MINISTRY: FINANCE
REPUBLIC OF SOUTH AFRICA
Private Bag x115, Pretoria, 0001 • Tel: +27 12 323 8911• Fax: +27 12 323 3262
PO Box 29, Cape Town, 8000 • Tel: +27 21 464 6100 • Fax: +27 21 461 2934

Address by Trevor A Manuel, MP

Minister of Finance

Wits Business School

Management Excellence Award

5 October 2006

Thank you for this award. I am still not too sure what I have done to deserve an award for management excellence. I manage just a few people in an office space not much bigger than this room. I am pretty sure that you have not spoken to any of the people who occupy that office space because if you did, I'm sure that I would not be the recipient of such an award.

But… thanks anyway.

We all find ourselves muttering from time to time that "if you want to get the job done properly, you have to do it yourself." This is the problem of agency. There isn't time to do all the budget spreadsheets yourself, fix the leaking tap, restructure the aging politician's retirement plan, help the kids understand trigonometry, do your tax return, water the plants and work on global peace and prosperity all at once.

So for at least some of these projects, or part of each of them, we rely on other people.

But here is the problem. We rely on other people, but they are seldom perfectly or completely reliable. The great disillusioning factor which we have to come to terms with is that we can't do it all ourselves, and the power of delegation always carries the risk of disappointment.

Armed with the apparatus of Microeconomics I and a cursory reading of Adam Smith, of course, you might say Specialise!! The Market will provide!! Produce the commodity in which you have a comparative advantage, purchase everything else!!

An obscure economist named Ronald Coase explained nearly seventy years ago why we don't, in fact, rely on the price mechanism alone to address all the limitations of our individual competences. There are transaction costs, and they help explain why some things are organised across markets and other things are internally arranged. Within the family, there are conventional, or sometimes negotiated, divisions of responsibility. Within the firm, there is a hierarchy of duties and a structure of rules, sanctions and rewards. And in the National Treasury, the Minister says what has to be done.

Or rather that is how Ministers' of Finance fantasise about things.

The idea of transaction costs is an interesting and useful one. It is partly about incomplete information, and over the past thirty years, an extensive literature has evolved that attempts to explore how we deal with information shortfalls, how managers enjoy particular kinds of discretion as a result of imperfect information, for example, and how improved information standards – better accounting rules perhaps – can assist in addressing problems of agency.

I was having a discussion with Tom Boardman the other day. He said that, earlier that day, he'd met with all 450 of his branch managers. There were people from across the country, a diverse bunch of people with different capabilities, competencies and approaches. But he could fit all these people into one hall and have a discussion on their concerns. He told me this story as he empathised with the Minister of Education who has 27 000 branch managers. We have 27 000 school principals in our country. We simply cannot get them all into a single hall or venue and structure a discussion in a sensible fashion. The transaction costs of engineering such a discussion would be enormous, even with modern IT and communications systems. And so we organise our schools into districts, regions, and provinces. Information and perspectives are lost along the chain.

Agency, incomplete information and the economics of organisations and how they are governed, are areas of economic inquiry that have enjoyed something of a resurgence in recent years.

We have not made enough progress yet in applying these ideas to the public sector. And yet problems of agency, incomplete information and misaligned incentives are surely at the centre of the concept of government failure, or bureaucratic failure, so it is something of a puzzle that public sector economics has not mobilised these analytical tools more effectively.

It is not that we don't have good illustrative case material.

Consider, for example, an invention that dates back at least a hundred years and arguably is the single most significant source of power of the state, other than brute military force. I am referring to what is politely known as "withholding:" an arrangement built into the tax code which hugely reduces the administration and compliance costs of collecting personal income tax from employees, essentially by introducing an "agent" in the form of the employer as a disinterested intermediary between the receiver and the taxpayer.

Two further inventions also greatly strengthened the hand of revenue during the twentieth century – the idea of social security, which combines a withholding tax and a promise of future benefit entitlements, and the self-enforcing invoice-based value added tax, which operates through the opposing interests of buyers and sellers of intermediate products.

These are important features of the public finances of the modern state, but their underlying logic is not part of the standard toolkit. Yet this underlying logic is essentially economic in nature: it is about the structure of incentives between principal and agent, and how transaction costs can be reduced when these are well-ordered.

Which is an elaborate way of talking about some pretty simple, and hugely important, aspects of good management?

Whereas central bankers rely on a vast array of data to inform their decisions on just one variable in pursuit of a single target, the fiscus carries the entire matrix of social, developmental, economic and political aspirations of the nation. It is no surprise that the budget process is characterised by an information overload and frequently by a woefully inadequate quality of data and analysis.

We are getting better at this, but there is still more work to be done. Good management is very largely about good information, and organising that information in accessible, digestible ways.

To return to Ronald Coase. Let's assume that we have a small river, a woman upstream who makes leather and a man downstream who catches fish in the river. In making the leather, the woman introduces a small amount of pollution into the river. The level of pollution affects how much fish the man can catch. Let's assume that they both have equal bargaining power and there are no transaction costs. Coase theorem argues that property rights over the river could be ascribed to either party, to achieve the same social outcome. This is counter-intuitive.

Coase argues that if we ascribe rights over the river to the man, he would charge a fee to the women to use the river. For every rand he lost in fish, he could increase the fee to the woman, therefore taxing the pollution. Conversely, if we ascribed property rights to the woman, she could charge a fee to the fisherman. If she pollutes the river, her income would drop.

Even in this very simple example, we can list all the things we need to make this scheme work. First, we need someone to be able to monitor the amount of fish caught or leather produced and pollution introduced into the river. We need a legal process to draw up a contract which regulates this transaction. We need an arbiter to decide on matters when a dispute arises. We need the rule of law to enforce contracts, even between private citizens.

If we take modern, complex societies, globalising economies, diverse communities, wildly differing bargaining strengths and imperfect markets, the role of government becomes incredibly complex and difficult. In taking decisions on even simple matters, the stakeholders, interests and factors that have to be taken into account requires the Wisdom of Solomon. And I will be the first to admit that we do not always get this right.

The prospects for successful management can be enhanced by improving the alignment between the accountability chain, institutional governance, managerial incentives and public policy objectives. Alongside these aspects of the internal organisation of public services, there are also challenges in the interaction of public and private sector arrangements, and in the interplay between national and international trends.

These dimensions of public policy add even more complexity to the discipline of public finance and to the practice of public policy making and implementation. The tidy division of the world into public and private sectors, and domestic and foreign affairs, has given way to much more complex institutional arrangements and hence a more elaborate intellectual apparatus.

To demonstrate just one of these complexities, let me give you an example from a public / private partnership we have - to equip and maintain the Nkosi Albert Luthuli Hospital in Durban. Here, the private sector installs the equipment in the hospital, maintains the equipment and replaces items when they break or malfunction. Let's assume a light bulb breaks. The hospital has to inform the company that a light bulb has broken; the company sends someone to do a damage assessment and then sends someone else to fix it. If the bulb is out of order for an extended period, the hospital can impose a penalty on the private contractor. This particular PPP has won international awards.

However, for the deal to work, it requires a contract with detailed specification on what equipment is needed and what service standards are required. The contract must have penalties for transgressions of the agreement. It then assumes that the hospital has a system to track what breaks down when, and when it was reported to the private company. It then needs to track when the problem was fixed. If there was a delay, the legal department needs to be contacted to impose a penalty on the company. If the company disputes this, it goes to court. The court has to decide on costs based on the integrity of these systems of tracking information. All of this entails huge transaction costs and a level of sophistication that often does not exist in a public hospital.

In theory, this PPP, and public private partnerships in general, have the potential to improve the standard of service in the public sector. Managing complex transactions is not easy and fraught with difficulty. It often takes decades for the institutional environment to drive down such costs, to make them routine and only then are we likely to see greater use of such partnerships.

The great advantage of traditional government arrangements or procedures is that they are simple, lines of authority are clear, rules and procedures are documented and familiar and the annual budget process provides a transparent and unambiguous assignment of resources to public purposes. Resources are raised through taxes, which have the great advantage to the fiscus that they are mandatory. But cooperative or contractual arrangements with the private sector, and international collaboration in pursuit of common purposes, are fraught with negotiation difficulties, problems of trust, possible conflicts of interest, risk, uncertainty, asymmetric power and interminable frustration.

Complexity is with us, and so we have to find a way through the barriers of misunderstanding.

Unless work is done on the terms and conditions of agreements, and the appropriate financing or pricing arrangements, cooperation will not happen.

Consider, for example, the challenge of mobilising private finance in support of public investment goals – small enterprise development, low-income housing, economic infrastructure, social and community investment, student loans, small farmer support programmes.

The Financial Sector Charter sets aside large amounts of money for these purposes, but the institutional arrangements are taking considerable time to be developed. The delays are partly about complexity, partly about trust, partly about misunderstandings. Well-structured public-private partnerships do take some time to design and negotiate. It would help if there were greater understanding of the basic agency and incentive problems. One simple idea that perhaps deserves greater currency is the idea of competition between service providers for a share of an agreed public resource envelope, based on defined measures of performance. A loan guarantee fund, or co-financing arrangement, for example, can be rationed between participating banks on the basis of agreed performance criteria – thus avoiding the overwhelming transfer of risk of failed schemes to the fiscus that characterises so many policy lending initiatives that have a redistributive or poverty-focused objective.

In managing these and other kinds of partnerships, and more generally in modernising the public service delivery, it is necessary to guard against unnecessary complexity.

The modern world offers many opportunities for public finance innovation, and for new kinds of partnership with the private sector and across national boundaries. There are enormous benefits from getting these reforms right. But getting them right, means keeping them simple, so that as reforms proceed we have more control, know more about what is going on, have a better understanding of how information is used and contributes to growth of the market economy.

Again, thank you for this award. I'm still no clearer on whether I deserve it.