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Initial address by Governor Carlos da Silva Costa to the "Towards a Comprehensive Reform of Public Governance" Conference

Calouste Gulbenkian Foundation, 28 January 2013

Good morning ladies and gentlemen.

I am delighted to be addressing you at this opening session of the conference on reform of public governance co-organised by Calouste Gulbenkian Foundation, the Public Finances Council and Banco de Portugal.

I would like to touch on three topics in this initial address. First I will present to you the motivation behind last summer's decision to organise this initiative and clarification of its scope. Then I will take a few minutes to differentiate public as compared to private management and the challenges that this presents for defining a public sector governance model. I will end with a short reference to some factors that I believe are critical to the success of comprehensive reform of the public sector in Portugal.

1. Motivation for the conference and clarification of its scope

About two years ago, the inability of the Portuguese state to refinance its public debt in the financial markets forced it to seek international financial assistance – for the third time in less than four decades – and to negotiate and carry out a vast economic adjustment programme.

Budgetary consolidation and the foundation of lasting sustainability in the public finances are, as we know, one of three key pillars of the adjustment programme agreed with the European Union and the IMF.

The behaviour of the Portuguese public accounts over the last 40 years has shown unambiguously that financial indiscipline has been the rule: high and persistent overall and primary deficits, unbudgeted spending and spending overruns, pro-cyclical fiscal policies, failed or postponed reforms, inefficient provision of public services and inadequate evaluation of public policies are recurring problems that are known to many.

Financial indiscipline in the public sector has seen many economic environments and policy regimes, as well as very diverse political configurations. The situation did not change with the integration of the Portuguese economy into the euro area.



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This overview reveals an undeniable weakness in the State's financial governance and leads us more generally to question the entire public governance model in Portugal – a model that has failed to prevent imbalances from emerging, or to allow for their timely correction.

This is exactly the focus we envisage for this conference.

The aim is not to debate the scope of the functions of the State, or the quantity of public goods that should be provided. The choice over the broadness of the State's functions and the amount of public services that society is prepared to pay for, sustainably, through user charges and taxation is a fundamental debate, but is for another time.

This joint initiative with the Calouste Gulbenkian Foundation and the Public Finance Council aims, rather, to stimulate discussion about what kind of institutional framework, irrespective of the scope of the State's functions, is most likely to ensure that the reduction of the public deficit will not be merely transitory. At the same time, public governance that promotes a more rational use of available resources will contribute greatly to the consolidation of the public finances.

In other words, the political decisions on goods and services provided by the State, or on which market failures are to be regulated, are in a different realm to the decisions over the governance model for the entities tasked with supplying those goods and services or for that regulatory remit.

In this latter realm, that which we propose to debate, questions arise such as:

- What are the risks and benefits of subcontracting public functions to non-public entities?
- What is the optimal degree of specialisation for the public entities' objectives and roles?
- Is it desirable to assign policy advice and operational tasks to different entities? (Should we, for example, separate the advice on tax policy from the collection of taxes?). If so, should these different kinds of entities be subject to different rules in terms of the degree of management autonomy and the subsequent accountability for results?
- Which budgetary model guarantees us results compatible with the medium to long-term sustainability of the public finances and best promotes efficient solutions in producing public goods and services?
- How do we ensure that public policy is defined and executed in a way that is consistent with our goals?
- What HR management model would create an independent body of public servants, who are highly qualified, motivated and respected by society, while at the same time ensuring staffing costs are compatible with the country's productive capacity?



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2. Challenges of public governance as compared to the private sector

These are difficult issues facing all countries, for which different solutions have been tried. It is impossible to separate these issues from the intrinsic characteristics of the public goods and services and from the way the public sector is financed. It is worth taking a moment to elaborate on these differentiating characteristics and the challenges they create for public governance – challenges that private entities producing goods and services for the market do not face.

First, measuring public sector output is fraught with difficulties. For example, this is the case for the economic regulation functions or the sovereign functions such as justice, defence, homeland security or foreign affairs. In these and other public sector areas, production is indivisible and is consumed by the public irrespective of the quantity demanded; it is therefore not subject to any kind of 'viability test' by the market.

Furthermore, in the case of goods provided by the private sector through the market, the cost and benefit associated with the consumption of a given good fall back on the agent that consumes it. In the case of goods provided by the public sector, there is a divergence between the private cost/benefit and the social cost/benefit. Indeed, as public sector production is financed by the taxpayers (through present and future taxes), its costs are shared by society as a whole. However, the benefits tend to be appropriated by a smaller group of people. For example, the construction of a bridge is financed by all taxpayers, but mainly benefits the inhabitants of a given area and the companies involved in its construction. This means that, on the one hand, the agents benefiting from specific public spending programmes have an incentive to work towards making that expenditure happen; and, on the other hand, scrutiny of the economic and social rationale for the expenditure tends to be insufficient, given that the financing cost is very dilute. This phenomenon – known in the literature as “the common pool problem” - creates a bias towards excessive growth in public spending.

A third point regards the intertemporal effects of the policies. As we know, many policy decisions have diluted effects on public sector revenues and expenses over time, or their effects are weighted towards the medium and long term. Given that the relevant horizon for political agents is inevitably linked to the electoral cycles, there is an incentive to take decisions in which the return for decision-makers takes place in the present and the costs to society are postponed to the future. For example, various decisions that in the past led to generous rules in awarding benefits or to expanding public-private partnerships must be analysed in this perspective.

The characteristics that I have listed here – and which, I repeat, are inherent to public sector production of goods and services – create, as we have seen, a set of perverse incentives which lead to inefficiencies and problems of aligning public sector output and the intended goals of that output.



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It is now the consensus view that these incentives may be redressed by public governance models which have a central purpose of promoting efficiency, effectiveness and transparency in the public sector's use of resources. As in other areas, there are no magic models or solutions: solutions must be found that are best suited to each society, while remaining consistent with the basic principles of efficiency, effectiveness and transparency.

3. Critical success factors for reform of the Portuguese public sector

If it is crucial to know and understand the public sector governance models that best promote value for money, it is no less important to understand what the determining factors are for the paradigm shift to be successful.

In Portugal, as in many other countries, wide-ranging reform of the public sector has already been attempted, sometimes inspired by international best practice, including approximating to private sector management models. Aside from various undeniable successes – and there are specific cases of excellence, for example, in the health and higher education sector, where progress has been remarkable and Portugal compares favourably at international level – the reforms undertaken have not led to decisive change in Portugal's public governance efficiency and effectiveness.

Thus I would also like this conference to address the factors that may lie behind many 'failed' reform attempts. Let me highlight some of the factors that seem to me particularly relevant.

Firstly, paradigm shifts require time, method and resources. It is simply unrealistic to try and correct weaknesses accumulated over many years in a short space of time. A profound analysis of the current problems is needed before advancing to solutions. A vision – to pinpoint where we want to get to – must be built and a strategy to get there must be defined. Finally, an action plan must be established bringing together the resources that will implement the strategy defined.

Secondly, paradigm shifts demand leadership, determination and perseverance, and are incompatible with frequent changes of course. The risk of fatigue and the power of passive resistance must not be underestimated. Thus, the relevant actors have to promote and nurture an ongoing appropriation of the goals and tools of reform, a process that is often referred to as 'ownership'. Intense, effective communication and broad consensus-seeking over the vision and strategy are key.

Thirdly, all those that play an important role in defining and executing reforms must be empowered to make relevant decisions. Effective delegation and accountability of project managers and directors are necessary.



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4. Final points

Allow me to conclude.

The public sector's financial indiscipline and the problems of efficiency and effectiveness in collecting and using its resources have been entrenched problems over the last four decades. As I mentioned, the situation has not changed in a meaningful way despite integration into the monetary union, which shows that there was no appropriation by the political, economic and social agents of the principles and rules of discipline underlying the single currency project.

Now is the time for us to get back on track.

A new social contract is needed, based on the development of inclusive institutions which subordinate public spending to the socially acceptable taxation level and a politically legitimated hierarchy of priorities.

The sustainability of this process depends on our ability to develop a public sector governance model that promotes sustainability, efficiency and effectiveness in the allocation of resources. The broad and lively debate that will take place here over the next three days will certainly make an inestimable contribution to building this new paradigm.

Thank you very much.

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