

PUBLIC SECTOR

OCTOBER 2007

Government as a **business**

Ian Davis, managing director of McKinsey, talks about the public-sector productivity imperative.

**Article
at a
glance**

In this transcript of a podcast, McKinsey managing director Ian Davis discusses the need for higher productivity in government, globalization, the challenge of aging societies in the developed world and ballooning populations in the emerging one, the role of regulation, and the relationship between the public and private sectors.

Also included are our editors' selections of further reading from the *Quarterly* archive, offering additional McKinsey thinking on each of the themes discussed.



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This transcript and its accompanying podcast originally ran in The Times of London on October 29, 2007, as part of a series on business ideas that are changing the world. Also included are further reading selections from our archive, offering readers additional McKinsey thinking on each of the themes discussed.

Introduction:

The public-sector challenge

Hello. I am Ian Davis, managing director of management consultants McKinsey & Company. Today I am not going to talk not about business, as you might expect, but rather about the public sector, and more important, the role we all have in ensuring that we continue to have an effective and efficient public sector.

While it is very easy to focus on the private sector as the locus of economic activity, fundamental to the strength of any society—and indeed of the private sector—is, I believe, a strong and productive public sector.

I emphasize this because public-sector productivity and success is not necessarily a given. Indeed, every single major government in the world today is facing a set of challenges in the next decade that will not be easy—not at all. And the ways those challenges are resolved will have a significant impact on the vibrancy of our entire society. The choices we make will affect our long-term prosperity and stability.

All you have to do is look at the beginning of the 20th century to realize that peace and prosperity cannot be taken for granted. In 1910 people believed that the economic boom would last forever, and no one imagined that the devastation of World War I was just around the corner. The destruction we faced in the first half of the 20th century was unthinkable—and yet, it happened.

As businesspeople, as citizens, we must enter the dialogue on how to help resolve the impending public-sector crisis. Strong words, but I do believe there could be a public-sector crisis. This is not a partisan issue, but an issue beyond political stance. In a sense the job of government is all of our jobs.



The double-barreled threat: Globalization and demography

The primary challenges governments are facing are twofold: globalization and demography. On one front we have globalization—bringing not only the promise of higher economic growth to those who join its ranks but also a whole set of new challenges. In the past decade the global economy has grown at a robust 5 percent annually, but trade flows have grown even faster, at 7.5 percent, and capital flows faster yet—at nearly 11 percent. The growth of information flows has been exponential.

The world is fundamentally more interconnected, with more goods, more capital, more people, and more information moving across more borders than ever before. In 1990 who would have imagined that the euro, a currency that didn't exist, would surpass the dollar in terms of cash circulation? Or that China would have surpassed the United States

as the world's largest technology exporter? The world today is fundamentally different than that of a decade ago.

National governments are generally ill equipped to address problems that increasingly supersede national borders—but they are expected to solve them nonetheless, when global shifts cause distinctly local disruptions. How, for example, are governments supposed to respond to the disruptions in local labor markets that globalization through the form of offshoring can often cause? And how are we to best solve truly global challenges? Issues like carbon emissions, intellectual-property standards, or efficient global capital markets?

Yet as challenging as globalization is for governments, it is the other challenge—demography—that may prove even more insidious. In developed economies, the swelling ranks of retirees will soon outpace the ability of governments to provide historically agreed-upon benefits in pensions and health care—much less anything else. In almost all of the Western European countries, in Japan, the United States, South Korea, and elsewhere, tax rates will have to more than double to support current benefit levels, given the expected size of the retiree pool relative to the workforce.

The agreements governments have with their citizens about which services are to be provided will be simply unaffordable. Something will have to give. And this demographic challenge to government is not just one developed economies are facing.

In the emerging economies, the challenge is at the other end of the age funnel: a population that burgeoned in the fertility boom of the 1970s and 1980s is just reaching working age, giving these countries not only a surplus of labor power but also a strong imperative for economic growth. China, for example, needs to grow at roughly 8 percent annually just to absorb its surging labor force.

Emerging-market governments will need to provide not only the infrastructure—both physical and social—necessary to keep growth on track but also new social safety nets to catch those who get left behind. In India, for example, lack of public infrastructure is cited by many as the number one constraint on economic growth. Yes, India is growing fast, but it could grow faster yet if it could reliably provide electricity, running water, and roads to ensure that its economy runs smoothly. According to the World Bank, the average Indian manufacturer loses 8 percent a year in revenue from power shortages alone.

How governments rise to meet these challenges will determine both the shape and pace of world economic growth for decades to come—and indeed, will fundamentally renegotiate the role and purpose of government. We are at a vulnerable point in time. The wrong steps could easily lead to a world of growing protectionism and slowing growth. We must help governments resist the urge to hunker down and close up during periods of stress. That would be the wrong answer. It would be to miss the opportunity to make government better and to reinvent itself for the 21st century.

Further reading

Can pension plans age gracefully?

Coming Soon: Serving aging baby boomers

The role of continued economic growth

The first, best thing we can do to help stave off a public-sector crisis—and I use the word with some care—is to continue to facilitate private-sector growth through an increasingly open economy. Research from the World Bank, the McKinsey Global Institute, and others consistently shows that countries who openly participate in globalization do better than those who don't.

Prosperity will both help fill government coffers and also reduce the need to provide deep social safety nets. The World Bank, for example, estimates that in the next two decades, if economic growth continues as projected, average per capita incomes in the developing countries will more than double, lifting literally billions out of poverty.

While the task seems obvious, it is often easier said than done. Indeed, given the current economic expansion, it is all too easy to forget government's crucial role in creating it—lifting trade barriers, improving global monetary policy, and facilitating open commerce. In such an open environment, it is also hard to remember that protectionism can return in a minute. And the currents of protectionism are most certainly out there. The Doha Round discussions of the World Trade Organization have been stalled since 2001, as members disagree over the future of open trade.

Further reading

Regulation that's good for competition

The productivity imperative

At the same time, and this is I believe equally important, we must see an improvement in public-sector productivity. It is imperative.

In the past decade, we have seen productivity growth in the private sector more than double in many Western countries as we have captured huge gains from the introduction of information technology and business process improvements. These have allowed businesses to be not only more efficient but offer better levels of service to their customers for lower prices.

Central to my argument is a definition of productivity that is broader than the one usually adopted in government circles. People often use the term “productivity” interchangeably with “savings”—seeing the word as synonymous with cost cutting and layoffs. But that is not productivity. Productivity achieves two goals at once: productivity simultaneously improves performance while decreasing costs. The magic is that productivity integrates both results and costs, conceptually and in terms of measurement.

Adopting the concept of productivity to the public-sector debate changes the argument from being about more government or less government to a conversation about more effective government. Productivity is about improving government performance, and the greater productivity imperative is for government to deliver better results—both in terms of quality and quantity. More effective tax collection, higher levels of student literacy, healthier citizens, and so on. So how do you get more from less?

This is critically important. In the United Kingdom and elsewhere, there are often bursts of separate activity—either to increase results or to drive down costs. But the two are rarely brought together. They're often presented as a bogus dichotomy: that results and costs are mutually exclusive. But they are not. For example, often when you streamline processes you can both improve output and reduce costs.

We are all aware that there is growing pressure on government to do more things and to do things better. It is not simply the need to take care of an aging population but other priorities as well, such as national security, public education, and improving a crumbling public infrastructure. Equally important, citizens want better services, more choice, more convenience, and improved customer service from government.

While there are differences between the public and private sector, you can replicate the drivers of private-sector productivity gains in government, and you can do more to increase performance management and innovation. Take a look at some Asian car companies, among the most efficient in the world. They still routinely set targets to take 30 percent or more cost out of the system. Not 5 percent, not 10 percent, but 30 percent. They get good, then they get better. Governments need to set those kinds of aspirational goals.

This can't be achieved by pressure alone—you need support as well. And you need training. In government reform efforts we have seen around the world, pressure without support simply leads to demoralization, while support without pressure leads to complacency.

Virtually all countries could benefit from adopting more of the approaches that have helped drive the productivity gains in the private sector over the past two decades—better transparency, improved performance management, better alignment of incentives, stronger accountability, better incorporation of technology, and, crucially, better attraction, deployment, and development of talent.

In the United Kingdom the Gershon Review of 2004 laid out ambitious measures to streamline public-sector bureaucracies. Three years later, there's still a long way to go to match private-sector levels of efficiency. And few other countries have been so ambitious.

Innovation will be crucial. One promising such innovation has been private–public partnerships. For example, the UK-based Secondary Market Infrastructure Fund provides an alternative approach to traditional municipal-bond financing. This fund functions similarly to a private-equity fund—coinvesting in public-works projects and then managing those investments in a much more aggressive way than traditional bondholders can.

Governments will also have to experiment with new approaches. In the United States, for example, wage insurance has been floated as an idea to help buffer the bumps caused when globalization displaces workers. In Europe new approaches to labor flexibility may help prevent similar kinds of discontinuities.

And these innovations can help solve not just national problems but global ones too. The Global Alliance for Vaccines and Immunizations (GAVI), for example, is a broad coalition that includes UNICEF, the World Health Organization, many national governments, the [Bill and Melinda] Gates Foundation, the vaccine industry, public-health organizations, and any number of nongovernmental organizations (NGOs). As a result of GAVI's efforts, more than 126 million children around the world have received vaccines since its founding in 2000.



Why is it so hard to achieve?

Four reasons are usually cited as barriers to improving public-sector productivity, but if we look a bit closer they are either no longer relevant or not as hard to overcome as first thought.

The first objection is that it's too hard to measure productivity. This can be complex, but public-sector productivity has been measured in the past, and headway is being achieved in other countries. Britain recently created the Centre for the Measurement of Government Activity to robustly measure government productivity. And before we dismiss this approach as imposing a private-sector methodology on the public sector, remember that in the past measuring and driving productivity in the service sector was also thought to be too hard.

The second objection is the lack of market forces and competition. Without external competition, public servants need to stimulate performance from within. Overall aims such as reducing crime or increasing literacy make setting targets harder, contrasting with the private sector's typical economic bottom-line orientation, which provides a natural focus. However, there are ways to direct greater focus. Top-down command and control by governments has been particularly effective around the world in areas such as literacy.

At the other end of the spectrum is the creation of quasi-markets, in which the customer is defined, choices are established, and new providers and mechanisms are introduced to ensure money follows the customer's choices. The restructuring of parts of the NHS [National Health Service] along quasi-market lines has brought early benefits but is still far from complete.

The third objection is the resistance to productivity. The public sector tends to have a more static workforce, employees have longer tenure, and in general they are resistant to initiatives that put their jobs at risk. But clearly this cannot last in some ways.

The public sector has to attract talent, and to do so it needs to distinguish clearly between higher and lower performers. Failure to do so will lead to the high performers leaving and finding jobs where their unique talent is valued. Furthermore, today there is no good reason why the public sector should be immune to the standard challenges faced in all other sectors of the economy.

And fourth, politics blocks reform. Public-sector transformation is clearly a long-term objective, and the political cycle is inevitably short term. However, improved public-sector productivity has

one significant factor in its favor. Of all the options available to government to deal with fiscal challenges, public-sector productivity is, perhaps surprisingly, the most politically palatable. The other alternatives of cutting services or increasing taxes, although conceptually easy, are increasingly challenging politically.

Further reading

Organizing for effectiveness in the public sector

Conclusion: The role of business

Meeting the coming public-sector crisis, as all this suggests, will require the engagement of a broad range of stakeholders. Indeed, if any one thing has to change in the public-sector debate, it is the attitude that government will solve its challenges alone. The belief that private-sector institutions—be they businesses, nonprofits, or simply citizens—can maintain a distant and often adversarial relationship to government must change. And vice versa.

All of these stakeholders will have to take a role in helping craft a solution for the challenges the public sector faces. For businesses, that may mean moving beyond a relationship with government that concerns only specific, immediately tangible impacts, such as regulation, and developing a broader dialogue about how to actually solve governmental problems.

Further reading

Public-private partnerships as a development engine