



**Institute of
Public Administration
Australia NSW**

Connecting people and ideas



Deregulating the Public Service economy

by

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1. Coping with Complexity

In 1958, Leonard Read, the founder and president of the Foundation for Economic Education, published a brief essay that for several decades was widely regarded as a classic exposition of the complexity of modern economies.

Read traced the constituent parts of the humble pencil back to their origins – cedar from Oregon; graphite from Ceylon (as it then was); lacquer, resins and carbon black from a variety of locations; an eraser made of rape-seed oil from what was then known as the Dutch East Indies, mixed with sulphur chloride and a small amount of rubber, along with pumice from Italy; bound with thin metal strips made of brass and nickel from a number of different countries around the world.

And he came to the conclusion that there was no single person who knew how to make a pencil. Many of those involved in its production had no interest in owning, let alone creating a pencil. And there was no one who designed or coordinated all of the activity that resulted in the production of such a basic item.¹

More recently, Thomas Thwaites, an art student at the Royal College of Art in London, pursued this same idea – attempting to build an electric toaster from scratch. Among other things, he tried to smelt iron ore in a leafblower furnace, and after a vast number of compromises, the best that he could make was a device that slightly warmed the bread.

Thwaites sums up his experience with a line from the Douglas Adams' book, *Mostly Harmless*: 'Left to his own devices he couldn't build a toaster. He could just about make a sandwich and that was it.'ⁱⁱ

Of course, much the same applies to many of the financial instruments created by the market in recent decades – no one knows how to make a derivative, or perhaps more seriously, how to unmake one.

We live in a world of astonishing complexity. And while it may not be necessary for Pitt Street stationers to be vertically integrated or to understand the limits of their supply chain, policymakers and institutional engineers charged with designing markets, taxing financial transactions, and establishing new organisations to deliver social services are expected to have a sophisticated understanding of how society works – or at least how significant human ecosystems *within* society work and how they might be made to work better.

For a long time, thoughtful observers have recognised that the complexity of modern society raises profound new questions for government. As long ago as the 1920s, John Dewey, the great American educationalist, wrote:



The ramification of the issues before the public is so wide and intricate, the technical matters involved are so specialized, the details are so many and so shifting, that the public cannot for any length of time identify and hold itself. It is not that there is no public. . . There is too much public, a public too diffused and scattered and too intricate in composition. And there are too many publics. . .ⁱⁱⁱ

That complexity has been exacerbated by the massive growth in the scale and scope of government that has taken place since the Second World War. One of my esteemed predecessors in the Spann Oration, Aaron Wildavsky, noted in the 1970s:

The larger the number of big programs. . . the more they bang into others, the more varied and indirect their consequences become. . . Complexity overcomes theory. Ability to control consequences by program design diminishes as unanticipated consequences increase. The more government does, the more it needs to fix what it does. The larger government gets, the less it responds to events in society, and the more it reacts to the consequences of its past policies. In an era of big government, policies increasingly become their own causes.^{iv}

It was not just that government increased in size in response to growing complexity. 'Economy of scale' became an ideology. The first response of the policy class, whenever one raises the possibility of devolution, is – 'What about economies of scale?' No one ever mentions the possibility that there might be diseconomies of scale. It is thought to be a self-evident truth – scarcely worth the argument – that bigger will be more professional, more efficient and better coordinated.

Partly because of this and partly because of the particular doctrines of political accountability that we have constructed, governments have delivery systems with long feedback loops. Under the 'policy implementation' paradigm, preferences are thought to flow from citizens to politicians, from politicians to policymakers, and from policymakers to service agencies. For the most part, feedback about changing needs is thought to follow this same loop.

This model assumes that service needs are much the same across the nation. Citizens are thought to have broadly the same preferences. Production functions – the relationships between inputs, outputs and outcomes – are assumed to be known and (generally) identical across the community. The quality and quantity of services are decided by the policy class. And innovation largely takes place amongst politicians, political advisers and policymakers.

The bureaucratic model imagines that front-line service providers – teachers, nurses, police officers and the like – think of themselves as public servants; that job freezes can be readily implemented among technical specialists without an impact on front line services; that a medical practitioner can be pulled into a departmental committee without there being consequences for delivery.



The result is a system that is insufficiently responsive to its various publics – to the diversity of consumer interests, if you will – and over-responsive to producer interests. It often delivers a poor quality of service. It is inefficient. There is little innovation in service design or in the scale and scope of delivery. It is better than the private sector in experimenting with organisational form, but it is hopeless at identifying and burning off failures at an early stage. And when successful innovation does occur, the system often fails at scaling up.

Our solutions to the complexity of modern society, then, are largely corporate: organisation on a larger scale; tighter coordination of the constituent parts; better regulation from the centre; more effective leadership at the top.

This approach has understandable appeal to the media and to ministers who are unduly influenced by their press secretaries. It is applauded by the business sector which is inclined to see government as a vast corporation.

A failure of leadership? Sack the current lot and start again. Recruit senior figures from the private sector. Send public servants on leadership training courses.

In his latest book, the ‘Undercover Economist’, Tim Harford comments on this instinct that we seem to share as human beings of believing in the potency of our leaders:

. . . we have an inflated sense of what leadership can achieve in the modern world. Perhaps we have this instinct because we evolved to operate in small hunter-gatherer groups, solving small hunter-gatherer problems. The societies in which our modern brains developed weren’t modern: they contained a few hundred separate products, rather than ten billion. The challenges such societies faced, however formidable, were simple enough to have been solved by an intelligent, wise, brave leader. . .
Whatever the reason, the temptation to look to a leader to fix our problems runs deep.^y

If Harford is right, then leadership is not the solution to the complex, large-scale problems of modern society – at least not leadership in the traditional way that we have understood that term. Has there been an embarrassing failure on the part of front-line public servants? The obvious solution – one that will be instantly recognised as a personal victory by the journalist who broke the story, by aggrieved citizens and relevant members of the policy class – is to introduce tighter controls.

It is now often claimed that interventionism of this kind is a recent phenomenon, a by-product of the 24x7 news cycle, but in *Economy and Society*, Max Weber argued that media scrutiny was one of the principal arguments for tight coupling:



The extraordinary increase in the speed by which public announcements, as well as economic and political facts, are transmitted exerts a steady and sharp pressure in the direction of speeding up the tempo of administrative reaction towards various situations. The optimum of such reaction time is normally attained only by a strictly bureaucratic organization.^{vi}

Let me pause here and note that Max Weber died in 1920.

Most political scientists would now say that Weber was wrong – that more bureaucracy is not the answer. As Al Gore noted in his *Reinventing Government* report in the early 1990s:

The problem is not lazy or incompetent people; it is red tape and regulation so suffocating that they stifle every ounce of creativity. . .

The [US] federal government is filled with good people trapped in bad systems: budget systems, personnel systems, procurement systems, financial management systems, information systems. When we blame the people and impose more controls, we make the systems worse. . .^{vii}

2. The Concept of a Public Service Economy

I want to argue that our response to the complexity of modern government should lie in less regulation of front-line public services, not more; in systems that are coupled less tightly rather than more; in empowering and developing the leaders of relatively small-scale organisations within the public service sector, in preference to building leadership at the top.

I would suggest that the key to successful reform lies in recognising the diversity of the public interest, in building a public service economy that is directly responsive to the concerns of customers rather than being dominated by producer interests.

The future of public services in this country – certainly in state and local government – lies in focusing more on the ‘firms’ that are charged with front-line delivery than the departments that are responsible for the design and implementation of policy.

Let me pause here to make clear – because I know that some will rush to the wrong conclusion – that I am talking about a public service economy not a public service market. I am not saying that such an economy can or should operate in the same way as the market for private goods and services, or that public service firms are or ought to be structured along the lines of the joint stock corporation, or managed with personal gain as the principal motivation.

It is central to my line of argument, however, that in the real world, public services are delivered through a diversity of organisational structures and not simply through the archetypal bureau or



department; that decision-making (and, indeed, policy-making) authority is distributed well down the service delivery chain and not simply concentrated at the top; and that the management and accountability systems that we have imposed on front-line service staff are grotesquely inefficient, resulting in huge deadweight costs.

3. Learning from the Ostroms

My concept of a public service economy has been heavily influenced by the work of the American political economists, Vincent and Elinor Ostrom. Some of you may be aware of Elinor Ostrom from her work on the collective management of environmental commons, which won her the Nobel Prize in Economics last year (the first woman to receive that award). But I am here referring to an earlier body of work, mostly undertaken in the 1960s and 1970s in company with her husband and a school of like-minded economists.^{viii}

The starting point for their analysis was research that had been done in the 1950s on the North American water industry, which recognised the rich 'variety of organizational patterns and institutional arrangements' in water management.^{ix}

On reflection the Ostroms realised that different public services were organised in different ways – the water sector was structured differently from the education sector, and they were organised differently from the policing sector – and the same services were often organised in roughly the same way across different geographies.

From this, they developed the concept of the 'public service industry' which, despite acknowledged limitations, they saw as 'useful in being able to identify areas of productive activity involving interrelationships among many different agencies and units of government concerned with the provision of similar public services'. And these industries, in their turn, operated within the framework of a wider public service economy.^x

The Ostroms recognised the limitations of thinking of public services as tightly-integrated structures where voters communicated their preferences by selecting decision-makers who were responsible for making production decisions.

The concept of the single self-sufficient public firm producing all of the public goods and services for its resident population is no longer a tenable concept for understanding the structure and conduct of the public service economy.^{xi}

They were the first to develop the concept of distinct supply and demand sides to the public service economy – they used the terms provision and production where today we would speak of commission (or purchase) and provision.^{xii}



And they recognised that through grants and contracting, it was possible for the scale and scope of the supply side to differ from that of the demand side. A national government could commission services from a small not-for-profit provider, while a local council could purchase inputs from a multinational corporation.^{xiii}

The Ostros and their associates understood the potential for variety on the supply side, but they were much more interested in the different economies of scale and scope and the rich diversity that existed (or could exist) in the design of collective consumption units – shaped by such factors as physical geography, management efficiency, political representation and local self-determination.^{xiv}

They recognised that economies of scale in consumption – a concept that has little meaning in the private sector where the unit of consumption is an individual – were closely associated with the economies of consultation and representation.

They saw that collective consumption units could range in size from small municipalities to national governments and even international regimes. They might be single-purpose or they might undertake a wide variety of tasks. And they did not always need to be organised as governments – Elinor Ostrom included neighbourhood organisations, condominiums and homeowner associations, churches and professional associations.^{xv}

They understood that through contracting, the supply side could be competitive, but they also recognised the potential for competition on the commissioning side of the public service economy. The Ostros advocated a robust form of federalism and what they referred to as ‘polycentricity’ in governmental organisation.

They recognised that in federal systems, politicians and policy entrepreneurs compete over the boundaries of life’s responsibilities – between our shared sense of nationhood and our desire to have decisions made close to us. They were much less concerned than others about overlap and duplication, which they saw as essential elements of a vigorous public service economy.^{xvi}

From very early on, they recognised that the concept of a public service economy implied that someone bore the responsibility for market design, for regulation and for adjudication.^{xvii} But they also saw the inherent difficulties involved in ensuring that competition between governments was fair and efficient.

We are speaking here of a truly federal system – federal not just in the same that there is constitutional recognition of state and federal (and perhaps local) governments, but federal in the sense of polycentric, with a variety of collective consumption units of differing scale and scope, and an array of providers on the supply side.



For the Ostroms, this was partly a matter of recognising the rich diversity that already existed in the public service economy, but was usually overlooked by the policy class in their desire to make sense of the world. However, the Ostroms' work was never *just* descriptive; they sought to influence the future direction of public policy.

Some would argue that in that regard, they largely failed: few policy analysts today have heard of them. But they had a significant impact nevertheless. Charles Tiebout, author of 'A Pure Theory of Public Services', was a member of their circle.^{xviii} Elinor Ostrom developed the concept of 'toll goods', referring to public goods that can be rationed through constrained entry. We are heavily indebted to them for the concept of the commissioner-provider split. And without that early foundation, it is unlikely that Elinor would have developed her interest in the management of common pool resources which won her the Nobel Prize.

I would also suggest that a reading of the Ostroms may be the best way of making sense of public service reforms in the UK over the past two decades – although I would argue that that influence was indirect. Their work is particularly useful in trying to understand the UK Civil Service White Paper, 'Open Public Services', released this past July. Consider the following:

We want control of public services to be as close to people as possible. Wherever possible we want to decentralise power to the individuals who use a service. But where a service is used by a community collectively, the control over services needs to be exercised by a representative body. In these circumstances we are clear that the principle should be to decentralise power to the lowest appropriate level. For many services, this will mean the community groups and neighbourhood councils. . .

We do not have an ideological presumption that only one sector should run services: high-quality services can be provided by the public sector, the voluntary and community sector, or the private sector. . .

With open public services, the job of government is not to specify which sector should deliver which service to which people; rather, it is to create an open framework within which people have the power to make the choices that are best for them, and where all good, innovative ideas for improving the quality of services are welcomed and encouraged.^{xix}

The Ostroms' concept of a public service economy is extraordinarily useful in making sense of such reforms. And it might assist governments in shaping the reform of public services in this country.

I would regard it as most unfortunate if, in the pursuit of increased diversity in the public service economy, Australian governments were to revert to a crude form of outsourcing which simply resulted in the wholesale transfer of public services into the hands of joint stock corporations. That would simply replace one kind of institutional monoculture with another.



Public services require a very different ecosystem from what we usually encounter in the private sector, and governments should actively encourage institutional diversity in such an environment. We know, for example, that not-for-profit enterprises prosper in the public service economy in a way that they do not in the marketplace.

This is one of the ways in which the Ostroms' work might be of service to Australian governments. It can also provide a theoretical framework for the devolution of authority (and accountability) to front-line service managers.

There is broad support for devolution in this country just at present. In recent years, Western Australia has introduced 'Independent Public Schools'. The federal government is favourable to this concept in schooling, and an encouraging start has been made in New South Wales. The current policy settings in the NSW Department of Health are also leading to greater devolution.

But we know from past experience, that this battle will be hard-fought. Already in Western Australia, it has been suggested that the empires are fighting back. It is vital that there is a broader theoretical framework underpinning these reforms.

4. Exploring the Public Service Economy in Australia

Since being appointed to the NSW Premier's ANZSOG Chair in Public Service Delivery in July, I have initiated a research project which seeks to understand how public service firms operate in this country.

The first stage of the project is descriptive. We are interviewing the managers of public service firms – schools, hospitals, prisons, and the like – with a view to giving them a voice and seeking to understand their experience of the policy and managerial environment within which they operate.

We know from other research that they are deeply frustrated by the red tape and regulation, by the confetti of instructions that continuously flutter down from head office. We know there is a vast pool of talent that is seriously under-utilised. We know that what little innovation does take place on the front line is undertaken by remarkable men and women who are bending and, in some cases, breaking the rules in their attempts to make a difference.

I hope that we might be able to quantify the dead weight losses associated with persistent intervention in the delivery of front-line services. There is some analysis of what happens when public services are contracted; and some comparative research on overheads in the public and private sectors and in centralised and devolved administrations. This suggests that the costs may be considerable, in some cases as much as 20 or 30 percent.



5. Some Possible Solutions

However, there must be a prescriptive element to this research. It is essential that we find ways to use front-line public service managers more effectively. I am a realist and I do not under-estimate the difficulty of that challenge. And while this project still has a long way to go, let me suggest where some of the solutions might lie.

a. Policymaking by tinkering

We have developed a version of democratic accountability which insists that politicians and policymakers have the right to intervene in the delivery of front line services whenever it is convenient – because if head office could not intervene at any time, then it wouldn't really be public accountability, would it?

But when we speak of tactical intervention of that kind, we are not speaking about accountability at all – we are talking about *control*. The policy class wants the freedom to tinker with service delivery as they go.

In large part, that is because the policy class fails to understand how management works. They live in a different world, with different time horizons, a different culture, a different set of challenges.

They reserve the freedom to endlessly adjust and re-adjust policy settings, in the interest of 'getting it right', failing to understand the immense cost that they impose on service providers, in terms of efficiency, innovation and service quality.

So policymaking should be strategic and interventions should be punctuated. Front line service managers and project managers must be provided with a clear policy and regulatory framework, which by definition, must last for somewhat longer than six months.

Of course there must be the capacity for intervention when there is catastrophic failure, but there must be an end to the endless tinkering. Give public service firms a service level agreement, a 'quasi-contract', for five or seven years and let managers get on with the job.

I am, as I said, a realist. I understand that politicians must sometimes be seen to take the initiative, and the electoral cycle and the news cycle mean that they must be seen to intervene. These are the realities of the modern mass media.

The solution to that, I believe, lies in greater use of pilots, and in breaking up the monoliths, so that different service managers are operating on different delivery cycles. Initiatives can then be tested through pilots, and rolled out over time, instead of attempting to scale up new initiatives all at once.



b. Process Accountability

To have the public service perpetually in fear of being named in parliament or humiliated in the media is not public accountability.

It might be a form of transparency, but of a nihilist kind favoured by romantics such as Julian Assange, who imagine that exposing and mocking the frailties of politicians and public servants will bring us closer to our shared ambition of good government.

This is entertainment, and it sells papers. It is unavoidable, since in a free society the occasions on which we silence the media must be very, very rare. It is a public service, because the media sometimes expose dreadful omissions or commissions that would not otherwise be brought to light.

But it is not accountability. And it creates dreadful distortions in the performance incentives faced by politicians and, without a considerable amount of countervailing effort, it adds massive costs to the delivery of public services.

Far too often, we design our public institutions to minimise scandal, not to maximise the social value of the services they deliver.

It has long been recognised that the traditional bureaucratic response to this blame-oriented culture is a retreat into accountability systems based on compliance with due process.

And the history of public management in the entire post-war period is an attempt to turn that around – to get public service managers to focus on performance, on the results, on the outcomes.

We have created a vast system of administrative law, populated by thousands of lawyers and judges, whose reason for existence is to force public servants to comply with the rules – regardless of whether those rules result in better outcomes.

In large part, I believe that the rapid expansion of public service contracting over recent decades is a rebellion against process accountability of this kind. In their frustration, politicians and policymakers are using contract law to supplant administrative law – because contract law makes it much easier to hold service providers accountable for results.

The challenge is to find a way of using contractual instruments within the public sector – making performance accountability finally work within government.

c. Lack of Trust

The third major source of dysfunctionality with the bureaucratic model lies in a failure to trust frontline management and staff. Harvard academic, Steve Kelman, studied this problem in IT procurement in the US federal government, exposing the bizarre outcomes that followed when procurement teams were not trusted to exercise discretion:



The problem with the current system is that public officials cannot use common sense and good judgment in ways that would promote better vendor performance. I believe the system should be significantly deregulated to allow public officials greater discretion [which would] allow government to gain greater value from procurement.^{xx}

Now, I hasten to add that I am not talking about blind trust. Trust must be earned. Trust must be accompanied by appropriate accountability. By and large, front line public service managers get that – they understand that increased autonomy and increased accountability are flip sides of the same coin.

One possible solution may lie in the use of quality certification for public service firms. This option is being tentatively explored in the education sector in this country – school principals are hoping that periodic auditing combined with certification might free them to some extent from meddling by head office in how they do their jobs.

However, we will never be able to devolve decision-making authority as long as outcomes are unclear. James Q. Wilson has pointed out:

... the more contextual goals and constraints that must be served, the more discretionary authority in an agency is pushed upward to the top. . . The greater the number and complexity of those goals, the riskier it is to give authority to operators.^{xxi}

If senior policymakers are unprepared to provide frontline service managers with a clear statement of requirement, then it will be virtually impossible to delegate real authority, and it will be dangerous to get rid of staff engaged in policy and oversight in head office.

d. Skewed balance of risk and reward

Finally, for all of the afore-mentioned reasons, frontline service managers face perverse incentives when it comes to innovating and taking measured risks in the delivery of outcomes. Punishment is often unfair and disproportionate to the mistakes that have been made. And rewards are too weak to justify taking measured risks to innovate or trying to improve the quality of delivery. We cannot expect serious innovation in public service delivery until this imbalance is addressed.

I recall a report by an American think-tank published several years ago which looked at high-performing schools in high poverty areas. The report identified leadership as the common denominator – but where the principals from the private and charter schools had a charter to innovate, those from the public schools were remarkable, almost charismatic figures.^{xxii} We cannot hope to build a public service economy based on heroes. Reform must be systemic rather than heroic.



6. Conclusion

As most of you are aware, I have recently returned from ten years in the United Kingdom, where I was intimately involved in the transformation of the public service economy that took place under Tony Blair and Gordon Brown.

When in 2000, I was offered the opportunity to work in the UK, I jumped at the opportunity because of all world leaders at that time, I believed that Blair had the clearest understanding of the fundamental changes that were taking place in government.

For the most part, the Blair Project was a search for the new model of public service management. It was time-consuming and at the time that he retired, it was incomplete, although under his Premiership, the public and private sectors did explore a wide range of possibilities, and for that reason, they are probably better positioned than most governments throughout the industrialised world.

However, given recent events in Europe, it might be argued that the Blair Project failed. They failed to understand that the European Model, which created in the aftermath of the Second World War, had reached its use-by date, and they failed to anticipate the scale of the transformation that would be required.

That has now changed. Let me pass over what is happening in Italy and Greece: in the UK – where some departments are facing cuts of 20 to 30 percent – senior officials are engaged in a project entitled ‘Transforming the Civil Service’, which is asking fundamental questions about the core business of government and the future of public services.

It is possible for those of us living in the Lucky Country to imagine that we will be immune from the radical changes taking place in the rest of the world. We will not have that luxury. It is only a matter of time before we are forced to fundamentally rethink the way in which our public services are financed, structured and delivered.

In my view, we must start by liberalising the public service economy.



Endnotes

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- ^{iv} Aaron Wildavsky, 'Progress and Public Policy, in Gabriel A. Almond et al (eds.), *Progress and Its Discontents*, Berkeley: University of California Press, 1982, p.370.
- ^v Tim Harford, *Adapt: Why Success Always Starts With Failure*, London: Little Brown, 2011, p.6.
- ^{vi} Max Weber, *Economy and Society*, Berkeley: University of California Press, 1978, p.974.
- ^{vii} Al Gore, *Reinventing Government: Creating a Government that Works Better and Costs Less*, New York: Times Books, 1993, p.2.
- ^{viii} The quickest way of accessing this literature is Vincent Ostrom (ed.), *The Meaning of American Federalism: Constituting a Self-Governing Society*, San Francisco: Institute for Contemporary Studies, 1991.
- ^{ix} Stephen C. Smith, 'Problems in the Use of the Public District for Ground-Water Management', *Land Economics*, Vol.32, No.3 (August 1956), pp.259-269; Vincent Ostrom, 'The Political Economy of Water Development', *American Economic Review*, Vol.52, No.2 (May 1962), pp.450-458.
- ^x Vincent and Elinor Ostrom, 'A Behavioral Approach to the Study of Intergovernmental Relations', *Annals of the American Academy of Political and Social Science*, Vol.359 (May 1965), pp.137-146, at p.140. The concept of the public service economy had been published earlier in a seemingly more developed form in Vincent Ostrom, Charles M. Tiebout and Robert Warren, 'The Organization of Government in Metropolitan Areas: A Theoretical Inquiry', *American Political Science Review*, Vol.55, No.4 (December 1961), pp.831-842.
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- ^{xii} Richard Musgrave had recognised the point in 1959, but the Ostroms and their associates were the first to develop the concept and its implications – Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy*, New York: McGraw-Hill, 1959, p.15.
- ^{xiii} Ostrom, Tiebout and Warren, 'The Organization of Metropolitan Areas. . .', p.833.
- ^{xiv} Ostrom, Tiebout and Warren, 'The Organization of Metropolitan Areas. . .', pp.835-838.
- ^{xv} Elinor Ostrom, 'The Comparative Study of Public Economies', *American Economist*, Vol.42, No.1 (Spring 1998), pp.3-17 at p.5
- ^{xvi} The clearest exposition of this view of federalism is Albert Breton, *Competitive Governments: An Economic Theory of Politics and Public Finance*, Cambridge: Cambridge University Press, 1996.
- ^{xvii} Vincent and Elinor Ostrom, 'A Behavioral Approach. . .', pp.143-146; Ostrom, Tiebout and Warren, 'The Organization of Metropolitan Areas. . .', pp.839-842.
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- ^{xix} HM Government, 'Open Public Services White Paper', Cm 8145, July 2011, pp.8-9.
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- ^{xxi} James Q. Wilson, *Bureaucracy: What Government Agencies Do and Why They Do It*, New York: Basic Books, 1989, p.133
- ^{xxii} Samuel Casey Carter, *No Excuses: Lessons from 21 High-Performing, High-Poverty Schools*, Washington: The Heritage Foundation, 2001.