# New Public Management as Trust Problem

## Explaining Cross-country Differences in the Adoption of Performance-related Pay in the Public Sector

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**Abstract**

This paper aims to explain cross-country variations in a paradigmatic element of NPM reforms: the shift from low-powered incentives (i.e. flat salaries) to high-powered one (i.e. performance-related pay systems). The paper presents a simple theoretical model based on insights developed for understanding the success of performance-related incentives in the private sector. This literature has underlined the need for a system of separation of interests within firms to make promises on incentives credible. The interests of those who benefit from the incentives (e.g. owners) must be relatively different from the interests of those who manage the incentive system (e.g. managers). Similarly, this paper argues that incentives in the public sector can only be implemented in those administrations in which there is a relative separation between those who benefit from the incentives (e.g. politicians) and those who manage the incentive system (e.g. senior civil servants). Where the interests of both groups totally overlap (e.g. the careers of senior officials and politicians are intertwined), incentives will be less credible and thus less likely. A quantitative analysis for 25 OECD countries confirms that incentives are significantly more used in those contexts with clearer separation of interests between politicians and senior civil servants. Narratives from Sweden, the UK, France and Germany illustrate the workings of the theory.

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## 1. Introduction

Since the mid 1970s there have been numerous reforms of public administrations worldwide. Two influential observers conclude that with exception of wartimes "there never has been the extent of administrative reform and reorganization that has been occurring during the period from approximately 1975 onward" (Peters & Pierre 2001, 1). The majority of the reforms fall into the category of New Public Management (NPM). While this is a concept initially associated with administrative reforms in Anglo-Saxon countries, today one may find NPM reforms in a much broader group of countries – although in very different shapes, degrees and depths (for overviews see Christensen & Lægreid 2001; Peters & Pierre 2001; Pollitt & Bouckaret 2004). Two main scientific challenges arise in the comparative study of NPM. Firstly, despite the large scholarly interest in NPM, existing theories fall short to explain cross-country variations. Secondly, we face the problem of how to scientifically tackle a concept as broad as NPM. We lack reliable comparative measures that travel well from country to country and, more fundamentally, there is no clear consensus on what constitutes a NPM reform. The aim of this paper is to address both questions by proposing a simple theoretical model focused on one particular but paradigmatic NPM reform – the introduction of performance-related incentives in the public sector – and by subjecting it to a comparative empirical test at both quantitative and qualitative level.

Roughly, the general explanations of adoption of NPM reforms search for causes of cross-country variation in three spheres: administrative culture, politics, and economics. Taking into account the early reforms in the 1980s in the UK and US, several authors have attempted to explain NPM as a distinctly phenomenon of the Anglo-Saxon administrative culture – often referred to as the "public interest" tradition (Castles & Merrill 1989, 181; Pollit 1990). Although it can be convincingly argued that many high scorers on NPM emphasis are Anglo-Saxon countries while most low scorers are not, as long as we move from the 1980s onwards, we find many high scorers in culturally non-English contexts, such as the Scandinavian countries or Korea (Hood 1996, 274).

Regarding political explanations, some scholars see NPM reforms as the result of the ascension to power of the "New Right" in the late 1970s-early 1980s (Bach 1999; Barlow et al. 1996). However, again the literature underlines the increasing number of counter-examples to the New Right hypothesis, like the implementation of NPM programs by social-democratic governments – e.g. in Sweden and New Zealand (Hood 1996, 275).

In relation to economic factors, one of the most pervasive explanations of NPM reforms in general, and human recourses management changes in particular is that they are the result of the competitive pressures from economic globalization (Keller 1999, 58; Thompson 2003, 50). This might be a reason for the general development of NPM over time, but it is harder to see how it may explain variations across countries with similar economic structure – such as small, open, corporative countries like Austria, Denmark, and Sweden (OECD 2004a).

We contend that insights from organizational economics used for explaining the introduction of NPM-like reforms in the private sector may help us understand variations in the adoption of NPM across public administrations better than the existing prevailing accounts in the literature. But, firstly, we must narrow the scope of our analysis, identifying an aspect of NPM which can be measured and travels well across countries. NPM is a too broad concept to guide a scientific research. NPM cannot even be considered as a general program or doctrine of reform, but more likely as "shorthand for a group of administrative doctrines that have figured prominently in the agenda for bureaucratic reform in several OECD countries beginning in the late 1970s" (Hood 1996, 268).

NPM mostly involves a combination of two values -individualism and hierarchism- and entails several doctrinal components – professional management of public organizations, explicit measures of performance, greater emphasis on output controls, shift to disaggregating of units, change to greater competition in the public sector, stress on private-sector styles of management practices, and emphasis on greater discipline in public sector resource use (Hood 1996:267-271). This paper focuses on one specific element of NPM: the introduction of incentives or performance-related pay (PRP) systems in the public sector. This element represents both the main values of NPM as well as most of its doctrinal components (Thompson 2003:50). As well, the shift from predictable flat salaries to PRP systems clearly exemplifies the essential change that, according to Naschold (1996), NPM implies in comparison to Traditional Public

Administration: the movement from rule steering to results steering. As OECD remarks, "the adoption of performance-related pay in the public sector reflects the influence of the private sector culture of incentives and individual accountability on public administration" (OECD 2004a, 4). In addition, since there are reliable cross-country indicators on the adoption of incentive systems, we contend that PRP is one of the best available proxies for assessing the advancement of NPM reforms in a country.

The remaining of the paper is organized as follows. Section 2 presents the theoretical argument of the paper, taking as starting point developments in organizational economics. Similar to the theoretical insights generated for understanding the difficulties to implement incentives in many private firms, we define the problem of incentives as a trust problem. We argue that the reason for the successful introduction of incentives in the public sector does not lie on a "good" or "bad" design of the incentives, but on the credibility of those who impose them. It is not difficult to design good incentives. What is difficult is to convince others that you are trustworthy and you will not manipulate *ex post* the management of incentives to your personal advantage. The main hypothesis of the theory is that PRP systems will be more likely in those administrations where there is a relative separation between those who benefit from the incentives (e.g. politicians) and those who manage the incentive system (e.g. senior civil servants). Section 3 tests this hypothesis with data for 25 OECD countries. Results show that, even after controlling for alternative hypotheses, those countries with a clearer separation between the careers of politicians and senior civil servants are more likely to introduce PRP systems than countries where those careers are more integrated. Section 4 provides case studies, analysing experiences with PRP systems in four countries belonging to different administrative traditions: Sweden, the UK, Germany and France. Section 5 concludes.

## 2. Theory: When Do Incentives Work?

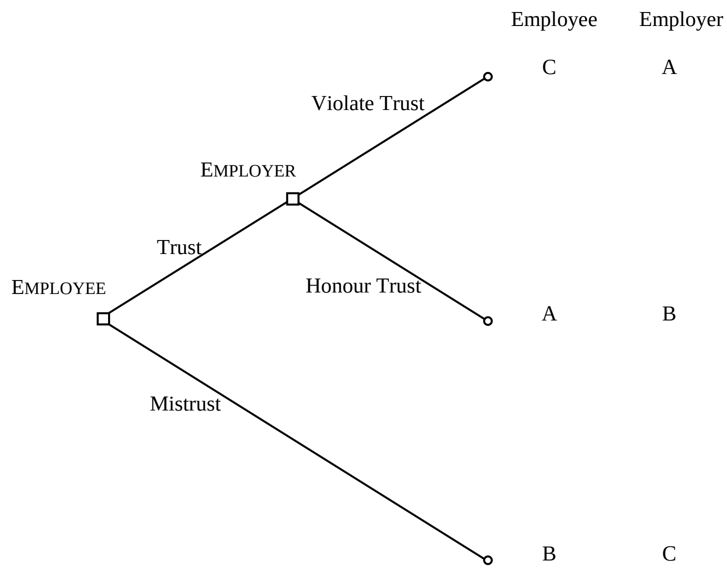
There is a well-established literature on why incentives should be imposed within organizations. In the first place, according to the psychological theory of expectancy, the association between the value of a reward and the probability of obtaining it if one exerts the necessary effort should improve performance (Lawler 1971). Secondly, for standard economic theory, incentives are an ideal way of solving the principal-agent problem in production, because they align the self-interest of employees with organizational goals. These arguments should also hold for most public organizations (for a survey of the literature showing it, see OECD 2004a, 14-15). Nevertheless, research on incentive systems has revealed that in practice they are fraught with many problems and they are less used than what standard principal-agent theory would predict (Miller 1992). The puzzle is thus that, although in principle incentives are the essence of economics, in practice they are underused. We lack a well-developed literature explaining why incentives are not imposed in many organizations. If the study of organizational disparities in the use of incentive systems has been overlooked for decades in the private sector (Prendergast 1999, 7), this neglect is even more notable for the public sector. There have not been significant attempts to understand systematic differences in the adoption of incentives across public organizations. Why are incentive systematically adopted in some institutional settings and not in others?

This section tackles that question by adapting insights developed by transaction cost economists (TCE) – to understand differences in the use of incentives across private firms- to public bureaucracies. Unlike traditional principal-agent theory, for which incentives will work if they are technically well designed in a contract, transaction cost economics considers that there are always behaviors that cannot be specified ex ante. Not all transactions involved in an incentive system can be established in a formal contract. In general, organizational success does not depend so much on how properly designed formal contracts are, but on the existence, between employers and employees, of "relational contracts" (Williamson 1975) or "psychological contracts" (Levi 2005) – that is, informal exchanges made possible by the accumulation of trust. In particular, the trust problem which prevents a more frequent implementation of incentives is the standard time inconsistency or credible commitment problem.

Miller (1992) illustrates the time inconsistency problem inherent to incentives with the example of the piece-rate system (figure 1). The employee moves first and has a choice of trusting the employer (working hard) or not trusting the employer (making a minimum effort). If the employee trusts the employer, the latter has the opportunity of honouring trust (e.g. paying the ex ante promised 10$ per each piece the employee produces) or violating trust (e.g. cutting the piece-rate from the promised $10 to a mere

5$ once he realizes how many pieces the employee is able to make).[1] The employer may have incentives to violate trust, because he obtains a direct benefit. Anticipating this violation, the employee does not trust the employer, which results in an outcome of minimum effort, a Pareto-suboptimal Nash Equilibrium (B, C).

**Figure 1.– The Problem of Incentives in the Private Sector**




Employer's outcome ranking A > B > C. Employee's outcome ranking A > B > C Mistrust (payoffs B and C represents a Pareto-suboptimal Nash equilibrium. (Figure adapted from Miller 1992).

This pervasive trust problem would explain why so many firms do not use incentives when they are technically feasible. The relevant question would thus be why do some firms succeed in implementing incentive systems? As in any other trust problem, one cannot expect a definite and clear solution. There is never a probability equal to one that the manager is not going to renege on her promises. But TCE literature has pointed out one relevant factor to understand the efficient introduction of incentive systems in some private firms: the existence of *separation of interests* -or separation of powers- at the managerial structure of the firm (Miller & Falaschetti 2001, 403). If the owner of a firm (the one who obtains the benefits) is at the same time its manager (the one who fixes the price of 10$ or 5$ per each piece produced), workers may lack incentives to work hard.

The reason is that the owner has more temptations for opportunistic defections (such as adjusting piece-rates downward), since she is going to directly benefit from violating trust. Miller and Falaschetti (2001:400-401) consider that "in a Madisonian way", managers and owners must act as mutual constraints. The owner of a company must act as a "passive owner" and rely on a manager whose preferences must be different from hers. The key issue is thus that, in the eyes of employees, managers possess *known different interests* than owners' (Miller & Hammond (1994, 22).

This finding by TCE contradicts standard principal-agent theory, for which the separation of ownership and control has been seen as a source of economic inefficiency (Berle & Means 1932, Baumol 1959). Since owners are "principals" and managers are "agents", anything that serves to reassert owners' control of firms should be applauded. Nevertheless, an increasingly consistent body of evidence is dismantling this principal-agent theoretical assumption. Evidence from different productive sectors shows that the entire firm (including owners) may be worse off when principal-agent problems are "solved" by reining in managerial independence (Miller & Whitford 2002, 239-246). The historical success of the American corporation – where shareholders are "separated" from the day-to-day managers – could be ultimately explained by the virtues of diffusion of powers within organizations.

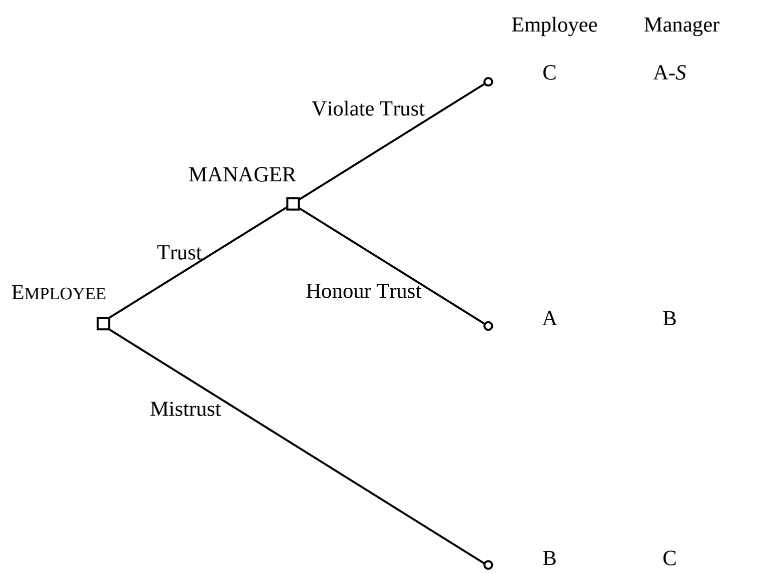
We contend that, despite the multiple differences between private and public managers, TCE theoretical insights may help us understand the uneven introduction of incentives we see across public organizations. Actually, some economists use one classic example of failure of incentives in the public sector to illustrate the importance of credible commitments and trust: the tale of the piper of Hamelin (Sala-i-Martin 2005). The public manager -the Mayor of Hamelin- offers 50,000 florins to the piper if the latter gets rid of the rats swarming the town. Nevertheless, once the town is free of rats, it is not anymore in the interest of the Mayor to reward the piper properly. The mayor may prefer to divert the 50,000 florins to build a hospital in a swing district or directly to his own pockets. There are reasons to think that many public employees, similar to the piper – and, more realistically, similar to the private employees analyzed by TCE – may face non-trustworthy public managers who are tempted to make ex post opportunistic defections.

OECD research indicates that, akin to what happens in the private sector, incentives in public sector create uncertainty among employees (OECD 2004a, 34) and, in general, the lack of trust is one of the most serious obstacles to the development of PRP systems (OECD 2004a, 44). Not unlike TCE literate on private firms, for OECD (2004a, 7), "PRP should be applied in an environment that maintains and supports a trust-based work relationship". OECD is thus also emphasizing the need for a psychological or relational contract between managers and employees in the public sector: "in such an environment there is a balance between formal and informal processes, with on-going dialogue, information sharing, negotiation, mutual respect, and transparency being prioritized" (2004a:7). Scholarly literature also underlines that, in order to work properly, incentives in the public sector must produce a "higher level of commitment" and be designed in a "humanistic" way (Abrahamson 1997; Thompson 2003, 59). Furthermore, there are reasons to think that incentives in the public sector depend even more critically on organizational trust than in private firms, because performance assessment is inherently difficult in the public sector and it requires a large element of managerial judgement (OECD, 1993; OECD, 1997). Even in the case of the UK, where incentive systems have been reported as generally successful, there is evidence of high levels of dissatisfaction and stress especially in the National Health Service and education (Horton 2000, 230). Accordingly, the interaction between governments and public employees could also be modelled by a two-person game such as the one depicted in figure 2. The game is identical to Miller's, with the only difference that it endogenizes the solution to the trust problem -the existence of separation of interests at the top of the organization- with the parameter *S*, which reduces the value of violating trust for the manager. Parameter *S* captures up to which extent there is separation of interests between those who mostly benefit from reneging ex post on promises on incentives (i.e. the public equivalent of "owners") and those who manage the incentive system (i.e. the public equivalent of "managers").

Although the ultimate "owners" or shareholders in a democracy are voters, we contend here that governments –and, in particular, the ministers or cabinet members- are the de facto owners. Unlike private sector owners, members of government are not entitled to the *residual* produced by public employees, but, as Hammond and Miller

(1994) remark, there are many ways through which politicians benefit from the residual generated by the provision of public policies. One does not need to resort to the tale of the pied piper to see examples of opportunistic defections by politicians in their relations with public employees. (See Lapuente 2007 for a historical account of politicians reneging on their promises to public employees in both authoritarian and democratic settings). Governments have frequent temptations to ex post modify a given incentive system and divert the resources to other ends. For example, as OECD (2004, 36) surveys regarding the failure of incentive systems in several countries, it is recurrent to see "disappointed expectations of employees who have been promised money for improved performance and then find it is funded by means of smaller increases in base pay."

**Figure 2.– The Problem of Incentives in the Public Sector**




Managers's outcome ranking A > B > C. Employee's outcome ranking A > B > C Mistrust (payoffs B and C represents a Pareto-suboptimal Nash equilibrium.

And who are the "managers" in public sector? In the complex structures of nowadays public administrations, it is difficult to identify a precise measure of who a public manager is, and, given the existence of many cross- and within-country differences, any decision will have a discretionary component. We thus rely in this dimension on previous work by public administration scholars who use the concept of “mandarins” for referring to the managerial ranks of civil service (e.g. Pollitt & Bouckaert 2004, 50-52). Mandarins or managers of the administration would be the senior civil servants or high officials, including, among other, positions like permanent secretaries in the UK, heads of agencies in Sweden or *directores generales* in Spain –that is, those the responsible for the day-to-day management of a public administration.

When there is no “separation” at all between ministers and mandarins, the parameter *S* would be zero. That would happen when ministers themselves, or very close political appointees, manage the incentive system. In general, using the terminology of organizational economics, the more *common knowledge* it is that the manager is fully responsive to all demands by the minister, the closer the parameter *S* will be to zero. One plausible assumption is that the more the careers of mandarins depend on ministers (e.g. mandarins are political appointees or mandarins may be offered political positions in the future), the lower the value of *S* will be. On the contrary, the more *common knowledge* it is that the manager is not fully responsive to all demands by the minister –and, for example, she values her reputation as a committed-to-employees, long-term manager- the higher the parameter *S* will be. Similarly, it is plausible to assume that the more independent the careers of ministers and mandarins are (e.g. mandarins are not politically appointed or mandarins are banned from becoming politicians in the future), the higher the value of parameter *S*.

In institutional settings with high integration of ministers-mandarins careers (*S* close to 0), public managers will obtain a higher payoff for violating trust than for honouring trust [(A – *S*) > B]. Nonetheless, in those polities with high separation of ministers-mandarins careers [*S* > (A – B)], the public manager will prefer honouring trust rather than violating trust. The intuition behind this is that a *relatively separated* public manager values more long-term reputation as a manager who honours trust than short-term political perquisites in case she violates trust. When facing a manager with relatively separated interests, the choice for the public employee in the previous movement changes in comparison to Miller’s trust game. Now minimum effort gives the public employee a sure payoff of B while maximum effort gives her the highest payoff (A). In other words, incentives induce public employees to undertake higher efforts in institutional settings of separation of interests between ministers and mandarins. The hypothesis one may derive from this adaptation of Miller's game to the public sector could thus be stated as follows: *ceteris paribus, the more separation between ministers' and mandarins' careers in a given polity, the closer link between performance and pay for public employees.*

## 3. Minister and Mandarin Relations and the Adoption of Performance-related Pay. Evidence from 25 OECD Countries.

The primary objective of the empirical analysis is to estimate the effect of minister-mandarin relations on the adoption of incentives in the public sector. This section presents a general map of the variance of these variables at aggregate level for 25 OECD countries, and section 4 offers case studies to analyse the evolution of the variables over time and illustrate the workings of the theory for four countries belonging to different administrative traditions: Sweden, the UK, Germany and Spain.

In principle, PRP is nearly universally present in all civil service reforms for the latest three decades (OECD 2004, 4). In practice, only some OECD civil service systems can be considered to have formalized PRP systems since frequently performance rewards are distributed without any formal assessment of individual performance (OECD 2004, 5). PRP systems have not really been implemented as such in many contexts, but simply grafted onto existing pay systems (Ingraham 1996, 260). Literature agrees that there is a great variation in the real implementation of incentives –that is, in the extent to which economic rewards are really linked to performance appraisal (Ingraham 1996, 260; Thompson 2003, 57). Consequently, as a dependent variable, we focus on up to which extent there is a real link between civil servants' performance appraisal and pay.

We obtain this data from the OECD's (2004a) Survey on Strategic Human Resources Management, answered by 25 member countries and which attempts to provide a comprehensive overview of the trends in PRP policies across countries. OECD classifies its member states in four main groups regarding the depth of their PRP systems. Performance appraisal and pay can be: *very much linked* (4), *somewhat linked* (3), *slightly linked* (2), or *not linked* (1).

Regarding our independent variable, it is important to remark in the first place that scholars have failed to agree on one single dimension to capture the essentials of minister-mandarin relations (Pollitt & Bouckaert 2004, 50-52). Some of the suggested dimensions are careers integration, politicization, and “bargains” between politicians and senior public officials (Hood 2002, 321; Peters & Pierre 2001, 3-8; Peters & Pierre 2004, 4-8; Pollit & Bouckaert 2004, 51). Out of the available alternatives, careers integration is the closest proxy for the independent variable of our theoretical model: how intertwined interests of ministers and mandarins are. We use a dichotomy suggested Pierre (1995, 208) and used by Pollit & Bouckaert (2004). They differ between separated and integrated careers and Pollit & Bouckaert have assessable data for 11 countries of our sample (Pollit & Bouckaert 2004, 51). We have coded the remaining 14 cases using available scholarly studies. We have browsed academic literature as well as OECD reports covering the relations between ministers and mandarins and coded each country on the basis of the assertions made on those studies regarding the integration of careers of politicians and senior civil servants. Each country observation is backed by a minimum of two studies and maximum of fifteen. An overview of the dependent and independent variables is presented in table 1, as well as information on the sources for each country.

For the cases covered by Pollit and Bouckaert (2004), the most clear examples of separated careers are those countries where civil servants are formally forbidden to be active members of political parties, such as the UK and Ireland (Van der Meer, Steen and Wille 2007, 41).[2] However, formal rules are not the only element determining the separation/integration of minister-mandarins careers. It also depends on informal rules of acceptability in a given political-administrative context. Although countries like the Netherlands, Denmark and Norway may experience some particular political appointments, their public administrations are generally considered non-politicized (Van der Meer, Steen & Wille 2007, 42).

For the additional cases, we have searched for mentions of the extent of separation/integration of careers where available. Otherwise, we have focused on references on the existence or not in a given country of the two types of politicization pointed out by Peters and Pierre (2004): top-down politicization (i.e. the extent of political appointees in administrative posts) and bottom-up politicization (i.e. the extent of political activities by civil servants). The careers of civil servants and ministers will be more integrated the more civil servants can be removed by politicians and the more civil servants can be appointed for top political positions. For example, for the Greek case, Sotiropoulos (2004:258) explicitly refers to both the extensive penetration of the civil service by successive incoming governments (top-down politicization) and the strong involvement of civil servants in party politics (bottom-up politicization).

**Table 1**
**Minister and mandarin relations, administrative culture, and PRP systems in 25 OECD countries.**

| Country | Minister/Mandarin relations | Link between performance appraisal and pay** | Year of first PRP reform |
|---|---|---|---|
| | Integrated Minister/Mandarin relations | | |
| Austria[3] | Integrated | Not linked | No reform |
| Belgium* | Integrated*** | Not linked | No reform |
| Czech Republic[4] | Integrated | Very much linked | Missing data |
| France* | Integrated | Slightly linked | 2004 |
| Greece[5] | Integrated | Not linked | No reform |
| Hungary[6] | Integrated | Slightly linked | 2002 |
| Italy* | Integrated*** | Slightly linked | 1993 |
| Japan[7] | Integrated | Not linked | No reform |
| Luxembourg[8] | Integrated | Not linked | No reform |
| Mexico[9] | Integrated | Not linked | No reform |
| Portugal[10] | Integrated | Slightly linked | Missing data |
| Spain[11] | Integrated | Slightly linked | 1984 |
| | Separate Minister/Mandarin relations | | |
| Australia* | Separate | Very much linked | 1997 |
| Canada* | Separate | Somewhat linked | 1964 |
| Denmark[12] | Separate | Somewhat linked | 1987 |
| Finland* | Separate | Somewhat linked | 1992 |
| Germany* | Separate | Somewhat linked | 1997 |
| Iceland[13] | Separate | Slightly linked | 2002 |
| Ireland[14] | Separate | Slightly linked | 1995 |
| Korea[15] | Separate | Very much linked | 1999 |
| New Zealand* | Separate | Very much linked | 1988 |
| Norway[16] | Separate | Somewhat linked | Missing data |
| Sweden* | Separate | Very much linked | 1989 |
| UK* | Separate | Very much linked | 1985 |
| US* | Separate | Somewhat linked | 1978 |

* Data on Minister/Mandarin relations from Pollitt & Bouckaert 2004, 42.
** Data on the link between performance appraisal and pay are from OECD Human Resources Management Party 2004b, 17.
*** Data missing on integration/separation dimension. Politicization is used as a proxy. Pollitt & Bouckaert 2004, 42.

The correlation between minister and mandarin relations and the type of PRP is very high (0.71), and it is even higher if we focus on the 11 countries coded by Pollitt and

Bouckaert (0.85). In order to disregard a spurious relationship and to test the relevance of our independent variable vis-à-vis alternative explanations in previous literature, we conduct the multivariate analyses shown in table 2. In the different models we control for the administrative culture of the country, the influence of right parties in the government, the GDP, and the degree of economic globalization (trade openness).

As already mentioned, we control for four alternative explanations. First, we introduce a proxy for the *administrative culture* in each country. According to OECD reports, the reasons for cross-country differences in incentive systems lie in countries' traditions (OECD 2004:6). "Rechtsstaat" administrative traditions regarding employees – like "closed" civil service systems – would develop more "collectivist" incentives while "public interest" traditions – like "open" civil service systems- would foster more "individualistic" incentives such as PRP. This is also common wisdom within the scholarship (Parrado 2007, 2). Generally speaking, literature has emphasized that NPM reforms – such as a PRP systems – are mainly introduced in countries with a "public interest" tradition, like the UK, Canada and New Zealand. We use the dichotomy "rechtsstaat" and "public interest" tradition by Pollitt & Bouckaert (2004, 41) for the 11 cases of their sample and different standard sources on the same dichotomy for the additional 14 countries. The dummy administrative culture has value 1 for "public interest" countries and 0 for "rechtsstaat" ones.

Secondly, we also introduce a control for the influence of the *political right*. As mentioned above, several scholars see NPM reforms as the result of the rule of right governments (Bach 1999; Barlow et al. 1996). Examples often mentioned are the Thatcher government in the UK and the Reagan presidency in the US. To estimate the effect of the political right we use the number of years since 1985 with a government dominated by a right party as an approximation. Data on the influence of a right party in the government comes from the Database of Political Institutions.

Thirdly, as also argued above, one of the most prevailing accounts for NPM reforms in general and HR management changes in particular is the one that sees them as the consequence of the competitive pressures from globalization (Thompson 2003, 50). We test this hypothesis by introducing a standard proxy for the level of globalization experienced by each country: the degree of *trade openness*. To disregard the possibility that either this variable or any other would be simply capturing the effects of the level of economic development, we control for the *GDP per capita* as well. Economic variables come from Gleditsch Expanded Trade and GDP Data and the Penn World Tables respectively.

**Table 2**
**OLS and ordered logit estimates for the link between performance appraisal and pay in the public sector**

| | | **OLS regression estimates** | | **Ordered logit estimates** |
|---|---|---|---|---|
| | **Predicted direction** | **Minister/ mandarin model (11 countries)** | **Minister/ mandarin model (25 countries)** | **Minister/ mandarin model (25 countries)** |
| Minister/mandarin relations | Positive | 1.52** | 1.65*** | 5.0*** |
| Administrative culture | Positive | 0.50 | 0.27 | 0.93 |
| Years of right party government, 1985-2004 | Positive | -0.03 | -0.02 | -0.06 |
| GDP per capita | Positive | -0.00008 | -0.00004 | -0.0002* |
| Trade openness | Positive | -0.0051 | -0.0002 | -0.014 |
| Constant | | 4.3** | 2.7* | |
| $R^2$ | | 0.89 | 0.59 | |
| Pseudo $R^2$ | | | | 0.34 |
| n | | 11 | 25 | 25 |

*** p<.001, ** p<.05, * p<.10

Table 2 uses both Ordered Logit – given that our dependent variable, with four categories, does not properly qualify as a continuous variable – as well as OLS regressions – as an additional test and because, unlike Ordered Logit, it allows us to undertake the analysis of the narrower sample (11 cases). The first and second columns show the OLS regressions with, respectively, the 11 cases of Pollit and Bouckaert's (2004) sample, and the 25 cases when we include the 14 additional OECD countries. The minister and mandarin variable is the only significant factor – and at very high levels: 0.001 and 0.01 – in both datasets, trumping out the effects of the four control variables pointed out traditionally in the literature. The proxy for administrative culture variable goes in the predicted direction, but, intriguingly, the party variable and the two economic variables go in the opposite direction. Despite that, these results do not empirically support that left governments implement more incentive systems due to the lack of significance of the coefficients, but they rule out the hypothesis that right governments foster incentives in the public sector.

OLS analysis indicates that the type minister-mandarin relations have an effect on the PRP-level, but the results should still be interpreted carefully. As already mentioned our dependent variable is a categorical variable – not well suited for using normal OLS regression. In column 3 we correct for this using Ordered Logit. Nonetheless, as one can see, even with different empirical specifications, we obtain almost identical results. The only difference is that *GDP per capita* -paradoxically the only control variable which has not been explicitly listed by the scholarship as relevant for understanding NPM variations, and which was slightly insignificant with the OLS regression (p=0.109), now it becomes slightly significant (p=0.066). Nevertheless, given its lack of theoretical support, its low and instable level of significance as well as its poor bivariate correlation with the dependent variable (-0.05), we are not in conditions of concluding any relevant (negative) effect of economic development on PRP systems.

**Table 3**
**Predicted values of PRP-levels**

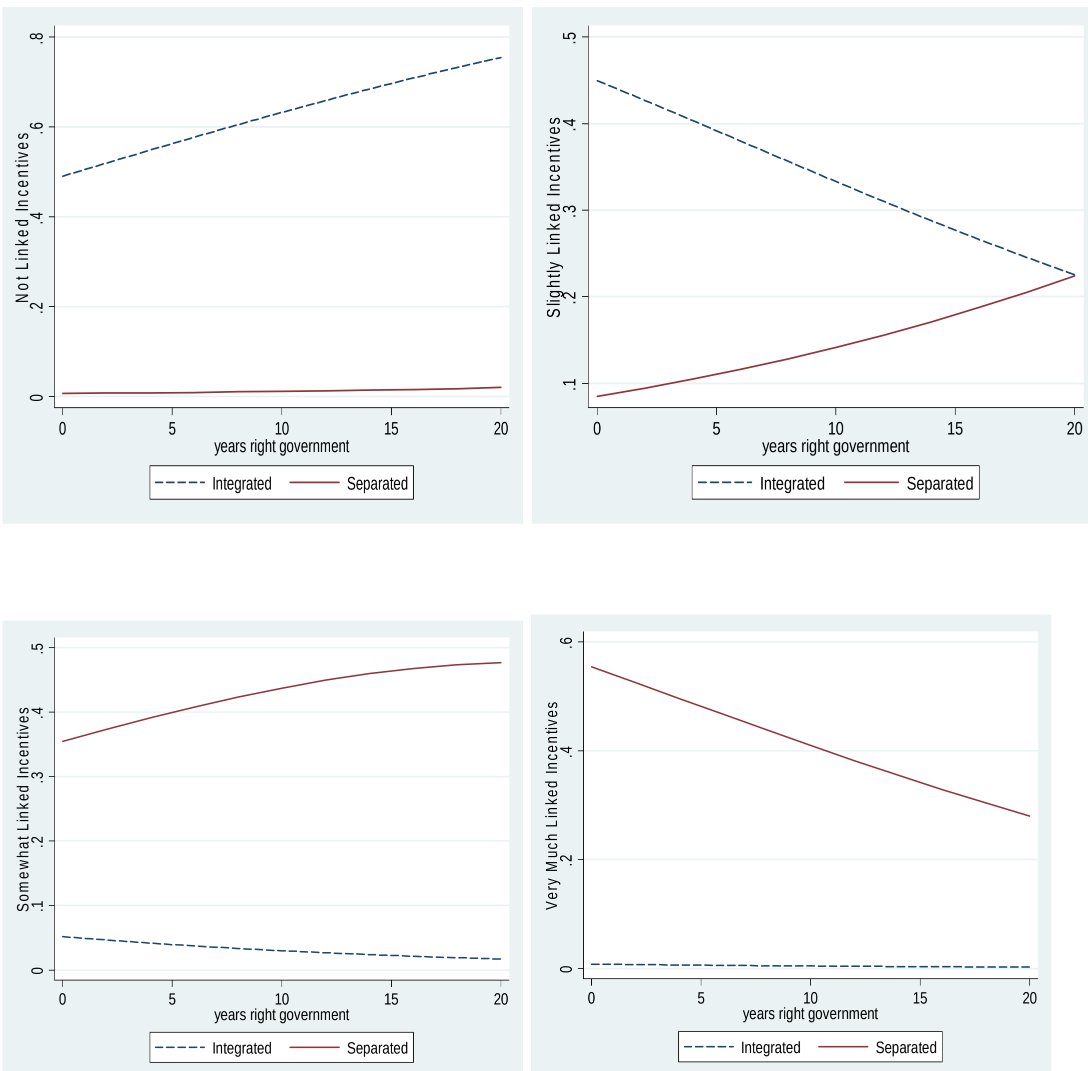
| | **PRP-level** | | | |
|---|---|---|---|---|
| **Minister/mandarin relations** | **Not linked** | **Slightly linked** | **Somewhat linked** | **Very much linked** |
| Integrated | 0.61 | 0.35 | 0.03 | 0.005 |
| Separated | 0.01 | 0.13 | 0.43 | 0.43 |

*Comment*: The table shows the predicted values of PRP when the minister/mandarin relations are integrated or separated, and all other variables are kept at their mean.

Since Ordered Logit coefficients cannot be interpreted directly, table 3 reports the predicted probabilities that the dependent variable takes each one of its four different values under the two alternative categories of our independent variable. As standard in the literature, we keep the other independent variables at their mean. One may thus see that, ceteris paribus, countries with integrated minister-mandarin relations have a 61%

probability of having the lowest level of incentives (*not linked*) and a mere 0.05% chance of developing the most sophisticated PRP system (*very much linked*). Quite the opposite, countries with separation of interests between ministers and mandarins have very high probabilities of implementing the two most advanced systems of incentives (43% for both cases), and almost negligible probabilities of having the two least advanced types of PRP.

**Figures 3-6. Probabilities of Types of Incentives as a result of Minister-Mandarins relations and Government Party.**




Similarly, figures 3-6 graph the probabilities of each one of the four possible outcomes of the dependent variable as a result of both ministers-mandarins relations and the years under right government. In the first place, graphs help us visualize how countries with separation of careers always have lower probabilities of implementing the two least advanced PRP systems (*not linked* and *slightly linked*) and higher probabilities of introducing advanced PRP systems (*somewhat linked* and *very much linked*). At first sight, long tenures of right governments during the last 20 years do not seem to exert a systematic effect on incentives. Nevertheless, at least for the most extreme cases (*not linked* and *very much linked*), graphs show how the more years under a right government, the poorer the prospects of implementing advanced PRP systems a country has – i.e. a higher probability of *not linked* and a lower probability of *very much linked* PRP systems. We keep in mind, however, that the party variable is not significant in any of the models presented in table 2.

Overall, we interpret the results of these quantitative analyses as a support for the main hypothesis in this paper. Irrespective of the statistical specification, the type of minister-mandarin relations is significant on the .001 level when all 25 countries are analysed. Even if we use a smaller dataset, with the 11 countries from Pollitt & Bouckaert, and thereby excluding the 14 countries that we have coded, the effect of the minister and mandarin variable is still significant at a very high level (.01). These levels of significance are especially remarkable if we take into account the limited number of observations in both samples.

## 4. Minister and Mandarin Relations and the Adoption of Performance-related Pay. Evidence from Germany, France, Sweden and the UK.

In this section we briefly analyze the adoption of public sector PRP systems in four European countries that represent different administrative traditions. We study one “public interest” country –the UK- and three countries belonging to different sub-types of the “rechsstaat” tradition – Sweden (“Scandinavian”), France (“Napoleonic”) and Germany (“Continental” or “German”). Regarding their PRP systems, France would posses one of the least advanced incentive systems, Germany would be somewhere in between, while Sweden and the UK would be in the group with the clearest link between performance and pay in the public sector (OECD 2004a, 17).

Unlike the previous large-n study, the analytic narratives depicted in this section give us the possibility of examining the evolution of the variables over time, and not just at cross-sectional level. The time dimension is important to disregard one alternative explanation for the results shown in section 3: that the separation between minister and mandarins is a part of the same NMP reform package that includes PRP systems. This challenge is addressed in the case studies.

*France*

France has a weak incentive system for public employees, and it is considered as a "laggard" in the introduction of NPM reforms in human resources (Thompson 2007, 53). To start with, as we have seen in the quantitative analysis, there is only a slight link between performance appraisal and pay. In addition, France exclusively uses bonuses and not merit increments as PRP (OECD 2004, 32). According to the OECD, it could even be argued that "there is no real PRP system in France" (OECD 2003:France). As mentioned in the theory, the lack of a clear delimitation between the careers of politicians and civil servants may help us understand the limited introduction of incentives within the French civil service system. Under conditions of mixture of interests, there will be frequent temptations for "managers" of the administration to opportunistically distort the incentive systems with ad hoc and subjective performance appraisals.

A 2004 report of a French committee of enquiry into the cost and efficiency of public services outlines the flaws of the appraisal process in France, stating that "the adjustments made are not all based on an objective appraisal process. Individual appraisals with systematic annual interviews are by no means the rule. The opacity of the bonus system and the lack of rigor in the methods for individual and collective staff appraisal, [which are not] based on explicit criteria, lessen the legitimacy of bonus adjustments" (OECD 2004, 38). Likewise, the OECD country report on the implementation of PRP in France denounces its "lack of transparency", that it is "complex and obscure for most civil servants" and, finally, that "bonuses are usually distributed according to other criteria than performance" (OECD 2003). Obviously, it is difficult to identify the exact mechanisms of our theory – blurred lines of demarcation between the careers of senior bureaucrats and ministers – as the main drivers of the widespread subjectivism detected in the French appraisal system.

Nevertheless, OECD itself, when analyzing the failure of the French and other PRP systems, recognizes that politicization is one of the main impediments for developing objective performance appraisal systems. OECD (2004, 34) considers that PRP systems create uncertainty on who the "winners" and "losers" will be, and they can only work when they are perceived as mechanisms of "procedural justice". Public employees are more likely to accept PRPs -even if they know that incentives could sometimes be disadvantageous to them when they do not manage to perform appropriately- if they feel that the process of distribution of incentives is "fair". OECD explicitly states that politicization impedes this: "where the level of political appointments is high, 'procedural justice' mechanisms [i.e. PRP systems] may be harder to set" (2004, 39). In presence of extensive politicization of the managers of the administration, PRP systems will likely have a "demotivating impact" on public employees (OECD 2004, 39). This can be specially true if we take into account another significant difference between the British and the French incentive systems pointed out by the literature: while the management of British PRP is delegated to autonomous agencies, pay setting is highly centralized in France (Thompson 2007, 53).

*Germany*

Germany is also often considered a NPM reform "laggard" (Thompson 2007, 53-54), and has been referred to as a "solid rock in rough seas" (Schröter 2001, 61). Therefore it seems contra intuitive to find Germany in the group of OECD countries with the second clearest link between performance appraisal and pay in the public sector, which puts Germany in the same category as the US, Canada, Denmark, Norway and Finland (OECD 2004b:17). If we accept the general scholarly observation of Germany as a "laggard", which could be the explanation of the German over-performance when it comes to the introduction of incentives in the public sector? Again we would argue that the separation between minister and mandarin interests, in line with the theory of this paper, is the most probable explanation.

To start with, the two most obvious alternative explanations, party politics and administrative culture, do not seem to hold. A performance appraisal system for the public sector in Germany was introduced 1997. It was then initiated by the CDU-FDP-led Government in the so-called "Aktionsprogramm" 1997. The pay appraisal system was then strengthened in the act "Governing the Structure of Remuneration" in 2002 and this time introduced by the SPD-Greens-collision Government (OECD 2004, 53; Schröter 2001, 66). Thus, the performance appraisal system has been supported by both the political left and the political right in Germany. In addition, the German introduction of a PRP does not seem to fit the administrative cultural explanation either since Germany clearly belongs to the *Rechtsstaat* category (Benz & Götz 1996:19).

The explanation suggested in this paper argues that a pay appraisal system will be introduced only when minister and mandarins are separated, so employees in the public sector can trust the assurances made to them by mandarins. Here Germany seems to be a middle case in comparative terms. The public administration is politicized to some extent, but there of minister and mandarin careers are still separated. Many scholars, including Pollitt and Bouckaert (2004), have noted that the top layers of the senior civil service in Germany are fairly politicized (see also Goetz 1999; Schröter 2004). However, also noted by Pollitt and Bouckaert (2004), this does not necessarily imply that the careers of ministers and mandarins are integrated. Pollitt and Bouckaert (2004, 42) do in fact consider Germany as a case of "separated" careers for minister and mandarins. The same observation has also been made by other scholars (Pierre 1995, 208). According to the theory presented in section two, this institutional separation is probably necessary for the mandarins to make credible promises the pubic sector employees. It is also worth noting that the separation between minister and mandarins is not a product of the same reform initiative as the pay appraisal system. The institutional relation between minister and mandarins seems to have remained unchanged over time. As Schröter writes, "it even seems that every care has been taken not to disturb the delicate links between political and administrative actors" (Schröter 2001, 69).

*The United Kingdom*

The UK is a leading example of NPM practices in human resources (Thompson 2007, 51). It is also an early one, since by 1997 virtually all civil servants had at least an element of their pay determined by individual performance review (Corby & White 1999, 18). The UK has also one of the most flexible assessment systems of public employees. It has suppressed some rigid performance rating systems, giving more emphasis to verbal assessment and to qualitative methods. This flexibility is considered by the OECD as a better way to identify excellence and differentiate average performance (OECD 2004a, 27). In addition, the UK uses both types of PRP mechanisms -merit increments as well as bonuses. Consequently, the OECD country report on the implementation of PRP in the UK presents opposing findings to those in France: "reward schemes work well" (OECD 2003, UK). Among the reasons for the success of incentives in the UK, the OECD lists several elements that countries like France are reported to lack: "transparency", "employee involvement", "sense of fairness", "realistic and clear goals", "proportionality of the reward to the effort" and "impartial and high quality people management". Again, it is difficult to detect the particular mechanisms of the theory of this paper as the main drivers behind those characteristics of the British PRP systems, but both OECD reports as well as academic studies emphasize the key importance of an administrative structure based on autonomous agencies for the success of incentives in the UK (Thompson 2007, 52; OECD 2003, UK; OECD 2004a, 63). It is the institutional setting of non-politicized independent agencies what has created the necessary trust to efficiently implement British PRP systems.

In addition, the UK is one of the few OECD countries where incentives systems have been subjected to research on their motivational effect over public employees. The impact of PRP on motivation tends to be in general ambivalent because of the difficulties to obtain hard data and the natural preference of employees for safe payments (OECD 2004a, 40). Nevertheless, "a quite substantial minority of line managers reported that PRP had caused many of the staff to work harder" (OECD 2004a, 39).

The incentive system in the UK, as well as in the other OECD countries where it has been implemented, is far from perfect and is subject to the same problems of lack of trust pointed out for private firms by the organizational economics literature reviewed above.

There is no automatic correlation between the introduction of PRP and increased motivation. Similar to what happens in many private organizations, generally speaking, PRP's positive effects on the motivation of current public employees tend to be overestimated by policymakers and its adverse effects underestimated (OECD 2004, 40).

Nonetheless, PRPs have been shown to have a significant positive impact as a recruitment incentive. Both academics and policy advisors agree that one of the most important problems today public administrations face worldwide is the recruitment of competent employees (Ingraham et al. 2000; PUMA/HRM 2000; Coleman Selden 2003, 39). Public organizations are increasingly competing with private sector firms for recruiting qualified employees (OECD 2000). The countries which have been able to introduce real PRP systems – although they seem to obtain limited motivational effects over current public employees- have been capable of "attracting a different type of person to the public service, those – possibly the more dynamic – who feel they will obtain the better pay available in a more competitive pay environment" (OECD 2004, 40). Incentives in countries with clear mandarins/ministers separation – like the UK, Sweden, Denmark or Finland – are the ones, according to the OECD (2004, 40), in which PRP systems have been able to recruit innovative and more risk-taking staff. At the same time, PRP systems in these countries have also led to better retention of high-quality staff. On the contrary, countries with more mandarins/ministers integration – such as France – are the ones reported by OECD as having more problems to retain qualified employees, who increasingly move to the private sector (PUMA/HRM 2000; Coleman Selden 2003, 40).

Research conducted by the British CEP shows that incentives in the public sector have increased the ability to both attract and retain top quality school teachers in England and Wales. Not only this, but the research on PRP for teachers in the UK does also present tentative evidence on the positive impact of incentives on organizational outputs - i.e. they would lead to a "maximum effort" using the terminology of the game theory. Scholars point out that the introduction of PRP is positively related to rising pupil academic performance (Marsden & Belfield 2005, 1). Likewise, the introduction of incentives within the British Inland Revenue has been associated with two positive organizational outcomes: a better adaptation of employees to the varied needs of the different parts of the tax service (OECD 2004, 42) and a large increase in productivity (Marsden & French 1998, 35).

The beneficial effects of PRP for schools as well as for other British public organizations seem mostly to be the result of the introduction of systematic appraisal systems and managerial "goal setting" approaches together with PRP (Marsden 2004; Marsden & Belfield 2005). Managers of British public organizations have used appraisal and goal setting to redefine the established performance norms in their organizations (OECD 2004a, 41). Similar to the high credibility of incentives one should expect with non-politicized managers according to the theory of this paper, the evidence indicates that managers in the UK have been able to effectively "renegotiate the effort bargain" "with the explicit or tacit agreement of as many employees as possible" (OECD 2004, 41). Furthermore, research on British incentive systems shows how they have been credibly used by managers to implement wide-ranging organizational changes, through linking pay bonuses to new objectives at the individual and the departmental levels (Marsden 2004, 351).

*Sweden*

In the late 1980s and during the first half of the1990s Sweden introduced a performance appraisal system in the public sector. Roughly during the same period, civil service status has been changed also in other ways, replacing lifelong employments by employment on a permanent contract basis (OECD 2004a, 11; OECD 2004b, 7). According to the OECD, Sweden is together with five out of twenty five countries one of the settings with the clearest link between performance appraisal and pay in the public sector (OECD 2004b, 17). In general, public administration scholars seem to agree that Sweden, in comparative terms, has been fairly successful in implementing NPM reforms (Hood 1996, 277; Thompson 2007, 51).

This is somewhat surprising, given the strong *Rechtsstaat* tradition of the Swedish civil service (Pierre 2004, 41). As mentioned above, scholars have often associated NPM reforms with countries belonging to the administrative culture of "public interest". What is more, the Swedish case also seems to challenge any claims of NPM reforms as an effect of a neo-liberal agenda of right-wing parties. Actually, most NPM reforms in

Sweden were introduced by the Social democrats (Hood 1996, 277). According to Pierre (2001, 133), the division between pro- and anti-NPM-reform actors did not go between the political right and the political left in Sweden. NPM reforms were instead advocated by actors within the Agency for Administrative Development (Statskontoret), the National Audit Office (Riksrevisionsverket), and the Ministry for Finance (Finansdepartementet) (Pierre 2001, 136; Premfors 1999, 163). Accordingly, there seems to be neither an “administrative culture” nor a party political explanation for the introduction of NPM reforms in Sweden.

As Pierre remarks, “the Swedish case provides an almost ideal setting for ensuring that the civil service does not become politicized” (2004, 41). Thus, in line with the theory in this paper, we argue that incentives in the Swedish public sector have been possible thanks to the institutional separation of ministers and mandarins. What is more, the division between policymakers and civil servants in Sweden has a long history, and this dualistic structure of the administration is often considered the backbone of the Swedish administrative model (Premfors 1991; Ruin 1991). It is therefore likely to believe that this separation between the ministers and mandarins has helped create the trust necessary to introduce individual incentives for employees in the public sector.

## 5. Conclusions

This paper has provided a parsimonious explanation for a puzzle that the prevailing cultural, political and economical explanations of NPM reforms have been unable to account for: how to explain that such widely differing societies as Japan, Mexico, France or Ireland end up possessing similar NPM incentive systems which, in turn, are different from those of countries like the US, the UK, Korea or Sweden.

The theory of this paper comes from developments in transaction-cost economics which consider that the main obstacle for the implementation of high-powered incentives in an organization is the lack of trust. Thus, the problem with incentives is mostly a problem of organizational trust. The problem in any social organization is not finding an efficient incentive system – this is relatively easy – but to find an efficient system that members believe will not be opportunistically subverted by the superiors (Miller 2000, 6).

The paper has offered theoretical arguments and empirical evidence that the solution of this trust problem is an institutionally-induced trust, which may be fostered if the interests of ministers and mandarins in the administrative system are separated.

Unlike common wisdom in the literature, this paper does not argue that PRP requires a certain historical legacy, or “a mature and well established civil service culture and a stable political and policy environment.” (OECD 2004a, 8). What PRP simply requires is a suitable institutional design: an organizational structure with relative separation of interests at the top. Similarly, it is a common place to argue that PRP systems always involve trade-offs and thus “there is no ‘best’ solution” (OECD 2004a, 8). In contrast, we contend that, despite incentives inherently entail costs in terms of higher risk than flat payments, there are *better* and *worse* solutions depending on the institutional setting where incentives are applied. Incentives are *more of a trade-off* in some institutional contexts than in others.

Our argument is backed with a quantitative analysis of 25 OECD countries, and case studies of Germany, France, Sweden and the UK. Even after controlling for alternative cultural, political, and economical explanations our quantitative analysis show that PRP systems are significantly more used in countries with an administrative setting that separates the ministers and mandarins. The case studies illustrate the evolvement of the PRP system in the four countries over time, and speak against claims that the separation of minister and mandarin interests and an introduction of PRP are in fact part of the same reform agenda.

Up to which extent can we generalize the results of this paper? There are two main reasons why the findings here may be valid for explaining broader cross-national differences in the adoption of NPM. Firstly, as argued above, the particular NPM element this paper addresses – performance-related pay in the public sector – is a paradigmatic one, since it exemplifies the main underlying values behind NPM as well as several of its main doctrinal components. Secondly, literature is increasingly pointing out one beneficial collateral effect of PRP: they are a window of opportunity for the introduction of many other significant reforms (OECD 2004, 42). For instance, incentive systems have generally facilitated more flexible working methods, encouraged team working, strengthened the information and communication technology and allowed the development of better training policies. In other words, if incentives work other NPM seem also to work.

Assuming that one of the main concerns of governments is how to improve public sector productivity as well as "increase and maintain their competitiveness as an employer" (OECD 2000; Coleman Selden 2003, 40), and thus they are interested in implementing efficient incentive systems, which could be the normative implications, if any, of this paper? In order to make incentives feasible for the public sector, policy advisors tend to recommend an "improved design" of PRPs – including aspects such as developing a simple performance appraisal framework, consultation with staff, or the use of quotas (OECD 2004, 34-35). Nevertheless, as TCE has shown for private firms and this paper for public bureaucracies, the successful implementation of incentives does not seem to critically depend on their specific technical design. Instead one should devote her efforts to a more basic organizational question: up to which extent employees trust managers?

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## Notes

[1] The essence of the game is a problem of information asymmetry. Managers can never be sure how employees' marginal cost of effort functions look like, and employees are systematically trying to protect that informational advantage. But, if the employee trusts the manager and works hard, the latter discovers the employee's real marginal cost of effort function (Falaschetti 2002:163).
[2] Nevertheless, even in these cases, one could disagree about the extent of real separation of interests between ministers and mandarins. Civil service is inherently a political creation and this can never be made fully apolitical (Peters and Pierre 2004). So, although for sake of simplicity and following Pollit and Bouckaert (2004) we use the categories "separated" and "integrated", we could more realistically use the terms "less" and "more" integrated.
[3] Müller 2007, 41 pp; Liegl & Müller 1999.
[4] Vidláková 2001, 99; Bertelsmann Stiftung 2007, 18; Goetz 2001.
[5] Lyrintzis (1984:99), Featherstone (1990; 2005:229), Spanou (1996:107; 2001:107), Sotiropoulos (1994:349; 1996; 2004a:405; 2004b:258, 260, 2007:17),
[6] Gajduschek 2007, 354; Vass 2001, 166-169; Goetz 2001.
[7] Muramatsu & Krauss (1984:128-129), Schneider (1993:339), Nakamura (2001:176-178).
[8] OECD 2004a, 17.
[9] Schneider (1993:339,344), OECD (2007/6:12, 25) Bertelsmann Transformation Report 2008.
[10] Oliveira Rocha (1998:219), Puhle (2001:320), Sotiropoulos (2004a:409)
[11] Gutierrez Renon (1987, 1990), Beltran (1990:347, 1994:597), Cazorla (1992), Matas (1996), Alba (2001:1033), Puhle (2001:320), Baena del Alcazar (2002:326), Parrado (1997, 2000:266; 2004:231, 236-237) Sotiropoulos (2004a:409).
[12] Grönnegard Christensen 2006, 1006; Grönnegard Christensen 2001, 130. See also Nexö & Knudsen 1999; Grönnegard Christensen 1997.
[13] OECD 2004a, 17.
[14] Connaughton 2006, 56; Chubb 1992.
[15] OECD (2007/6:15, 25), Bertelsmann Transformation Report 2008.
[16] Laegreid & Pedersen 1996; Laegreid & Christensen 1998; Laegreid 2001.