,097
Belgium	3,731	3,962	4,562	6,952	14,467	20,742
Canada	2,911	3,861	5,368	8,753	16,176	22,198
Denmark	3,017	3,992	5,116	8,812	15,227	23,010
Finland	1,668	1,846	3,220	6,230	12,949	20,235
France	2,876	3,227	4,042	7,546	15,106	20,808
Germany	2,985	2,796	5,403	7,705	14,114	18,596
Italy	1,785	2,587	3,505	5,916	13,149	18,740
Netherlands	3,424	4,220	4,831	8,287	14,705	21,591
New Zealand	4,298	5,641	6,300	9,465	12,347	16,010
Norway	1,937	2,780	4,088	7,208	15,129	24,364
Sweden	2,561	2,802	4,857	8,688	14,937	20,321
Switzerland	3,833	4,314	6,397	12,457	18,779	22,025
United Kingdom	4,492	4,548	6,856	8,645	12,931	19,817
United States	4,091	5,552	7,010	11,328	18,577	28,129

Source: Angus Maddison, The World Economy: Historical Statistics, OECD 2003, Tables 1c and 2c

Table 3
PER CAPITA GDP GROWTH BY REGION OR TYPE OF COUNTRY, 1900-2000
(In 1990 “International Dollars”)

	1900	1920	1940	1960	1980	2000
Western Europe	3,077	3,305	4,984	7,607	14,057	19,806
Other Western	4,015	5,397	6,838	10,961	18,060	27,065
Latin America	1,200	1,635	2,119	3,392	5,886	6,385
East Europe	1,438	n/a	n/a	3,070	5,786	5,804
USSR	1,237	n/a	2,144	3,945	6,426	4,351
East Asia	623	959	1,251	962	1,870	3,794

Source: Angus Maddison, The World Economy: Historical Statistics, OECD 2003, various tables

Notes: “**Other Western**” countries are Australia, Canada, New Zealand, and the United States
“**Western Europe**” includes the 12 European countries listed in Tables 1 and 2
“**Latin America**” covers 8 countries (Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela)
“**East Europe**” covers 7 countries (Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia)
“**East Asia**” covers 16 countries (China, India, Indonesia, Japan, Philippines, South Korea, Thailand, Taiwan, Bangladesh, Hong Kong, Malaysia, Nepal, Pakistan, Singapore, Sri Lanka, and Burma)

Table 4
GENERAL GOVERNMENT EXPENDITURE AS PERCENT OF GDP
SELECTED YEARS, 1913-1996

	1913	1920	1937	1960	1980	1990	1996
Australia	16.5	19.3	14.8	21.2	34.1	34.9	35.9
Canada	n/a	16.7	25.0	28.6	38.8	46.0	44.7
France	17.0	27.6	29.0	34.6	46.1	49.8	55.0
Germany	14.8	25.0	34.1	32.4	47.9	45.1	49.1
Italy	17.1	30.1	31.1	30.1	42.1	53.4	52.7
Japan	8.3	14.8	25.4	17.5	32.0	31.3	35.9
Netherlands *	9.0	13.5	19.0	33.7	55.8	54.1	49.3
New Zealand	n/a	24.6	25.3	26.9	38.1	41.3	34.7
Norway	9.3	16.0	11.8	29.9	43.8	54.9	49.2
Spain *	11.0	8.3	13.2	18.8	32.2	42.0	43.7
Sweden	10.4	10.9	16.5	31.0	60.1	59.1	64.2
United Kingdom	12.7	26.2	30.0	32.2	43.0	39.9	43.0
United States	7.5	12.1	19.7	27.0	31.4	32.8	32.4
Average	12.1	18.9	22.7	28.0	42.0	45.0	45.4

Source: Vito Tanzi and Ludger Schuknecht, Public Spending in the 20th Century, Cambridge University Press, 2000. Table 1.1

Notes: * Through 1937, data cover only central government expenditures

Table 5
GENERAL EXPENDITURE AS A PERCENT OF GDP,
BY SECTOR, 1870-1996*
(17 Western Countries, Averages)

	1870	1913	1937	1960	1980	1996
Consumption Expenditure	4.6	n/a	11.4	12.6	17.9	17.3
Subsidies and Transfers	1.1	n/a	4.5	9.7	21.4	23.2
Public Education	0.6	1.3	2.1	3.5	5.8	6.1
Health	n/a	0.3	0.4	2.4	5.8	6.4
Pensions	n/a	0.4	1.9	4.5	8.4	9.6
Unemployment Payments	n/a	n/a	1.3	0.3	0.9	1.6
Public Investment	2.0	2.8	3.8	3.2	3.5	2.9
Defense	n/a	n/a	3.7	3.4	2.5	2.0

Source: Vito Tanzi and Ludger Schuknecht, various tables

Notes: * Year indicated, or closest year for which data are available.

Table 6
GENERAL GOVERNMENT REVENUE AS PERCENT OF GDP
SELECTED YEARS, 1870-1997*

	1870	1913	1937	1960	1980	1990	1997
Australia	17.8	16.7	14.9	24.4	29.7	35.5	35.1
Canada **	4.1	5.5	22.6	26.0	36.1	41.9	43.5
France	15.3	13.7	20.5	37.3	46.1	48.3	50.6
Germany **	1.4	3.2	15.9	35.2	45.0	43.0	45.0
Italy	12.5	14.7	31.1	24.8	36.9	42.4	47.9
Japan	9.5	n/a	n/a	18.8	27.6	34.2	32.1
Netherlands **	n/a	6.4	11.9	33.9	51.6	49.0	47.7
New Zealand	n/a	n/a	27.0	n/a	n/a	52.1	47.6
Norway	4.3	7.7	10.9	32.4	49.0	52.3	52.1
Spain **	9.4	10.3	11.9	18.7	30.0	38.2	39.5
Sweden **	9.5	6.7	8.5	32.5	56.1	63.3	61.1
United Kingdom	8.7	11.2	22.6	29.9	39.6	38.7	37.8
United States	7.4	7.0	19.7	27.0	30.0	30.8	32.1

Source: Vito Tanzi and Ludger Schuknecht, Public Spending in the 20th Century, Cambridge University Press, 2000. Table III.1

Notes: * Year indicated, or closest year for which data are available.
 ** Until 1937, only central government revenue

TABLE 7
THREE MODES OF SERVICE DELIVERY

	Who Receives	How Is It Financed	What Are Key Incentives
Markets	Customers	Prices	Self-Interest
State	Citizens	Taxes	Political Interest
Voluntary	Clients	Contributions	Civic Interest

Notes: All three modes coexist in Western countries, but the boundaries differ among these countries.