



Three Paradigms of Public-Sector Reform

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Introduction

In businesses everywhere, globalization is driving higher productivity. The ability to source capital, raw materials, finished goods, and sometimes talent from an ever-broadening global pool has put enormous pressure on companies to become more efficient. These benefits ultimately flow to the consumer in the form of lower prices and higher living standards, although there are often painful adjustments along the way, in which whole industries relocate and employees must “retool” for new careers.

Now, globalization is beginning to have similar effects on the public sector. A number of areas for which national governments have long been responsible in many countries – education, health care, welfare, and pensions, for example – are finding themselves newly exposed to international comparisons, and in some cases actual international competition. Witness the arrival of foreign companies as providers of some routine operations in the U.K. health system.

This disruption was inevitable. In the early 1980s, developed nations began to notice significant failings in their public-sector systems. This was the time of America’s “A Nation at Risk” report, part of whose explicit charter was “comparing American schools and colleges with those of other advanced nations;”¹ the U.K.’s “Better Schools” White Paper; and similar reports elsewhere.² Then, in the early 1990s, the long boom began to create a wealthier and more demanding population in the West, and therefore growing numbers could afford private alternatives in education and health care. Adding to the pressure, employers consistently argued that the graduates of the public education systems were not up to the strictures of a more demanding workplace. In short, there was a growing clamor for ever-improving performance but no corresponding increase in the willingness to pay higher taxes to fund it.³

If there were changes on the demand side, there were changes on the supply side, too. For example, the management of the economy became increasingly a matter of responding to global markets. This shift, too, brought pressure to keep the tax burden under control and to improve the management of public finances. In this environment, public services became highly visible as areas in which governments needed to make a difference.

While the globalization of capital markets means that capital can move around the world at the touch of a button, the market for human capital is not so flexible. As a result, governments are finding that maintaining or improving the quality of a nation’s

1 “A Nation at Risk” was issued in April 1983 as the report of then-Secretary of Education’s National Commission on Excellence in Education. The report can be found at <http://www.ed.gov/pubs/NatAtRisk/risk.html>.

2 Better Schools, HMSO, 1985.

3 For more on this productivity imperative in public services, see “How Can American Government Meet its Productivity Challenge?” by Tony Daner, Thomas Dohrmann, Nancy Killefer, and Lenny Mendonca, July 2006. Available at www.mckinsey.com.

human capital is an increasingly important aspect of developing a country's living standards, well-being, and competitiveness. This case is brilliantly made in a recent U.S. report, "Tough Choices or Tough Times."⁴ Economic success thus demands the improvement of educational and health-care systems, and involves making a country, in particular its cities, more attractive through improvements to the environment, reductions in crime, and the provision of modern transport solutions.

For much of the past 50 years, progress in these areas in many countries has been hampered by the tension between what we may loosely call liberal and conservative, or leftist and rightist solutions. It is an interesting feature of today's situation, then, that the demands of globalization, which make it imperative that governments solve these problems, also offer a solution to this longstanding tension. They do so not because compromise is the only way we are likely to succeed, but because globalization has changed conditions to such an extent that a melding of the two philosophies is the only solution likely to be adequate to the challenge.

Broadly put, in the past, leftist solutions have tended to emphasize equality at the price of uniformity, and rightist solutions to offer diversity at the price of inequality. We now face a world in which economies that wish to be competitive will need to provide *everybody* with high-quality services, while retaining sufficient flexibility to allow for a high degree of personalization and choice, reflecting the growing diversity in people's lifestyles, beliefs, and aspirations. One might call this strategy providing "a high floor and no ceiling." In political terms, new solutions will have to provide the equality prized by the left *and* the diversity prized by the right. This point

is now broadly agreed on, at least in concept, across the political spectrum in many countries.

Combining equity, diversity, and constantly rising quality has thus become the challenge for the public sector in the developed world. The overwhelming evidence in Europe and North America suggests that rising to this challenge is very difficult indeed. But failure is no longer an option for governments. As a growing proportion of the population becomes wealthier, more people are able to provide for their health, education, and security independently of publicly provided services. If they do so, they become uninterested in the quality of the public system and less willing to pay taxes to support it. When support for public services among the wealthy erodes, it becomes politically difficult to maintain the necessary tax rates. Once the tax base crumbles, public services will spiral downward to become merely a safety net for society's poorest members.

In these circumstances, the "high floor" will go unbuilt, and society as a whole will pay the price in terms of undeveloped human capital, crime, drugs, and social dislocation. One sees examples in many spheres: 45 million Americans are uninsured for health care; prisons are bulging in California and the U.K.; and riots have shaken Paris's suburban ghettos. In counterpoint to these examples of societal stress, in both Europe and North America, there is a growing prevalence of privileged and even gated communities abutting swathes of urban decay.

This is a prospect that has little to commend it economically or socially, even for the most privileged elements of the population.

⁴ *Tough Choices or Tough Times: The Report of the New Commission on the Skills of the American Workforce*, National Center on Education and the Economy, San Francisco: Jossey-Bass, 2006.

21ST century solutions

How, then, do we make the public services good enough that increasing numbers of wealthy people still choose them, or at least see their social value, thus binding them into the system and thereby generating enough revenue to secure both steadily improving performance and increasing equity? Commonalities among the more successful efforts to create more effective education, health, policing, and social security systems suggest that there are three paradigms for reform in large-scale systems; that each is suitable in different circumstances; and that, regardless of which approach is selected, the political center plays a crucial role.

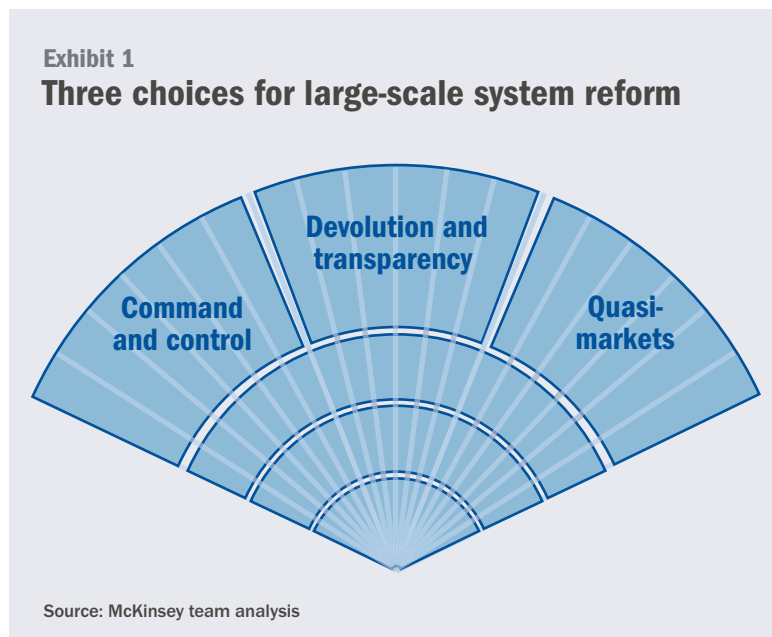
THREE PARADIGMS

Exhibit 1 sets out three paradigms for the reform of any large-scale public service: command and control, devolution and transparency, and quasi-markets.

Command and control is often the first choice of governments that want urgently to enact change – and to be seen enacting it. As the phrase implies, it involves top-down management approaches and conveys at least an impression of government taking charge. If executed well, it can be highly effective. The U.K. government’s National Literacy Strategy between 1997 and 2001 and its approach to reducing health care waiting times between 2000 and 2005 are good examples. It should be noted, however, that there is nothing worse than command and control incompetently implemented, and so it is an approach that

must be undertaken with a full understanding of the government’s ability to deliver.

At the other side of the “fan” in Exhibit 1 is a second paradigm, described here as “quasi-markets.” Given the stunning gains in productivity and customer services brought about in recent decades by the global market economy, and the difficulty governments have had in delivering improved public services, the idea of applying market forces to public systems has obvious attractions. One option, of course, is full-scale privatization, in which the public service ceases to be public. This approach has worked across the globe in areas such as telecoms and utilities, but governments have generally hesitated to apply it in areas such as education or policing, for reasons of equity, feasibility, and politics. Quasi-markets make the introduction of elements of the private sector feasible by introducing options such as retaining public control of commissioning services but having private providers deliver them. Examples include Medicare in the U.S.; encouraging the use of independent sector providers of rou-



tine operations in the U.K. health-care system; and private providers of public schools in Philadelphia.

However, applying market-like pressures within a public service is not always straightforward. One must be able to define a clear customer, offer customer choice, bring in new providers, and ensure that the money follows the choices made by the customer. Charter school programs in New York State and California, and voucher programs in Milwaukee and Florida, offer American examples of quasi-markets in action. Evidence of impact is so far mixed, however, and success seems to depend on the precise design of the program. For example, Swedish education reform, which has brought in new providers and offered much greater choice, appears to have been successful, while the radical restructuring of England's National Health Service along quasi-market lines has brought some early benefits but is still far from complete.

What of situations in which a government wishes to reform a service without resorting to command and control, but where the conditions for the success of quasi-markets are not present? For example, in the provision of prisons, courts, or policing, it is either not possible or not desirable to define a customer and offer choice from a range of providers.

In the model called here “devolution and transparency,” the government can devolve responsibility to the frontline units delivering the relevant service and then use transparency – making public the results of differing units in a way that allows comparisons to be made – to drive performance. Units that succeed can be rewarded and potentially expanded; failing units can be made subject to interventions and ultimately shut down. To work,

this model depends on genuine devolution of operational control along with accountability. Where accountability has been devolved to principals in some U.S. school districts without offering them commensurate operational flexibility, the benefits have been limited at best. Iowa's “charter agencies,” which have been exempted from state bureaucratic requirements in return for strict accountability for results, is an example of this model in action.

The model can operate in a fully public system – the most famous example being the New York City Police Department, where the Compstat process generated competition between precinct commanders – or within a service in which a mix of public and private providers compete on equal terms. This can be done by separating payor and provider and encouraging competition for large contracts offered by the government or its agencies (known as “contestability” in the U.K.). This approach has been widely adopted, with significant success. Examples include the use of private prisons in California and the contracting of local education services in the U.K.

Where fully applied, the devolution and transparency model has proved sufficiently beneficial that some informed commentators have suggested applying it fully to all government services.⁵ Moreover, it has the advantage that it can be applied in combination with the quasi-market approach. For example, while the quasi-market approach has been put in place in some public school systems, it is important to acknowledge that it has limitations in this sector. In a true market, the customer may change providers regularly. But parents are naturally reluctant, for good reason, to change their child's school often. For this reason, market pressures on

5 See David Osborne and Peter Hutchinson, *The Price of Government: Getting the Results We Need in an Age of Permanent Crisis*, New York: Basic Books, 2004.

schools tend to be weak. If, however, as is the case in the U.K., New Zealand, and Holland, devolution and transparency are also introduced, pressure on school performance tends to be significantly strengthened. Indeed, one of the most successful examples of quasi-markets in combination with devolution and transparency is the widely admired, radical U.K. reform of teacher training, under which students have choice, government sets standards, successful providers are rewarded, and underperforming providers are ultimately removed.

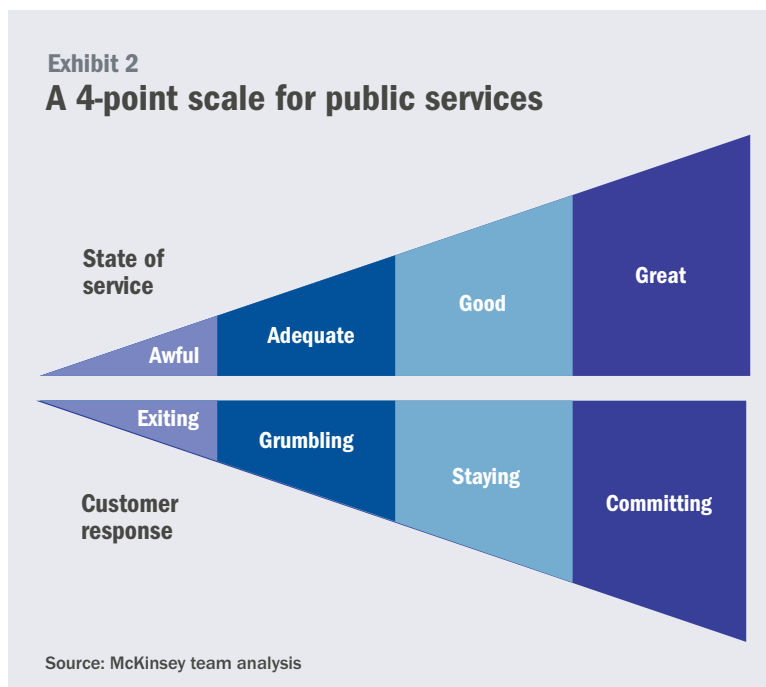
SELECTING A PARADIGM

To some degree, these paradigms will be familiar to any government leader, and there is intense ideological and political debate about the merits of each. The truth is that each model is appropriate in different circumstances, and all should be deployed within a total government system if it is to balance equity and diversity with support for high quality.

In *Good to Great*, Jim Collins explains the characteristics that distinguish great companies from good ones. More recently, he has explained that similar characteristics apply to all good organizations, regardless of whether they are in the business or social sector.⁶ Unfortunately, some organizations, including many of those that have historically been insulated from the pressures of the

market, cannot yet call themselves “good.” Accordingly, work done in the U.K. under Prime Minister Tony Blair used an extended, four-point version of this scale designed to encompass the full range of performance for the various public services whose improvement was sought (*Exhibit 2*).⁷ The scale also suggests what the consumer reaction is likely to be at each point on the scale.

This categorization is crude but useful. Generally speaking, when services are “awful” and users are exiting the system, command and control solutions are appropriate. This is certainly true in a crisis, but it also applies in circumstances of endemic underperformance. In such cases, the public, and even the workforce within the service, will usually accept strong



⁶ Jim Collins, *Good to Great*, New York: HarperBusiness, 2001, and *Good to Great and the Social Sectors: Why Business Thinking Is Not the Answer*, New York: Collins, 2005.

⁷ For four years (2001-2005), I had the privilege of heading Prime Minister Blair's Delivery Unit, which was responsible for overseeing the implementation of his priority public-sector reforms. It was during this time that we developed this scale.

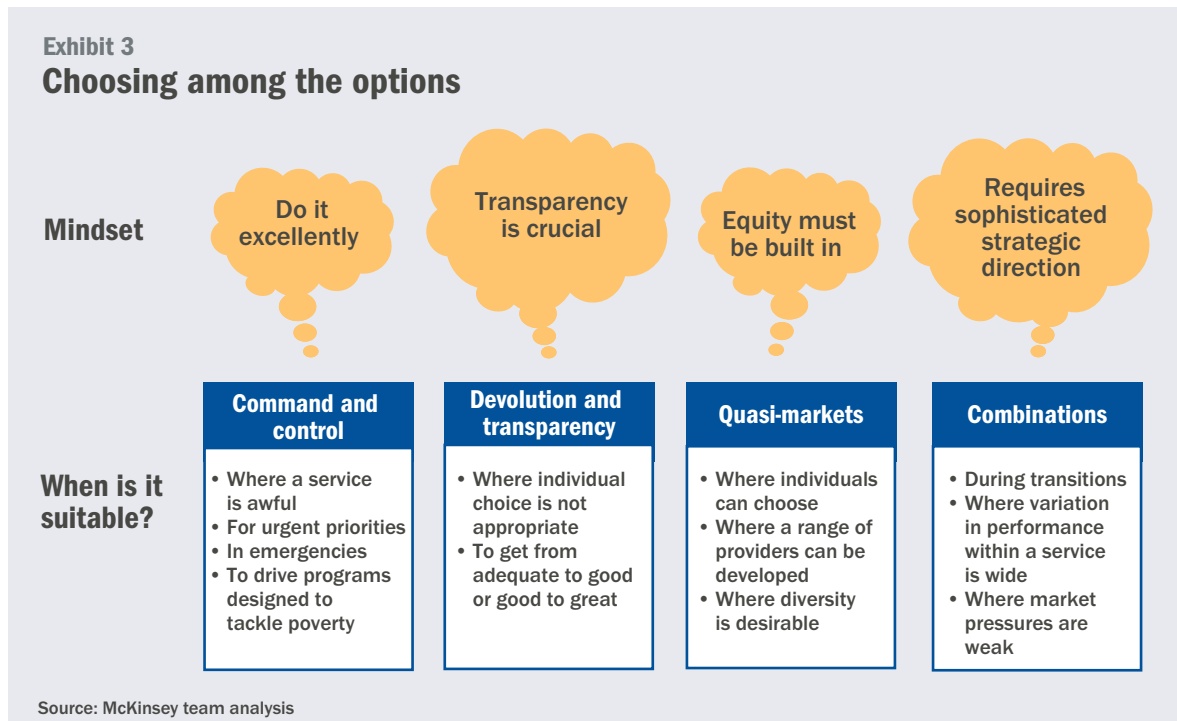
government intervention as long as it is effective. This is, after all, how the market handles bankrupt companies and how CEOs deal with underperforming companies. The U.K.'s National Literacy Strategy, for example, was justified by the fact that elementary school literacy had barely improved in the 50 years leading up to the mid-1990s.

Once adequate performance is established, however, the benefits of command and control are less clear. Governments find it hard to sustain the focus and drive on which command and control depends. Frontline leaders find themselves constrained by government regulation. Moreover, while shifting performance from “awful” to “adequate” is a substantial achievement, it does not satisfy the consumer, who continues to grumble until performance improves substantially. In the end, achieving great performance in the public sector, no less than in the private sector, requires unlock-

ing the initiative, creativity, and motivation of leaders throughout the system, rather than just those at the top. This cannot be done without substantial devolution and/or providing the freedoms of a quasi-market. In short, you can mandate “awful” to “adequate,” but you cannot mandate greatness, which must be unleashed.

Exhibit 3 summarizes the circumstances appropriate to each of the three paradigms.

As noted, actual and political conditions mean the three paradigms will often be applied in combination in any real large-scale service. For example, in health-care reform in the U.K., while quasi-market pressures are increasingly being brought to bear as patient choice increases, budgets are being devolved to the frontline and hospital performance is being made transparent. In addition, command and control is being applied in situations where



hospitals are performing poorly, whether clinically or financially.

Exhibit 3 also draws attention to some of the issues the different paradigms raise. For example, as quasi-market pressures are introduced, the threat to equity must be managed. For example, as part of its school reform mandate, Sweden has welcomed independent providers of new schools. To prevent cherry picking, however, these schools are not permitted to select students on the basis of academic performance. In London, when a choice of providers was introduced in health-care operations, the government provided assistance with transportation costs to low-income patients to ensure that the choice was real.

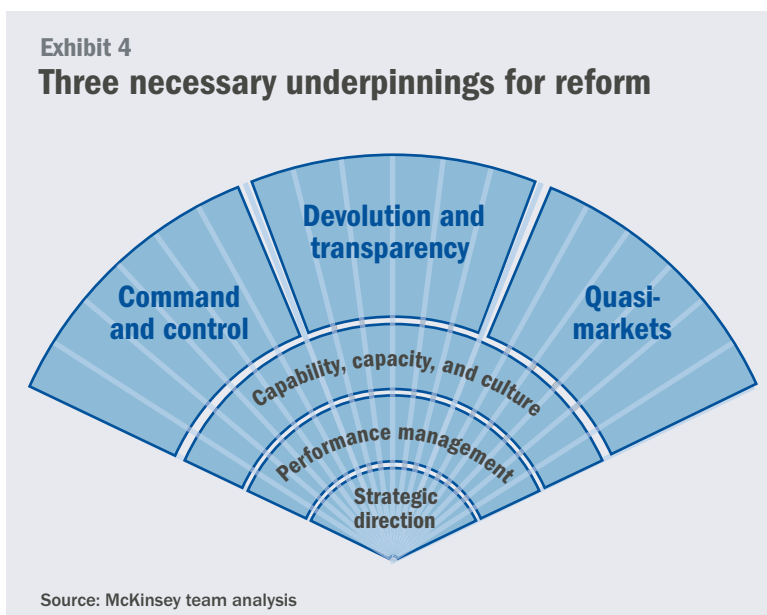
The role of government

Reforming a large public service is a sophisticated challenge. Whichever paradigm is chosen, it will work only if three underlying requirements are in place (*Exhibit 4*).

The first requirement relates to the **capability, capacity, and culture** of the service in question. This means that the people who provide the service must have or must acquire the right skills. It means sufficient resources must be allocated to get the job done. And it means an appropriate performance mindset must be established among those providing the service. The precise nature of the mindset required will obviously differ, depending on which paradigm is being implemented. Given

that real-world situations typically require a mix of paradigms, the demands on the flexibility of the service providers can be considerable.

Unfortunately, unhelpful and inflexible attitudes toward reform are often particularly entrenched in the public sector. Many public servants argue that, to put it bluntly, government should “give us the money and get out of the way,” yet they are also quick to respond to problems by saying, “What is the government going to do about this?” These two responses are contradictory yet still frequent. And when public servants (generally reinforced by the media) demand that governments act, act is precisely what governments do. The result, built up over many years, is an often stultifying set of bureaucratic regulations. This is how many disappointing public services came to be the way they are. Many U.S. teachers’ union contracts developed in precisely this kind of destructive, accretive fashion, as did the health and safety regulations affecting many sectors.



If governments are to become more strategic and less bureaucratic, the mindset of public servants has to change so that the question becomes, “How can we in this public service solve this problem, with government help if necessary?” Only at this point can the required cultural shift begin to take hold. The government responsible must have a strategy for establishing the right conditions for this to happen. Notably, there must be a mindset shift among senior government officials, equivalent to that sought in the body of public servants, so that the two shifts become mutually reinforcing. Exhibit 5 highlights the dozen individual shifts that are most important for the required change in culture to occur.

The second requirement is that the government engage in rigorous **performance management**. None of the three paradigms can work without it. Performance management starts with information: Data on performance must be published, so that service providers can see how they are doing and can benchmark their performance against others. The public, the ultimate funder of the service, must also see the return it is getting on its investment. Neither parents nor patients can exercise choice without good information. And, as governments move away from command and control, the capacity to intervene when a service is underperforming is crucial. This cannot be done without reliable, up-to-date information on performance.

Exhibit 5

The required cultural shift

From	To
Hit or miss	Universal high standards
Uniformity	Diversity
Provision	Choice
Producers	Customers/citizens
Inputs	Outcomes
Generalization	Specificity
Talk equity	Deliver equity
“Received wisdom”	Data and best practice
Regulation	Incentives
Haphazard development	Continuous development
Demarcation	Flexibility
Looking up	Looking outward

Source: McKinsey team analysis

More generally, the ability to manage performance in either of the two circumstances other than command and control requires new attitudes and skills. Managing large contracts or markets can be technically complex, and governments must ensure that they are well prepared for these transitions and have the necessary skills. For example, since the competitive sourcing initiative in the U.S. government began, the Office of Management and Budget has sought to ensure that agencies seek a better trade-off between cost and quality in procurement, rather than focusing only on cost. In London, the city's transportation department has awarded 30-year contracts to private companies to maintain the underground system. The contracts have break clauses every seven-and-a-half years to allow for updated negotiations. Each of these initiatives requires leading-edge contract management and general commercial expertise among public officials.

Third, because public-service reform is complex and only possible over several years, **strategic direction** is a necessity. You need to know where you are going if you are to have a decent chance of getting there. Developing a good strategy is a sophisticated challenge for a large business. In a political environment, with all its attendant pressures, this challenge is even more daunting. A small, well-qualified, courageous group – a kind of “guiding coalition”⁸ – must oversee the sequencing and implementation of reform. Given the controversy such reform often generates, only a sustained, well-thought-through strategy will work. The support for this strategy should build over time, both within the public service itself and among the public. Hence the importance of sequencing: A long-term strategy must be protected through the delivery of short-term results.

TYPICAL PROBLEMS

Without these three requirements in place, the chosen reform model will not work. And so it is well to be aware of the pitfalls that await even the most talented leaders of public-service reform. Exhibit 6 (*overleaf*) highlights some of the problems governments typically face when applying the models discussed here.

Some of these dangers have already been discussed. A few require a little more explanation.

One common error, as governments move away from a command and control approach to one of the other models, is believing that they can “let go” – that devolving responsibility or creating a market brings their role to an end. In fact, the three requirements remain vital – they just change in character. To borrow a boating metaphor, the government's role may change from rowing to steering, but it does not disappear.⁹

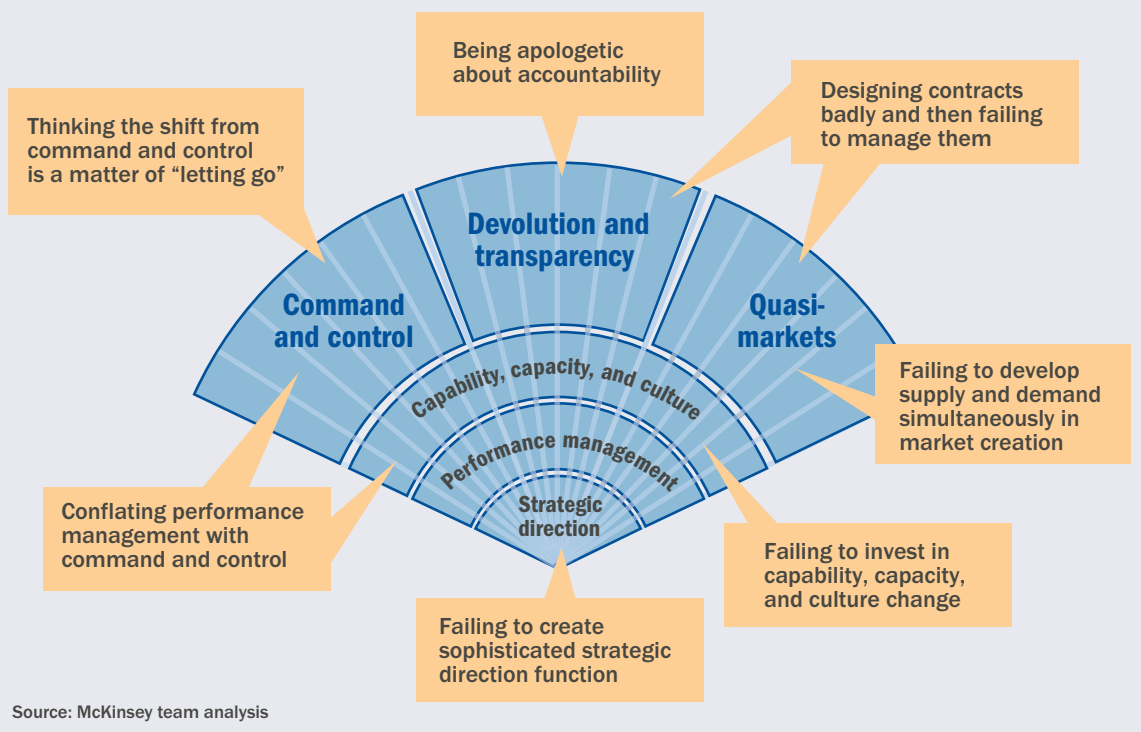
A second common error is designing contracts poorly and then managing them ineffectively. The inevitable result is that the benefits are not realized. This is why the growing interest among governments around the world in improving procurement is as much about realizing benefits as about reducing costs.

A third common error is for governments, often under pressure from public-sector providers, to become apologetic about transparency and accountability. In the end, if taxpayers are to be convinced of the value of their investment, and if consumers of

⁸ The phrase is John Kotter's. See *Leading Change*, Boston: Harvard Business School, 1996, p.6ff.

⁹ David Osborne and Ted Gaebler, *Reinventing Government: How the Entrepreneurial Spirit Is Transforming the Public Sector*, New York: Plume, 1993, p.25ff.

Exhibit 6 Pitfalls that can impede reform



public services are to make informed choices, transparency is both necessary and desirable.

Finally, a fourth error is to fail at creating quasi-market conditions by not paying attention to both supply and demand. If contracts are awarded, but there are few or no credible potential providers, the reform cannot succeed. Similarly, potential providers of a service are unlikely to make a major commitment to an emerging market unless they see long-term potential.

Conclusion

The imperative for governments to deliver better services at an affordable cost can no longer be

ignored. In recent years, experimental reforms such as those discussed here have created much controversy. To some, the reforms have been ideologically unacceptable. Others have deemed them irresponsible. And many complain that they have been deployed either without a clear strategy or simply based on a dogmatic belief in one paradigm of reform or another.

Yet like it or not, the acuteness of the productivity challenge requires new paradigms. Governments must develop a clear strategy for the “when” and the “how,” focused above all on the pragmatic implementation of whatever is likely to be most effective. Different public services will need different approaches to reform. The same services will need different approaches at different times. These

three paradigms provide a toolkit for government reformers to recognize how to reform and when, and what each choice requires of them and their organization.

Where public services deliver high performance at an affordable cost, they will underpin much wider economic success, as education provides the human capital – and health care and other services the social context – for success. A virtuous cycle develops in which successful public services engender public willingness to pay the taxes necessary to strengthen the services further. Underperforming public services, by contrast, weaken

the prospects for economic growth and lead taxpayers to doubt the value of their investment, creating the opposite cycle.

Economic growth and greater social cohesion, or economic decline and social fragmentation: The outcome depends on the approach taken and the commitment with which it is pursued. Over the past two decades, public-sector reforms have generally been disappointing, but the evidence on which to base successful reforms is now becoming apparent. The three paradigms set out here, based on that evidence, can support governments in making wiser reform choices in the future.

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