Chapter 5
Operational Efficiency

Operational efficiency is the ratio of the resources expended by government agencies to the outputs produced or purchased by them. The resources can be measured in money terms or in terms of other inputs, such as work hours or years. Output is conventionally measured in volume terms, but qualitative dimensions can also be measured. These include the accuracy of payments (or of other transactions), the timeliness of services, the courtesy with which they are provided, and the satisfaction of recipients. In measuring operational efficiency, these qualitative indicators can be correlated with the volume of resources or other inputs.

Operational efficiency generally refers to government consumption expenditure in the national income accounts, in contrast to allocative efficiency which covers investment expenditure and transfer payments as well. For example, operational efficiency is concerned with the cost of processing pension claims, but not with the amount paid out in benefits. The distinction is not always clear-cut, however, because operational efficiency often affects program allocations. In unemployment compensation for instance, the volume of benefits paid varies with the efficiency (accuracy, timeliness, etc.) with which claims are serviced. Nevertheless, it is useful to distinguish the cost of producing outputs from the cost of providing a particular level of benefits. The distinction parallels the one commonly drawn between outputs and outcomes.

Operational efficiency spans much more than the running costs of government agencies, though this is the

part of the budget that has been most impacted by recent efforts to enhance efficiency. In some developed countries, running costs add up to only about 10 percent of the central government's budget, but this low percentage typically excludes significant operating expenses, such as the cost of repairing and maintaining roads, feeding prison inmates and hospital patients, and teaching schoolchildren. Even with an expanded definition, operating costs have declined as a share of national expenditures in developed countries, though they still are a significant part of the budget. In these countries, the bulk of the central government's budget is spent in transfers to households and to subnational governments. In developing countries, transfer payments tend to be less prominent and operating costs dominate the national budget. In some of these countries, operating costs are very high because public employment rolls are bloated and productivity is low. Regardless of the composition of the budget, operational efficiency is important because it affects the availability of resources for social development, citizen attitudes toward government, the relative prices of government and market-provided goods and services, the integrity of government, the allocation of resources between the public and private sectors, and the reliability of information on public finances and programs. Operational efficiency is particularly important in poor countries. When government is inefficient, public sector wages tend to be low, much public expenditure is absorbed by deadweight administrative costs, and the government is robbed of resources needed for critical social development.

During the past two decades, significant advances in management theory and practice have generated new interest in improving operational efficiency. With concepts and applications liberally adapted from institutional economics and business organizations, the new public management (or managerialism, as it is sometimes called) has led in some countries to expanded operating discretion for public managers, new forms of contracting within government and between public entities and private providers, greater attention to results and accountability for performance, and the modernization of information systems. Some countries have sought to improve operational efficiency through the ex ante specification of output targets and the ex post review of results. Efficiency

gains have been very high in countries (such as the United Kingdom and New Zealand) that have separated service delivery from policy advice and the purchase of services from the provision of services, leading other countries to consider a similar restructuring of their own operations.

Following the structure of previous chapters, this chapter discusses the evolution of operational efficiency, its key elements, and institutional, informational and incentive prerequisites of reform.

Evolving Concepts of Operational Efficiency

Operational efficiency deals with the relationship of budget inputs and program outputs. Over the years, many governments have sought to enhance operational efficiency by controlling the inputs; recently, a few have shifted to control of outputs.

Modern budgeting began in 19th Century Europe as a process for controlling the volume of inputs—both total expenditure and the individual items. But while spending control always has been an essential feature of budgeting, the manner in which it is exercised has changed over the years. Budget control has gone through three stages: external control of spending items by central agencies; internal control on inputs by spending departments; and managerial discretion and accountability for producing outputs. In the formative years of their budget systems, all governments seek to establish external control. Some have persisted with external control even when their budget system was highly developed; others have moved to internal control systems. Thus far only a few have shifted to managerial accountability for outputs. *This sequence indicates that a government must establish the rudiments of external control before it can safely switch to internal control, and it must have robust internal controls before it can entrust managers with broad flexibility and accountability for resources and outputs*. Some developing and transitional countries seeking rapid improvement in public administration have tried to leap from inadequate internal control systems to managerial accountability, but (as discussed below) there may be substantial risk in ceding broad discretion to managers before internal controls are highly developed.

The form of budget control affects operational efficiency in several ways. First, the various approaches differ in

their informational requirements and procedures, and, therefore, in the operating costs they impose on government departments. Second, the controls differ in the incentives they give managers to be efficient in spending public money. To anticipate the argument made later, devolving control to managers reduces information and compliance costs while giving managers incentives to improve efficiency. But these gains come with the risk that if internal control is not effective and accountability is not strictly enforced, spending control might break down, and there would be a loss in efficiency. Table 5.1 compares the three types of control system.

External Control

This form of control has three basic characteristics: spending actions and control of operating funds are entrusted to two distinct entities; control is exercised exclusively over inputs; and control is imposed before any action entailing the expenditure of funds is taken.

External control means that line managers must obtain authorization from central controllers before they spend public money, even if funds were budgeted and appropriated for the purpose. The outside authority usually is the finance ministry, the civil service agency, or an agency responsible for overseeing the government's purchase of supplies and equipment. In some governments approval has to be obtained for each discrete transaction; in others, blanket authorization is provided for a group of expenditures. For generations, external control was practiced through Treasury control in the United Kingdom and other Westminster countries; by inspectors or controllers of finance in France, Germany, and many other countries; and through line item budget and accounting systems.

Looking back at the evolution of public expenditure management in developed countries, one can understand why strict external controls once were regarded as a signal advance in public administration. At one time—a century ago in many countries, only a few decades ago in others—government was small, its program objectives modest, and needed administrative skills were in short supply and concentrated in central agencies. Civil service systems and rules were in their infancy, procurement was not well regulated, and public accounting practices were not standardized.

Table 5.1: Types of Expenditure Control

Type of control	*Exerised by*	*What is controlled*	*Mode of acountability*
External Control	Central Agencies	Inputs: specific items of expenditure	Compliance with Itemized Budget and Government-wide rules Preaudit of transactions
Internal Control	Spending Departments	Inputs: classes of expenditure	Department Systems comply with Government-wide standards Postaudit of transactions
Managerial Accountability	Spending Managers	Outputs and total running costs	Accountability for outputs Ex ante specification of outputs Ex post audit of results

External control was an appropriate response to this unsatisfactory state of affairs, for it inculcated the habits and ethic of compliance with rules in government organizations. Because control was centralized, operating managers had to hone the skills of preparing and implementing detailed budgets, employing and supervising staff under civil service rules, and purchasing supplies in accord with government regulations. They also had to provide central authorities with periodic reports on their activities.

To the extent these conditions still persist, as they certainly do in many developing countries, it would be appropriate for management reforms to concentrate on strengthening external controls, so as to reduce corruption, build up managerial capacity in central agencies and spending departments, and prepare the way for shifting to internal controls.

External control is exercised on the input side of the budget; outputs are not explicitly considered and data on them are not systematically compiled.

Despite its limited scope, input control can be effective because it is activated before spending occurs, it can be applied uniformly throughout government, it economizes on public expenditures, it separates those who decide on the legality and propriety of expenditure from those who actually spend the money, and it can be pinpointed to specific transactions. But adverse effects on operational efficiency are ignored because these controls pertain only to inputs.

Although external controls may have worked reasonably well in developed countries when government was small, as public expenditure increased, the individual items receded in importance. Moreover, operating agencies now had their own administrative competence, and central agencies such as the ministry of finance became more interested in program and economic issues than in operating detailed input controls. Within departments, corps of line managers were trained to operate modern personnel, budgeting, and procurement systems. It became prudent, therefore, to entrust them with some measure of managerial discretion.

As a government grows, the cost of managing on the basis of external control escalates. These controls are costly because they are enforced by burdensome procedures, and require extensive monitoring. They breed both a compliance mentality—it is more important to follow the rules than to operate efficiently—and evasion of the rules. In countries which enforce external controls, managers learn how to "game" the civil service pay and classification system, how to spend on coveted items even when budgeted funds are not available, how to rig contracts so that purchases are made from favored vendors. An informal administrative culture emerges: there are the rules, and then there are the ways things really get done. This double standard—strict rules and loose compliance—is a breeding ground for inefficiency and corruption.

Internal Control

External control still is practiced in some developed countries, but since the postwar period there has been a marked trend towards internal control. In its most basic sense, *internal control means that those who spend public funds have first-instance responsibility for ensuring the legality and propriety of their actions.* Under internal control, operating agencies must establish personnel, purchasing and other management systems that comply with government-wide stan-

dards. Control still focuses on inputs, but managers no longer have to obtain outside approval before they act. In lieu of preaudit (before the expenditure is made), the government shifts to postaudit (after the financial period has ended), and instead of reviewing all transactions, it samples a small number to ascertain whether the system in operation (and not only in design) complies with the rules.

Although internal control vests managers with greater operating discretion, uniformity still is demanded. In managing resources, they must abide by government-wide pay and classification schemes, they must make purchases following prescribed procedures, and they must comply with externally-imposed rules. The key difference is that they rather than outsiders make the determination as to whether a particular transaction would be in compliance with the rules.

Internal control improves operational efficiency by reducing compliance costs and by giving mangers some leeway in organizing work and carrying out assigned responsibilities. Nevertheless, internal control, as it has been practiced in various countries, is only a modest step forward. Managers still feel bound by external rules, they still operate with a compliance mentality, and despite the liberalization of operating rules, managers still are strictly regulated in using the funds appropriated to them.

There are three main reasons why internal control does not put managers in charge. First, the pursuit of uniformity deprives managers of operating discretion. "One size fits all" still constrains public managers. Second, managers still must receive central approval for key operating decisions. For example, a central agency typically assigns accommodation to government agencies, charging their budgets for actual or imputed rents, even though managers have little or no say about the premises they occupy. Finally, when central agencies relax their control, the controls often migrate to departmental headquarters. From the perspective of operating managers, it makes little difference whether they are restricted by the central civil service board or by their own department's personnel office. In both situations, managers cannot exercise judgment on how best to operate.

Although they do not enable managers to optimize operational efficiency, internal control systems facilitate the transition from external control to

arrangements which give managers virtually complete control of operating funds. Without the experience, information, and managerial skills developed under internal control, managers would not be prepared to take full responsibility for operations.

Managerial Accountability

This arrangement shifts the focus of control from inputs to outputs, from what managers are buying to what they are producing. It does so by giving them broad discretion to spend appropriated resources, in exchange for which it holds them accountable for performance. The two sides of the exchange are inextricably linked: without discretion, managers cannot be held accountable for results; and without being held accountable for results, managers would (or should) not be given operating discretion. Only a few countries have moved in this direction, most notably, New Zealand, the United Kingdom, Australia, and Sweden.

In countries embracing managerial accountability, managers are given wide discretion in spending operating funds. They can decide how much to spend on personnel, whom to hire, how to pay them, the premises to be occupied, whether services should be provided in-house or outsourced, and so on. The government may retain some residual controls, such as equal opportunity rules for staffing, maximum pay levels for senior civil servants, or a ceiling on the value of contracts that can be tendered without competitive bids.

Some governments have been spurred to enlarge managerial discretion by adverse budget conditions. Faced with chronic deficits and escalating transfer payments and interest charges, some have sought to cut operating costs, by means of spending freezes, across-the-board cuts, cash limits, and other methods. Britain has had cash limits on operating expenditures since the mid-1970s; Japan has enforced a sinking lid on these expenditures for approximately two decades; Australia cuts operating budgets by a percentage equal to a required efficiency dividend; Sweden has constrained operating costs for almost two decades; the United States has had a statutory limit on appropriations since 1990. The longer these constraints are in place, the more onerous they become, and the greater the risk that affected departments will adjust to the loss of resources by cutting the volume or the quality of services.

Governments can seek to avert hidden cuts by specifying the outputs that are to be produced with budgeted resources. Most of the countries mentioned above have greatly increased the volume of output data published in the budget and related documents. A few (New Zealand and the United Kingdom) routinely compare actual and targeted outputs; others (Australia and the United States) use a variety of performance measures. In these and other countries, the government has taken steps to make managers accountable for outputs through annual reports, performance measurements systems, and the auditing of performance data.

But targeting outputs is not likely to induce managers to be more efficient if they lack discretion in using appropriated funds. Being accountable for outputs requires that managers have the freedom to decide on the mix of inputs. Accordingly, a few countries have greatly increased the operational discretion of managers. Australia and the United Kingdom have running cost arrangements that give managers a lump sum operating budget. Australia and Sweden allow managers to carry over unused operating funds from one fiscal year to another and, in some circumstances, to prespend a small portion of the next year's operating funds.

New Zealand probably has gone further than any other country in reorganizing its public expenditure system to increase managerial discretion and accountability. Since the early 1990s, appropriations have been made by output classes; the budget, the supporting estimates, and appropriations do not itemize inputs. The budget, appropriations, and financial statements are on an accrual basis, showing the full cost of producing outputs. Departments are charged for the capital invested in them by the government, and they are charged for depreciation of fixed assets. Departments manage their cash balances, earning interest if the rate of spending is lower than expected and paying interest if it is higher. If departments divest assets (for example, by remitting excess cash balances to the government), they reduce the capital charge, and the savings can be applied to any other operating expenses. Accountability for outputs is maintained through a series of contract-like documents. When the government submits the budget to Parliament, each department tables a "forecast report" itemizing the major outputs to be produced pursuant to the amounts bud-

geted for it. More detailed specification of outputs is contained in purchase agreements negotiated each year between the chief executive of each department and the minister purchasing outputs on behalf of the government. In design, but not always in practice, the minister has the option of purchasing outputs from the department or from any alternative supplier. These and other features of the New Zealand model are reported to have produced substantial gains in operational efficiency. Additional information on New Zealand is provided in Box 5.1.

Managerial accountability contributes to operational efficiency in two ways. First, by targeting (and, in a few countries, contracting for) outputs, it makes managers responsible for the volume, timeliness, and quality of the services produced. Unlike control systems which define efficiency in terms of economizing on inputs, managerial efficiency expands the opportunity for efficiency by optimizing on outputs. Second, by giving managers full (or near-full) operating discretion, this arrangement enables them to apply their professional skills, judgment, and information to select the most efficient mix of inputs. For example, managers have incentive to economize on the cost of accommodation because savings can be applied to any other operating expenses.

Application to Developing and Transitional Countries

There is understandable interest in developing and transitional countries to accelerate the pace of reform by adopting the most advanced and promising innovations devised by developed countries. This interest has been whetted by the attention and acclaim given the New Zealand model, and by the hope that enormous gains can be quickly achieved in operational efficiency. Yet there are important preconditions for the successful implementation of managerial accountability, and these should not be ignored by countries striving to improve public sector management.

The typical developing or transitional country has a formal external control system, extensive evasion of the controls, and low operational efficiency. Advising these countries to go through the sequence of managerial reforms outlined earlier—first establish reliable external controls, then shift to internal control systems, and only after these systems are well

Box 5.1: New Zealand's Contractual Model

In every formal contractual relationship, five conditions must be present in order for the parties to enter into the agreement and to perform according to the terms of the contract. (1) The two sides must have an arms length relationship; (2) the purchaser must have freedom to purchase goods or services from alternative suppliers; (3) the supplier must have freedom to produce the contracted goods and services; (4) the contract must specify the cost of the goods or services; and (5) the contract must specify the performance required of the supplier.

Beginning with the enactment of the State Sector Act 1988 and the Public Finance Act 1989 and continuing into the 1990s, New Zealand has transformed public management to satisfy each of the five conditions for contracting.

(1) Arms length relationship. In most departments, the government has decoupled policy advice from service delivery, either by hiving off the latter into new organizational units or by reorganizing the department into a number of discrete business units. For example, the Ministry of Defense was restructured so that it is responsible only for providing policy advice to the minister; military operations are entrusted to a new organization, New Zealand Defense Forces which contracts with the Minister for various services.

(2) Purchaser freedom. In New Zealand, appropriations are made to the Minister who has the option of purchaser services from government departments, other public entities, or outside suppliers. In fact, most services are purchased from governmental suppliers, but many are not.

(3) Provider freedom. To enter into contract, providers must have discretion to manage their operations as they deem appropriate. In New Zealand, each department is headed by a chief executive who serves under an employment contract for a fixed term. The chief executive has full discretion to use the resources available to the department, without constraints on the amounts that can be spent on personnel, supplies, and other inputs.

(4) Specification of cost. In contracting, the purchaser and supplier must agree on the amount of money that the former will provide to the latter. This amount must reflect the full cost of producing the services. Accordingly, New Zealand accounts and budgets on an accrual basis, which shows the full cost (including depreciation charges and a charge on the use of capital) of producing the services.

(5) Specification of outputs. Finally, contracts must specify the outputs to be supplied. This requires that outputs be specified in advance and that departments compare actual outputs to targeted outputs. In New Zealand, the budget is prepared and appropriations are made by output class, not by inputs. Moreover, each department submits a "departmental forecast report" specifying the outputs for the next fiscal year, and negotiates a purchase agreement with the Minister specifying the outputs to be provided. After the year is over, each department published an annual report detailing both its financial performance and its outputs for the year.

embedded move to managerial accountability—may seem to be a prescription for failure. After all, why rely on centralized controls (civil service classification and pay schemes enforced by a central agency, budget estimates that itemize and separately control each category of inputs, and so on) when these controls breed corruption, evasion, and inefficiency? Why stretch out the process of managerial reform over decades when the opportunity is at hand to leapfrog to state of the art systems?

Notwithstanding these arguments, governments take enormous risks if they adopt a regime of managerial discretion and accountability before strong, reliable controls are in place. *There are two elements to effective controls systems: workable rules and procedures; and patterns of behavior that accept the rules and procedures as legitimate*. To say of a country that actual expenditures do not conform to the amounts shown in the budget, or that the hiring and remuneration of staff is not based on civil service rules and procedures, is to say that the time is not ripe for managerial freedom.

Rules work when they are accepted as fair and rational. It is for this reason that external control typically precedes internal control, and that internal control is a precondition of managerial accountability. External control nurtures the habits and practices of managing according to the rules. True, it takes a bite out of operational efficiency, but the cost is justified when the rule of law is implanted in the public administration.

Once this occurs, government can safely adopt systems of internal control which entrust operating managers with greater control of their inputs. In a formal sense, internal control means, as was explained earlier, that the spending agency is responsible for systems that ensure legality and efficiency in expenditure; in a behavioral sense, it means that the controls are internalized, that managers accept the rules—not because their actions are monitored by others or because they would be penalized for violating the rules—but because they regard the rules as legitimate and workable. Without this behavioral dimension, internal control would open the door to abuse, no matter what safeguards are built into the formal control systems.

This culture of compliance paves the way for managerial accountability in which managers have formal

carte blanche in purchasing inputs but are responsible for producing budgeted outputs. Managerial accountability does not mean that anything goes in spending inputs; it means rather that managers, having internalized the rules, can be trusted to spend properly and efficiently. Without this internalized behavior, managerial discretion would be risky and costly.

Although developing and transitional countries may not be ripe for avant-garde managerial systems, the process of development need not stretch over decades or longer. The process can be accelerated by (a) rationalizing external controls, removing duplicative and deadweight controls (for example, by consolidating budget items and civil service classifications); (b) tendering internal control authority to well-managed departments that can handle enlarged responsibility; (c) instilling a managerial ethic in the public service through skills-based and behavioral training; and (d) developing first-generation performance measuring systems. These steps would enhance operational efficiency and prepare the way for bolder reforms in the future.

Basic Elements of Managerial Accountability

Inasmuch as managerial accountability systems are in their infancy, their basic elements have not yet been standardized. Nevertheless, the following elements seem essential in systems that purport to give managers operating discretion in exchange for enforcing strict accountability. Some of those are discussed in Table 5.2.

- *Managers are given global operating budgets*

  Within this total, spending items are fungible; managers have incentives to be efficient because they have more to spend on some items by spending less on others.

- *Managerial control is devolved to operating levels*

  Those who provide the services (field offices, for example) are given their own operating budgets and managerial flexibility. Without devolution, managerial power would be concentrated in headquarters and operating managers would lack incentive to be efficient, or opportunity to be accountable.

Table 5.2: Instruments for Improving Managerial Accountability

Instrument	*Advantages*
Running Costs Budget	Managers are given a single allocation for all operating expenses to spend on inputs as they deem appropriate, thereby reducing compliance costs and giving manager incentive to operate efficiently.
Devolved Budgets	Line managers in field offices and other units control their own operating budgets, thereby enabling them to respond to local needs and conditions and to operate efficiently.
Efficiency Dividend	Percentage reduction in operating budgets equal to expected annual productivity gains compels managers to seek efficiency improvements.
Output Specification	Expected outputs are specified in the budget or related documents, thereby giving managers advance notice of expected performance, and enabling the government to compare targeted and actual results.
Separation of Purchasers/Providers	Reduces capture of purchasers by providers and enables purchasers to choose among alternative providers, thereby creating internal markers within government.
Market Testing	By comparing the cost of purchasing services from its own agencies versus outside suppliers, the government can select the most efficient means of obtaining services.
Performance Agreements	Contracts between the government and chief executives or their agencies specify the resources to be made available and the output to be provided, thereby establishing a basis for assessing individual or organizational performance.
Annual Reports and Audits	Agency reports on financial results and outputs are independently audited to assess reliability and relevance of performance information.

- *Costs are allocated to outputs or activities*
  If managers are to be efficient, they must be charged the full cost of producing outputs and of carrying out required activities. Some countries use cost allocation models for apportioning overhead and other indirect costs; a few have cost accounting systems in which resources are accounted for on an accrual basis. Along with allocating and accounting for costs, it is necessary that managers have discretion with respect to the costs charged their budgets. For example, if they are charged for accommodation, they should have freedom to decide where their operations will be located.

- *Expected outputs are specified in advance*
  Expected outputs are specified in advance, either in the course of compiling the budget or in contracts between managers and their superiors. Ex ante specification requires that outputs be measured or stated in a form that enables those purchasing or providing outputs to know what they are buying or selling. A few countries (most notably the United Kingdom) specify a small number of key performance targets; others (such as Australia) encourage managers to specify the full array of outputs to be produced.

- *Purchaser and provider roles are split*
  In conventional public administration, policy decisions on what the government should do are combined in the same organization along with operating decisions on how services should be provided. This functional integration was long regarded as a virtue because it facilitates the free flow of ideas and feedback between policy makers and operating managers. But in modern public expenditure management, it often is regarded as a disincentive to efficiency because (a) policy makers are captured by providers, (b) policy makers lack needed independence and information to

Table 5.3: Types of Output Targets

Type of measure	*Example*
Volume/Workload	The agency will process 562,400 claims during the fiscal year.
Timeliness	97 percent of claims will be processed within 3 days of receipt; 99 percent within 5 days.
Quality	The error rate on determination of eligibility shall not exceed 2 percent. The error rate on amount paid per claim shall not exceed 3 percent.
Service Quality	At least 60 percent of recipients are very satisfied with the service; at least 80 percent are satisfied or very satisfied with the service.
Unit Cost	The average cost per claim processed will be $4.62

enforce accountability, and (c) policy makers do not have the option of buying services from the most efficient supplier. Some countries (the United Kingdom through its Next Steps initiative, New Zealand by restructuring departments) have separated policy advice from service delivery. Separation aims to create an arms-length relationship in which purchasers have freedom to obtain services from in-house or alternative suppliers. It should be noted, however, that this decoupled model is not widely applied and some countries (such as Australia) have rejected it.

- *The government maintains a comprehensive performance reporting and auditing system*
  To maintain accountability it is important that results be systematically compared to targets, and that data on results be subject to audit. In the countries moving in this direction, it has proven much easier to audit financial performance than program outputs. Nevertheless, some countries now require that each department publish

auditable performance data in its annual report.

- *Managers are personally responsible for cost and outputs*
  Once they have operating discretion, managers can be held responsible for expected results by linking their pay and job tenure to performance. Implementing this feature of managerial accountability would compel the government to abandon conventional civil service rules concerning pay classifications, appointment, and termination. Under an accountability regime, managers would be employed under fixed-term contracts that specify pay and other working conditions as well as performance expectations.

Institutions, Information, Incentives

Adopting a managerial accountability system portends significant shifts in rules governing operational expenditure, the roles of budget controllers and spending managers, and the information produced and used in running government activities. Because managerial accountability is still in the early stages of development, practices have not been standardized yet, and significant differences have emerged in the approaches taken by the countries that have moved in this direction.

Rules

Two sets of closely linked rules are prerequisites for establishing managerial accountability. One pertains to the use of operating resources, the other to accountability for outputs and other dimensions of performance. The first without the second would give managers license to spend as they wished; the second without the first would make managers accountable for results over which they have little or no control.

The first set of rules regulates the volume and use of running or operating resources. In managerial accountability, running costs are cash limited; that is, managers are required to operate within a fixed budget with no supplementation during the year for cost overruns, except possibly for those due to demand-generated increases (over which line managers have no control) in the volume of outputs. Moreover, the cash limits are set progressively lower each year to capture expected efficiency gains. Typically, this

enforced cutback is applied across-the-board to all operating budgets, but agencies still can bid for additional resources during budget formulation. For example, if the "efficiency dividend" were set at 2 percent of operating expenses, each agency's baseline for running costs would be reduced by this percentage. However, agencies could, in the course of compiling the next year's budget, seek additional operating resources above the baseline. Once the operating budget is decided, managers have broad discretion in using resources, including authority (in some countries) to carryover some unused funds to the next fiscal year, or to prespend a small portion of the next year's running costs. Line managers—not controllers in central agencies or departmental headquarters—decide on the amounts spent on personnel, supplies, equipment, and other puts. This managerial discretion might be hedged by limits on pay and certain other expenditure items.

The second set of rules pertains to accountability for performance. Ideally, expected performance would be specified in advance so that the budget would be an explicit or implied contract on the services to be produced in exchange for the resources provided. Table 5.3 provides examples of types of output measures that may be specified in the budget or related documents. As illustrated in this table, performance measures are not limited to the volume of outputs; quality, cost, and customer attitudes also can be measured.

Once outputs have been specified, it should be possible to hold managers accountable for results. The results can be presented in annual reports or other documents and formatted in ways that facilitate comparison of projected and actual outputs. Ideally, to maintain accountability, performance measures should be reviewed by independent auditors empowered to note deficiencies in the data and to recommend remedial actions.

Roles

External control concentrates decisions on expenditures at the center of government and operating responsibility at the bottom; internal control keeps operational responsibility at the bottom but shifts spending control to the center of departments; managerial accountability devolves both control of resources and responsibility for results to operating units within departments. These units can be field offices which directly deliver services, regional

Box 5.2: Performance Targets in the United Kingdom

Published performance targets are a central feature of management reform in the United Kingdom. These targets have been developed pursuant to two initiatives which have transformed central government: the Next Step program launched in 1988 and the Citizen's Charter started in 1991. Although they were launched by Conservative Governments, both initiatives have been so successful that they have been continued by the Labor Government elected in 1997.

Next Step refers to a process by which responsibility for service delivery has been transferred from central departments to agencies which have been granted operational independence. As of 1996, there were 129 such agencies, comprising approximately three quarters of the civil service. Each agency operates within a discrete area of responsibility. It is thought more efficient to have a large number of agencies, each with specific targets than a small number of agencies with multiple responsibilities. The Government publishes an annual report that compares actual performance against targets for the previous year and specifies targets for the next year.

The citizen's Charter aims to improve the quality of services by publishing standards which users can expect for each service they receive from Government, and entitling users to an explanation (and in some cases compensation) if the standards are not met. In addition to certain Government-wide standards (for example, that officials or employees will meet with citizens no later than 10 minutes beyond the time for which an appointment was made), each department and agency has its own service standards.

The following performance targets and results pertaining to social security (published in the 1996 Next Step Reports) illustrate the types of performance information used to improve service operations.

	'93-'94	'94'-95	'95-'96	'96-'97
Income Support Claims Cleared in 5 days				
Target	71%	71%	63%	63%
Outturn	74%	69%	67%	
Accuracy of Payments				
Target	92%	92%	87%	87%
Outturn	91%	87%	78%	
Customer Satisfaction				
Target	85%	85%	85%	
Outturn	84%	83%		
Overpayment Recovery (millions of pounds)				
Target	54	75	110	92
Outturn	80	117	122	

offices which oversee operations within a defined area, headquarters units which provide overhead services, or any other organizational area with specified resources and responsibilities.

In the countries that have embraced managerial accountability, several models have been developed. (1) Sweden has a long-standing separation going back to the 19th century, between small ministries which have political and policy-making functions and a large number of independent agencies which carry out government programs. Managerial accountability has spurred the government to clarify the relationship between the two types of entities and to strengthen accountability mechanisms. (2) Since the late 1980s, the United Kingdom has established more than 130 executive agencies (popularly referred to as "Next Steps" agencies), each headed by an appointed chief executive, and each operating under a framework document that delineates what the agency can do on its own accord and the matters for which it is accountable. See Box 5.2 for a description of the Next Steps initiative and sample performance targets used in it. (3) During the 1990s, New Zealand separated most service-delivery functions from policy-advising units, introduced output-based budgeting, and various contract like documents in which resources and outputs are specified. (4) In contrast to other countries, Australia has retained consolidated departments, but has pushed for devolution of resources and operating discretion to field units.

This organizational variety may be partly due to the different political—administrative cultures of the countries that have emphasized managerial accountability. But behind the various approaches lie two distinct strategies for encouraging managerial accountability. One is managerial, the other is contractual. Managerialism refers to systems in which managers are given broad scope to run the organization according to their judgment; contractualism refers to relationships in which agents who provide services write explicit agreements with principals who control resources on the services to be provided. Contractualism spurs government to decouple operations from policy; managerialism pushes government to combine the various responsibilities in the same organization. Managerial flexibility is precondition for internal contracts, for if managers lack discretion, they cannot be responsible parties to an agreement.

Table 5.2 describes some of the instruments devised in recent years to strengthen managerial accountability.

Information

Every form of control has distinctive informational demands. Maintaining external control requires a bottom-up informational flow, in which managers provide superiors with detailed information or their operations. Internal control allows for the consolidation of information sent by departments to central authorities, but still requires an extensive flow from operational levels to headquarters. Managerial accountability greatly reduces the volume of input information exchanged between organizational units, but also greatly increases the volume of cost and output information. Managers have to generate, compile, transmit, and analyze cost and output information; they need to specify these in advance, and to assess results against targets; they must develop new cost measurement, accounting and allocation systems, based on accrual principles; and they should have the capacity to price outputs independently of input costs. Table 5.4 presents various concepts used in measuring costs.

Compiling and processing the new types of cost and performance information is costly, especially during the early years of reform when new measurement and reporting systems must be developed. The more determined the government is in enforcing accountability, the greater these costs will be. To this writer's knowledge, no country has systematically measured the transaction costs of establishing performance targets, collecting data, monitoring performance, and assessing results. It is relatively simple for governments to estimate the costs foregone when input controls are terminated or relaxed; it is much harder for them to estimate the new costs assumed when managers are held accountable.

Managerial Behavior

Getting the incentives right is critical to the successful implementation of any managerial accountability system. This new approach is predicated on the expectation that managers will behave efficiently if given the information and opportunity to do so. But will they? Some managers may prefer to have more control if, as a consequence, they also are not held to account for failing to perform. Some managers may feel threatened by the mass of cost and performance information which they must prepare for use by others.

Table 5.4: The Definition and Measurement of Cost

Term	*Definition*
Expenditures	Amounts paid by government entities in the course of operating programs. Expenditures are recorded on a cash basis in the fiscal period during which the payment is made.
Cost (or Accrued Cost)	The resources used in producing goods and services, regardless of the entity incurring the expenditure or the fiscal period in which payment is made.
Cost Allocation	A method of charging costs to the activity/output which incurs them. Allocated costs include indirect and overhead costs, and costs paid by other entities or accounts, such as the cost of accommodation in government-owned buildings.
Activity Based Costing	A method of assigning costs to the activities (or "drivers") generating them.
Unit Cost	The cost of producing a unit of output. Unit costs are used to compare the relative efficiency of different service providers, to calculate changes in productivity over time, to allocate budget resources, and to charge users for services.
Marginal Cost	The cost of producing an additional increment of output, in contrast to the average cost of producing total output.
Variable Cost	Costs that vary with the volume of output, in contrast with fixed costs that are incurred regardless of the volume.

In real organizations, managerial accountability rarely is implemented in textbook fashion. Managers get mixed messages when they are given resources. They may be promised operating freedom but find that their budgets are hedged with all sorts of well intended restrictions (to guard against corruption or mismanagement), but the result is that they are

not really free to manage. They may be promised a certain volume of operating resources for each of the next several years, only to find that funds are cutback whenever the government is pressured to reduce the budget deficit; they may be given arbitrary budgets that are set without regard for the actual cost of producing the specified outputs; they usually are given fixed budgets that do not vary, even when the volume of outputs produced is driven up by exogenous demands.

Managerial incentives may also be weakened by the failure of government to use available performance information. It is not uncommon for managers to take special care in developing performance data only to find that the material is not used in allocating resources or in making other operating decisions. Managers who are turned on when a new performance-based system is introduced turn off when the information goes unused. There are many different ways of using performance information. Table 5.5 arrays the principal uses in a sequence from the least impact on decisions to the most. The last entry on the list—performance budgeting—indicates how far governments must go in transforming public expenditure management to optimize operations. A true performance budget is a variable budget. Introducing variable budgets in the public sector is a challenging task because (a) appropriations are legally fixed limits on expenditure, (b) few governments have reliable accounting systems for apportioning costs and for distinguishing between fixed and variable costs, and (c) managers rarely have sufficient operating authority to control costs as the volume of outputs varies. In government, the near-universal practice is to authorize fixed budgets that do not vary with changes in the volume of outputs. The major exception occurs when organizations are voted net appropriations which permit them to spend certain self-generated money, such as revenue from user charges. Efficient firms, by contrast, have variable budgets, which distinguish between fixed and variable costs.

Giving managers operating freedom would require, among other things, abandoning government-wide civil service systems and much greater use of temporary, seasonal, and part-time workers who can be hired or sacked as work levels rise or fall.

Incentives for operational efficiency also depend on advances on the accountability side of the equation.

Table 5.5: Using Performance Information to Improve Operations

Activity	*Purpose*
Performance Measurement	Provides basis for specifying expected performance and assessing managers and their organizations.
Performance Targets	Notifies managers of the specific results they are expected to achieve and establishes basis for assessing their performance.
Performance Reporting	Compares actual and targeted performance, with explanation of significant variances. Makes performance transparent and provides citizens/customers basis for judging the volume, quality, and cost of services.
Performance Auditing	Independent assessment of the reliability and relevance of performance reports.
Performance Benchmarks	(a) Provides basis for comparing performance with results achieved by other public or private producers; (b) Sets performance targets in reference to results achieved by most efficient producers.
Performance Contracting	Formal agreement between the government and internal or external providers setting forth amounts to be paid and outputs to be supplied.
Performance-Based Pay	Links all or a portion of a manager's pay to performance.
Performance Budgeting	Allocates resources on the basis of expected performance, with each increment in resources linked to a specified increment in output.
Variable Cost	Costs that vary with the volume of output, in contrast with fixed costs that are incurred regardless of the volume.

Governments must establish challenging performance targets, monitor compliance, and intervene to reward successful performance or to penalize inefficient managers. Although some progress has been made on this front, governments generally have found it much easier to divest input controls than to vigorously enforce accountability.

Summing Up: Pathways to Operational Efficiency

There are many routes to improving operational efficiency, but few shortcuts. Governments seeking rapid progress in this area of expenditure management would do well by beginning with an assessment of their current control systems. If, as often is the case in developing countries, departments are operating under the burden of externally imposed and enforced controls, the government should assess not only the compliance costs, which are likely to be substantial, but whether departments actually comply with the rules. Have departments accepted the rules as fair and workable, or do they regularly ignore or evade the rules? In managing human resources, as well as in managing public money, do departments accurately record transactions, or do they deliberately and repeatedly miscode information? Answers to these and other questions provide vital clues in gauging a government's readiness to switch from external to internal control. The efficacy of every internal control system depends on ingrained habits of abiding by rules, perhaps not in every case, but in almost all. Without these habits, internal control systems would not be reliable, and governments could not have confidence in the information supplied by their spending departments.

Internal control is the bridge between external control and managerial accountability. Moving to internal control is no small feat, for it reduces compliance costs, and bolsters the capacity of departments to manage their own affairs, without having each of their actions reviewed, and possibly vetoed, by central controllers. Once internal controls are in place, the role of central controllers is transformed from preauditing transactions to auditing systems. Each department maintains its own systems (for civil service, expenditure, procurement, information management, etc.) subject to government-wide standards. In auditing systems to ascertain compliance with these standards, central agencies typically sample a small number of trans-

actions to determine whether the systems work according to blueprint. For the most part, however, departments manage their own operations.

Yet from the perspective of line managers, the shift from external internal control often is hardly noticed. The controls seem to be as onerous as before, and compliance as rigidly enforced. The reason for this is that in shifting to internal control, the controls previously exercised by central agencies often migrate to department headquarters. For managers hobbled by command and control public administration, it makes little difference whether the detailed rules are enforced at the center of government or at the center of their own department. In either case, compliance is the order of the day, and considerations of performance fall into neglect.

Managerial accountability liberates managers from the straitjacket of one size fits all rules and procedures. In gaining new operating freedom, however, managers are made to abide by tougher, more transparent performance requirements. Expected performance is targeted in advance, and actual results are compared to the targets. In some venues, detailed performance contracts are written and government is restructured to give it greater opportunity to purchase services through market-type competition between in-house and external suppliers.

Managerial accountability systems are still in their infancy; the oldest were established in the late 1980s or early 1990s. There is reason to believe that these systems have improved operational efficiency by reducing compliance costs and giving managers strong incentives to be more efficient. Countries that have gone down this path give no evidence of backsliding. In fact, the Labour Government elected in 1997 after 18 years of Conservative rule, has retained, and in some cases deepened, most of the managerial reforms it inherited.

Should developing countries start down this path as a means of improving public services and making operations more efficient? The answer depends not on the attractiveness of managerial accountability systems but on the robustness of current control systems. A government that has reliable internal control systems in most departments may be a suitable candidate for giving managers broad discretion. But a government that has not yet reached this stage of development would be advised to build sturdy control systems before

venturing to the difficult and risky task of managing on the basis of outputs rather than inputs. ❧