

# **THE SPIRIT OF REFORM:**

*Managing the New  
Zealand State Sector  
in a Time of Change*

Allen Schick  
August 1996

A Report Prepared for the State Services Commission  
and The Treasury, New Zealand

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## **PREFACE**

In 1995 the State Services Commission and The Treasury commissioned Professor Allen Schick to carry out an independent study of the New Zealand State sector management framework. Professor Schick was selected to carry out the study because of his eminent standing in the field of public administration. Allen Schick is Professor of Public Policy in the School of Public Affairs at the University of Maryland, and a Visiting Fellow at the Brookings Institution in Washington D.C. He is a specialist in political institutions and government finance, and has carried out a number of studies for the OECD on government management reform.

The State Services Commission and The Treasury were seeking an independent review from a credible, external commentator, to assist with the on-going process of reflecting on and renewing the management framework. In particular, we wished the individual to make an overall assessment of the extent to which public and political confidence in the current public administration arrangements is justified, and to identify the key issues that should be given attention in the next few years. We were not seeking a comprehensive review of the reforms, or a detailed prescription for action.

As Allen Schick points out, all reforms need to refresh themselves and learn from other experiences, as well as from the validity of their own experiences. His perspectives in this area are what we view as the most valuable outcome from the report. This report highlights the need for balance in the various means of motivating public administrators, and highlights a number of issues that may warrant greater attention.

The State Services Commission and The Treasury view this report, and in particular Professor Schick's conclusions and findings, as the beginning of a process, rather than the end. Many of the issues raised by Professor Schick are not new, either to him or indeed to the New Zealand Public Service. We will draw on the report in working with each other and other departments in future efforts to lift the performance of the Public Service.

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**To: State Services Commission  
The Treasury**

I am pleased to submit my report, "The Spirit of Reform: Managing the New Zealand State Sector in a Time of Change". The report sets forth my observations concerning the reforms that have been carried out in the State sector during the past eight years. Although the report does not offer specific recommendations, I hope it will be of interest to those who have worked so diligently and productively to mould New Zealand's public management into one of the most creative and innovative public sectors in the world.

The title of the report is meant to indicate that reform is an ongoing process that does not end with the enactment of particular policies and procedures. In fact, one of the most surprising findings of this inquiry is that the process of reform has gained momentum in recent years and that many of the instruments now used to motivate public managers and hold them accountable for results were introduced after the State Sector Act 1988 and Public Finance Act 1989 were enacted.

This report has benefited from the insights provided by the more than 100 people, including political leaders, State sector managers and academic experts, who met with me during periodic visits to New Zealand. I am especially grateful to State Services Commission and Treasury staff who assisted me at various stages of the study. Michael Webster and Doreen Wilson of the State Sector Development Branch provided both logistical support and substantive advice. Their sound judgment and commitment to public service have greatly enhanced this work and made my task much more pleasurable. Jim Brumby had the lead responsibility in Treasury, and he handled that task with the intellectual integrity and analytical skill that are the hallmarks of that organisation. Alex Matheson had parallel responsibility at the State Services Commission. His wise counsel enabled me to appreciate that it is the men and women of the New Zealand State sector in which the spirit of reform flourishes.

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### EXECUTIVE SUMMARY

The State sector reforms carried out in New Zealand over the past eight years were heralded at their inception to be bold and unprecedented. This judgment has been vindicated by the transformation of public management through the ground breaking development and application of new methods of managerial accountability, including the shift from input to output appropriation, reliance on contracts, and monitoring of results.

This study was commissioned jointly by the State Services Commission and the Treasury to examine whether further improvements should be made in the management of the State sector. In carrying out this study it has become evident that the reforms have lived up to most of the lofty expectations held for them. The organisational cocoon of the old State sector has been broken open and structures reshaped through the application of the reforms' overriding principles. The State sector is more efficient, productive and responsive, and there generally has been significant improvement in the quality of services provided to New Zealanders. However, as with any leading edge technology, it may now be time to "debug" elements which have not worked as well as anticipated.

The reforms could be revitalised in three cluster areas: strategic management; the resource base; and accountability. Before reviewing these issues, the report considers the genesis of the reforms, the structure of the State sector and its organisational capacity.

#### **Putting Ideas into Practice**

In the mid 1980's economic and political conditions and exciting theories of public management converged to produce extensive changes in public organisations. Each of these factors was critical and unique; it is doubtful if bold reform could have been implemented if any had been absent. The creation of a framework for reform encompassed more explicit reliance on management tools as well as on the use of contracts. Other countries, before and since, have freed managers to manage within their public sectors, but none have demanded accountability through contract-like arrangements to the extent that New Zealand has. Managerial and contractual ideas are the sometimes converging, sometimes conflicting sets of principles which have shaped the New Zealand reforms.

#### **The Structure of the State sector**

New Zealand has a pantheon of departments and Ministers with an array of nondepartmental bodies. Some of the features of the governmental landscape predate the reforms, while others owe their existence to them. The report does not suggest major restructuring of the institutional arrangements, but it does suggest adjustments in some areas. Given the high accountability reporting burdens for small departments, the government should explore means of consolidating some departments or converting them into nondepartmental bodies while maintaining accountability for their performance. Central agencies should continue within their current spheres of responsibility but should be more clearly focused on vital government-wide tasks. There have been tremendous changes in the way the centre has delegated responsibility, but it would be naïve to argue that managerial freedom is incompatible with central direction. Finally, in examining Crown Entities, of which there are over 2,700, it is necessary to balance risk against independence. The Crown Entities spend approximately two thirds of the budgeted resources for the operation of government, but in spite of the considerable

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accountability requirements, Crown Entities' operations and finances are not as transparent as they should be.

### **Organisational Capacity**

As important as the structural arrangements are, it is in how well departments are prepared for the tasks expected of them both now and in the future that the success of the New Zealand reforms depend. The report examines the roles of Responsible Ministers, Chief Executives and senior managers in terms of ownership. It argues that the purchase and ownership roles of the Responsible Minister pull the departments in opposite directions. The purchase role has dominated to this point, as demonstrated by the annual purchase agreement, and now it is important that the ownership role be given greater scope. This could be accomplished through a realignment of Ministerial portfolios and departmental jurisdiction; through more detailed specification of ownership interests in performance agreements; and, through examination of expenditure on critical aspects of organisational capacity. The recruitment, motivation and retention of talented Chief Executives is vital and is somewhat hampered by complex appointment and evaluation procedures. This process should be simplified and made more flexible. As well, it is vital that there be a continuing supply of trained and public-spirited managers. The report suggests that the feasibility of the senior executive service might be re-examined, as its original objectives remain as valid today as they were when it was first attempted.

### **Strategic Capacity**

Having established the historical and organisational context, the report goes on to look at three areas that warrant special attention. The first of these is strategic capacity, or strategic management, which relates to a department's ability to respond to future changes in its environment. The original reforms emphasised annual actions and outputs to an extent which neglected medium and long term planning. In spite of some corrective innovations, including the Fiscal Responsibility Act 1994, New Zealand is still geared more to the short-term production of outputs than planning for the future. Some of the recommendations in this area include a greater reliance on, but not formalisation of, departmental strategic planning. These plans should bear the imprint of Responsible Ministers as well as have guidance from the central agencies. It is also recommended that a multi-year framework be applied to promote reallocation of resources based on shifting priorities and the Strategic Result Areas process. The adoption of MMP will in all likelihood diminish the government's ability to strategically plan for the long haul. It is recommended that the fiscal planning tools, prescribed by the Fiscal Responsibility Act, be used elsewhere in government policy and strategy. These are: a set of guidelines to influence but not restrict government policy; a medium-term perspective; and transparency in strategic policy. The current SRA/KRA (Strategic Result Areas/ Key Result Areas) arrangements are working well and form a good basis for further improvements in government's strategic capacity.

### **Resource Base**

The resource base, or the ability to allocate resources efficiently in terms of the outputs to be produced, is examined in light of getting both the financial incentives right for managers and getting the price right for the production of outputs. Financial reforms in New Zealand have been extensive, innovative and largely successful. However, although managers have accepted the basis for financial reform, there are a few recurring complaints and issues. Most of these revolve around financial incentives and the report suggests more financial flexibility in a number of areas. Pricing is tremendously difficult to get right in government because of fixed price budgeting necessitated in the absence of a market. The report recommends, in the absence of robust costing systems for some outputs, that it would not be

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inappropriate for the Vote calculation to be based more explicitly on the cost of authorised inputs. This approach is not optimal but could be used as an interim measure until more rigorous output costing systems are in place. The report also suggests that the capital charge, although prompting better departmental management of assets, might in time lead to the under-capitalisation of some departments, owing to some unintended incentives in the current arrangement. There is no evidence of a trend towards under-capitalisation but it is recommended that this be closely monitored. Greater financial flexibility is suggested in the wider use of Mode B net appropriations and an ability to carry over unused funds from fiscal year to year.

### **Accounting for Results**

Accountability has not been an afterthought in New Zealand, as it has in other countries that have implemented reform. Instead it has been robustly designed as an integral feature of the reformed public service. The model of accountability is patterned on the relationship of buyers and sellers in commercial transactions. The linchpin of the New Zealand accountability regime is outputs, which is a strong common interest of both Ministers and managers. Ministers purchase outputs, while departments are paid a negotiated price to deliver those outputs. However, this accountability arrangement is most effective when the market is contestable and buyers and sellers can establish an arms-length relationship. This is not the case for the majority of government outputs, and there are significant transaction costs incurred in maintaining an accountability arrangement based on detailed ex ante specifications. Although specifying and reporting on outputs has improved over the years, the report suggests that a greater use of trend and comparative data in the Estimates would improve the ability to judge performance and lessen the increasing demands from Parliament for supplementary questions addressed to departments. Departmental Forecast Reports are deemed to partly duplicate information already available in the Estimates.

The focus on ex ante specification has sometimes led to a checklist mentality which is positive from the perspective of having managers take accountability seriously for tasks they are expected to complete. It is less desirable if it narrows responsibility to simple compliance with what is on the list, and prompts Chief Executives to disregard responsibility for items not specified. The report recommends that internal management controls should be examined for their effectiveness in order to provide confidence that applicable laws and requirements are fulfilled. The report goes on to discuss the substantial accountability costs of the New Zealand system which are likely less than the deadweight costs of the old public service controls, but which are probably higher than they need to be to ensure performance. Each year brings with it new elements of accountability specifications which, although sensible on their own, have a heavy cumulative impact. The author argues for a model of accountability which encompasses responsibility, based not solely on greater specification of results, but based as well on values, judgment and leadership. Many of these characteristics are now picked up in the protocols developed by departments and central agencies in 1994.

## I. Introduction

During consideration of the Public Finance Bill in 1989, the Controller and Auditor-General advised Parliament that the legislation "will give effect to the most fundamental changes to financial management practices seen in New Zealand's history. These reforms are enormous, ambitious, and, in large part, unprecedented anywhere in the world". Half a dozen years later, this judgment has been vindicated by the extraordinary transformation of the State sector from centralised control of money, personnel, and other resources to devolved arrangements that give managers control of inputs, provide them with incentives to be productive, and hold them accountable for results. (In this report, the State sector includes the core departments and Crown entities; it does not include state-owned enterprises or local government.) In budgeting and financial management, employment and human resource management, modes of appropriation, use of internal contracts, and other tools of management, New Zealand has been more venturesome than any other country in discarding old practices and devising new ones. It has revolutionised public management without going through the protracted pilot testing and cautious implementation that have slowed innovation in some other countries. Measured by their bold objectives, conceptual basis, reliance on statutes, and speed of implementation, the New Zealand reforms have been truly remarkable.

In its emphasis on managerial discretion and accountability, New Zealand's approach resembles reforms introduced in Australia, the United Kingdom, Sweden, and several other OECD countries. But the more closely one examines New Zealand's progress, the more it becomes evident that it has ventured far beyond what has been tried elsewhere. The following are some of the major management innovations pioneered in the New Zealand State sector since the late 1980s.

- C Financial statements, the budget, and appropriations are on an accrual basis. Commercial accounting standards are applied to all public entities.
- C Departments prepare monthly financial reports, quarterly performance reports on their purchase agreements, half yearly reports on the chief executive's performance agreement, and an annual report on financial results and outputs. These reports and statements generally have been reliable and timely. The annual report is audited; in recent years, few have been qualified by the auditors. In addition to departmental reports, the government issues a combined financial statement.
- C Appropriations for operating expenses are made by output classes. The output classification is not a supplementary schedule but the main form of appropriation and the basis on which operating expenditure is controlled and accountability is maintained.
- C Departments (and certain other public entities) are headed by chief executives appointed under term contracts that set out conditions of employment. Public employees work under individual or collective employment contracts.
- C Managerial discretion is less constrained in New Zealand than in any other country that has reformed its State sector. Within budget limits and law managers are free to select the mix of inputs to be used in producing agreed outputs. They have flexibility in hiring and paying staff, obtaining office accommodation, purchasing supplies and services, and spending on other inputs.

- C Accountability for resources and results is maintained through contract-like arrangements within government. Performance agreements between Ministers and chief executives set forth standards and expectations for department heads; purchase agreements between Ministers and departments specify the outputs to be produced during the year.
- C A capital charge is levied on the value of each department's physical and financial assets, net of liabilities. Appropriations are struck to cover the cost of depreciation, thereby enabling departments to accumulate funds and repair or replace facilities without having to obtain a new appropriation of capital. Departments may request a capital contribution if cash in depreciation accounts is not sufficient to cover new investments.
- C Departments maintain their own bank accounts and are responsible for managing cash balances. They earn interest on these accounts; the rate earned depends on the extent to which actual cash balances are above or below the balances forecast for the period.

The government implemented these far-reaching reforms in less time and with less difficulty than had been anticipated in some quarters. With the passage of the State Sector Act in 1988, all permanent department heads became chief executives contracted for fixed terms. Within about eighteen months after enactment of the Public Finance Act in 1989, all departments had shifted from cash accounting and budgeting to an accrual basis. The transition to output-based appropriations also began during this period, and departments started preparing audited financial statements that complied with generally accepted accounting practice.

Despite these and other accomplishments, the objectives of reform were not completely met with implementation of the State Sector and Public Finance Acts. Transforming public management entails much more than changing organisational forms and appropriation formats. It takes more to hold managers accountable than to negotiate contracts and report on performance. The all-important factor in public sector reform is the behaviour of those in charge of government programmes and resources. Giving managers the freedom to manage does not mean that all will seize the opportunity and boldly revamp operations. Even when reforms have been implemented according to plan, there still has been need to fine-tune them in the light of subsequent experience and conditions. After the revolution, much work remains to be done.

Not every aspect of reform in New Zealand has worked out as expected. Although its reforms have been more comprehensive and rigorous than those introduced in other countries, they have been neither complete nor perfect; their effectiveness has depended on the manner in which they have been implemented as well as on underlying concepts and doctrines. This author has observed offices that have taken up the challenge and have thoroughly revamped their operations to improve performance, as well as offices that appear to be adrift and bereft of purpose. The difference between the high and low performing organisations is not just a matter of getting the right people for the job - although effective leadership does make a big difference - but also requires that missions and resources be properly aligned and that each organisation clearly knows what is expected of it.

Getting the alignment right is a continuing task of public management in New Zealand. In fact, innovation has not ceased with implementation of the original reforms. Important changes have been introduced outside the framework - but consistent with the purposes - of the State Sector and Public Finance Acts. These include purchase agreements that formalise understandings on the outputs to be supplied, the Fiscal Responsibility Act 1994 that requires the government to establish and disclose medium and long term economic and budgetary objectives, and the specification of

strategic and key result areas that indicate the government's programme and spending priorities. In addition, the Treasury frequently has adjusted the form or content of the Estimates, and the State Services Commission (SSC) has frequently modified the standard terms of performance agreements and the criteria for assessing the performance of chief executives. As important as these adjustments have been, they are consonant with the original objectives of New Zealand's management reforms.

Both within government and among outside observers interviewed for this study, there is overwhelming consensus on the superiority of the reformed system and hardly any sentiment for dismantling the new arrangements and going back to centralised control. Discussions conducted with more than 100 chief executives, senior managers, and informed observers, as well as with a small number of Ministers and Members of Parliament, reveal broad agreement that the reforms have improved the efficiency and quality of public services by encouraging managerial initiative and rewarding success. Managers have a much clearer understanding of their role and responsibilities; more timely and complete data on the cost of doing business and on what they are accomplishing with public funds; greater awareness of the needs and interests of clients and customers; and expanded opportunity to change operating procedures, the use of resources, and working conditions. They welcome the flexibility to select the best mix of inputs and the option to negotiate individual employment contracts. Many like the explicit output measures that let them know what is expected and how well they are doing.

One does not have to search far for efficiency gains in the reformed State sector. Most departments have reduced staffing levels and operating budgets without lowering the volume or quality of public services. New Zealand managers are convinced that they are doing more with less - in some cases, with a lot less - and that they have been able to reduce costs because of their new flexibility in managing resources. In interviews, many proudly pointed to cost-saving initiatives: leasing less expensive but higher quality accommodation when they no longer were compelled to take the premises assigned to them by the government; acquiring state-of-the-art information technology (IT) systems and modern office furnishings when they were liberated from constraining procurement regulations; hiring temporary and part-time workers in response to seasonal or cyclical fluctuations in workloads; eliminating whole layers of managers and the controls they wielded; negotiating wage levels that reflect market conditions rather than government-wide civil service contracts. These and other cost savings have been made possible by the reforms. They could not have been achieved if managers were still bound by *ex ante* controls enforced by central agencies.

Managers also acknowledge that across-the-board spending cuts have spurred them to be more efficient by reducing the real cost of their operating budgets. While some resent these cuts, they recognise that without pressure on resources, good managers would have had greater difficulty taking the steps needed to improve operations.

Systematic studies of the unit costs of producing standard outputs (such as the cost of processing welfare applications or tax filings) show strong productivity gains in some agencies, modest gains in others, and no significant improvements in a few. A Treasury survey of four departments found that one had experienced a 10-20 percent decline (in nominal dollars) in average unit costs over a four-year period; two had accommodated substantial workload increases with only modest increases in operating budgets; and a fourth had no significant change in unit costs. This checkered pattern suggests that letting managers manage may not always be a sufficient condition for organisational improvement. Some managers will restlessly seek fresh opportunities to do things better; others will be content with the status quo.

In view of truly dramatic changes in the management of some departments, one might expect larger productivity advances than those reported in the Treasury study. In interviews, some managers estimated that the reforms had produced annual efficiency gains of 10 percent or more. Some of these gains may have been absorbed, however, by high transaction costs associated with negotiating agreements and monitoring compliance, as well as by the expenditures made to improve working conditions. Undoubtedly, also, some of the more innovative departments have invested in improving the quality of services.

In New Zealand, as in other countries, there tends to be a close connection between organisational reform and the quality of services. Improved service is the hallmark of a reformed organisation; one is not likely to occur without the other. When innovation takes hold and managers use their new authority to question how the organisation is run and services are provided, matters that had long been taken for granted - such as long waiting times, the lack of chairs and other amenities for those made to wait, the shuffling of clients from one queue or desk to another, confusing instructions, and even curt behaviour - become more noticeable and less acceptable. As staff become more sensitive to the way clients and customers are treated, they may restructure the way the office operates to make it more hospitable and user friendly. Typical changes include simplifying forms and instructions, shortening waiting periods, giving clients one-stop service, brightening the office's décor, and modernising the furnishings and equipment.

Managers interviewed for this study are convinced that services have been upgraded and that staff are more sensitive to the concerns of clients and to the quality of services provided them. These widely held perceptions could not be confirmed by the study because it concentrated on the centre of government and on the corporate offices of departments and other State entities. Only two days were allocated to field visits - both in the Auckland area - not enough to thoroughly investigate the extent to which service has been improved in local offices. Yet even these brief visits produced encouraging signs that the reforms launched in Wellington have spread to the regions. Evidence of improved services was observed in a number of departments - such as Customs, Inland Revenue, and Social Welfare. Undoubtedly, other departments also have upgraded the quality of services, but it was not possible to assess the full scope of improvement in the short period available for field research.

The New Zealand Income Support Service in the Department of Social Welfare exemplifies the dramatic improvement possible when managers give priority to the impact of services on customers. Shortly after entering the Auckland Income Support Service office, each client is greeted by a receptionist who inquires concerning the purpose of the visit and the services sought. The Service has a target that each client should be met within 10 minutes after arrival. There may be a further wait, depending on workload, until a client meets with the assigned case worker. Staff are readily identifiable by their uniforms, which are not unlike those worn by flight attendants and are affixed with name badges that inform clients of the person they are dealing with. The area in which a case worker and client meet is configured so that both can view the computer monitor on which information concerning the case is displayed. Clients are urged to review the information and to discuss their concerns with the case worker. The data file for each client establishes the basis on which performance information is compiled and reported. The division aims to settle each claim for assistance within one day, compared to the weeks it often took to decide cases before Income Support was reorganised. To facilitate quick turnaround of cases, the number of persons and steps involved in each case have been reduced. In complicated claims, the case worker takes the problem to a nearby supervisor who is authorised to make on-the-spot determinations.

This is a high performance organisation, but one that faces stresses that were not present before Income Support was oriented to high productivity and customer service. Employees who worked in it both before and after reform are proud of the gains in efficiency and service quality, as well as of the recognition their office has received for superior performance. They are not embarrassed by the fact that they work for an organisation whose mission is to dole out welfare payments. They see themselves as providing services similar to those performed by commercial insurance firms - processing claims, determining eligibility, and computing the size of payments. They also see themselves as public servants with an obligation to ensure that the funds are well spent. They welcome the improved working conditions, the clear objectives, and the opportunity to suggest ways of improving operations. These positive attitudes came through during a group discussion with about one dozen middle managers and case workers. They feel reasonably good about their jobs and the organisation in which they work.

Service improvements cost money. Substantial sums have been spent by the Department of Social Welfare on training workers, developing and installing performance monitoring systems, refurbishing offices, and recruiting skilled managers. Some of these investments have been financed out of efficiency savings and have been made possible by the broad discretion given managers in spending operating funds.

Field managers in the Income Support Service and in other reformed organisations have more control over daily operations and, in turn, are more accountable to departmental headquarters in Wellington. Each field office has its own operating budget that may be spent by local managers without obtaining external approval. But local managers must regularly file reports that enable headquarters to compare results to plans and to performance in other offices across the country. A steady stream of reports informs central managers on outputs, costs, variances from plans and budgets, and other indicators. These reports pertain to the period (month, week, or day) just ended, so that managers can take timely action when performance falls short of the mark.

Although the devolution formula - more managerial freedom and more accountability - seems to produce a more efficient and responsive organisation, it can make for a more stressful work place. When control was centralised, managers worked according to the rules and had little discretion over what they spent and did. Now they have to make choices, and what they do is closely monitored. In the past, the focus on inputs shielded them against blame for failing. Performance expectations were rarely spelled out in advance, so there were few benchmarks for assessing how well they did. Staff were paid according to Public Service scales of occupational classifications and collective agreements, and the amount available for personnel was separately itemised in the budget. Now managers must decide how much to spend on human resources versus other claims on operating funds, the mix of staff to be employed, and (for those working on individual contract) how much they are to be paid. In the past, there was little movement between Public Service and private jobs; now staff move more freely and frequently between public and private employment. Once, managers rarely were taken to task when clients were dissatisfied with services; now, customer ratings often are reported along with other performance measures. Many managers talk about having to work harder than in the past and longer than the standard work day. They feel the pressure of shrinking operating budgets and elevated performance expectations.

In sum, government departments in New Zealand are no longer the organisational cocoons many once were. They are not sheltered by special rules, stable career patterns, incremental budgets, and ambiguous performance standards. They increasingly resemble business organisations. Change is ongoing, there is continuing pressure to drive costs down and efficiency up, managers routinely monitor results against plans, and they are more responsive to external conditions and customer

interests. There is more emphasis on teamwork and more pressure for conformity and group-think. Yet, at the same time, individuals are encouraged to approach their tasks with renewed vigour and creativity. All this can make for more productive organisations and more stressed employees.

### **Renewing Government Reform**

Although no one interviewed during the study favours a return to the old ways, many gripe about one or another practice. Some managers complain about the sinking lid on operating budgets, with no adjustment for inflation and across-the-board cuts. Some, as noted above, complain about having to work harder in a more competitive and less stable environment and without sufficient resources to accomplish all that is expected of them. They feel that the government is indifferent to rising workloads and that doing more is not compensated in the budget. One widely heard complaint is that despite cost and performance data, budget levels still are set arbitrarily, without genuine analysis of what it takes to complete assigned tasks. Quite a few officials, especially those in small departments, commented on the burden of complying with burgeoning information and reporting demands of central agencies and Parliamentary committees.

The litany of complaints voiced during interviews ranges across the gamut of reforms. Outputs are not properly specified, especially in activities involving policy advice; the assessment of chief executive performance is not sufficiently challenging, and their pay does not sufficiently recognise differences in performance; the central agencies have not truly forsaken the old control habits; narrow interests crowd out the collective interest and short-term considerations are favoured over longer-term interests, especially in allocating budget resources; outputs are not sufficiently contested to ensure that the government is paying a fair or market price; Parliament still questions department budgets in terms of inputs and demands vast amounts of information that have little bearing on what the money is buying by way of output; little headway has been made in specifying outcomes and in relating them to the outputs purchased by government; the government lacks an investment strategy and is running down its physical and human capital; the Department of the Prime Minister and Cabinet is not adequately resourced to provide strategic direction and to ensure that Ministers and departments uphold the collective interest; Crown entities spend a sizeable portion of State financial resources but are not sufficiently accountable to the government.

The length of this list - other items can be added - does not mean that complaining managers want to dismantle the reforms. Complaints are a normal and expected by-product of reform, especially when money is involved. Although most complaints should be taken seriously they should not call into question the logic or sturdiness of reform. There is near universal agreement that New Zealand government is much better managed now than before. Many of the complaints derive from the elevated standards and expectations set into motion by the reforms. Once there were few output measures; now managers question whether the measures in use are the right ones and whether they are sufficiently linked to the budget and appropriations. Once there were no performance or purchase agreements; now managers wonder whether the terms can be more clearly specified and enforced. Managers concede that capital should not be free, but they argue over the level at which the capital charge has been set.

One need not subscribe to every claim made on behalf of the reforms to conclude that they have brought enormous gains in government management, nor need one accept every complaint about the reforms to concede that additional improvement is within reach. In managing organisations and resources, there never is a point at which the process of reform is completed. Even when they work as expected, reforms have to be freshened and revitalised. If they are not, the new practices become

hardened into routines - the things that have to be done to get through the year - and those who carry out the procedures lose sight of the purposes the reforms were intended to serve.

Three clusters of issues warrant in-depth attention. The first pertains to the capacity for strategic management, the second to the resource base for government operations, and the third to accountability for outcomes, outputs, and resources. These issues are briefly summarised below and are considered in later chapters of this report.

(1) *Strategic capacity* refers to the capacity of government to define objectives and specify desired outcomes, establish priorities and reallocate resources to achieve them, and evaluate programmes and assess outcomes. It is evident that strategic capacity was inadequate in the early implementation of the reforms, but substantial adjustment has been made through the promulgation of medium-term budget goals, government strategy statements and the introduction of strategic and key result areas. But the government still has some difficulty in identifying outcomes and monitoring progress in achieving them, as well as in evaluating programmes in terms of specified outcomes. These issues are examined in chapter 5.

(2) *The resource base* is essential for the efficient operation of departments and the effective pursuit of government objectives. This base is determined through annual budget decisions, but its adequacy depends on the ability to allocate resources in terms of the outputs to be produced. To assess the adequacy of resources, one must consider the capital charge, the accounting basis for costing outputs, the use of net appropriations, and the capacity of the government and affected departments to adjust to variable workloads and outputs. Chapter 6 is devoted to consideration of these issues.

(3) *Accountability* is critical to the continuing success and acceptance of the reforms. It includes not only the reliability of financial statements, compliance with budgets and purchase and performance agreements, but also the robustness of internal control systems and the inculcation of an ethic of public responsibility throughout the departments and other public entities. These and related matters are considered in chapter 7.

### **Scope and Structure of the Report**

The present study was commissioned jointly by the State Services Commission and the Treasury to examine whether further improvement should be made in the management of the State sector. The terms of reference for the study are set out in Appendix I. In conducting the study, the author made two visits to New Zealand, in May and August 1995, during which he interviewed numerous officials and observers, as well as a number of Ministers and Members of Parliament. The author also reviewed more than 500 documents, reports, and other publications pertaining to reform of the State sector, including budget documents, financial statements, audits, corporate and strategic plans, purchase and performance agreements, legislation and Parliamentary reports, guidances issued by the central agencies as well as by various departments, and other relevant material.

The study concentrates on the State sector, especially the central agencies, core departments, and Crown entities. It does not deal with state-owned enterprises or local government. Moreover, it considers the work of Ministers and Parliament only to the extent they are relevant to management and operation of the State sector. The internal work of Parliament, the overall responsibilities of Ministers, and Cabinet work are generally outside the scope of this study.

This report provides one person's observations and comments. I believe the judgments and impressions recorded here to be sound and balanced, but I understand that others might come to different conclusions. The nature of management reform is such that an assessment cannot be grounded solely on hard evidence of what has succeeded or failed. One's own judgment must be brought to bear, as well as that of others - participants and observers - who have seen the reforms in operation and have thought much about how the system is operating.

Research for the report was largely completed before the Commission of Inquiry on the Cave Creek tragedy issued its report in November 1995. Because of teaching obligations and other work commitments, the present report was not completed until August 1996. In writing this report, I had available the findings of the Commission of Inquiry, some of which pertain to the State sector reforms. Nevertheless, I have decided not to comment in this report either on these findings or on the incident itself. The methods used for assessing the overall efficacy of the reforms are not the same as those that should be used in investigating a tragic breakdown in organisational performance.

In view of the impact of the reforms on the Public Service, I would urge that a separate study be undertaken of human resource management, including the recruitment, motivation, training and supply of skilled managers.

I am mindful of the strong interest, both at home and in the international community, in the New Zealand reforms. This report selectively focuses on matters that may warrant change. Inevitably, therefore, the tone is somewhat critical. But the number and tenor of the comments should not detract from one overriding conclusion: the reforms have lived up to most of the lofty expectations held for them. What has been accomplished in New Zealand is unprecedented anywhere else in the world. There are risks, however, in pioneering in public management, including the risk of having to learn from one's own experiences rather than from those of others. Without a doubt, the rich harvest of ideas and practices gleaned in New Zealand deserves consideration by other countries willing to take bold steps to improve the efficiency and quality of public services.

The following chapters of the report cover most of the salient reforms and the issues associated with them:

Chapter 2 summarises the economic and political conditions that paved the way for transformation of the New Zealand economy and the State sector. It also analyses the powerful ideas that shaped the reforms and distinguish the New Zealand model from public management initiatives in other countries.

Chapter 3 examines the basic structure of the State sector, focusing on departments, central agencies, and Crown entities. It briefly comments on the implications of delayed management and devolved responsibility for field units.

Chapter 4 turns from structure to capacity. Having mapped out the organisational entities that make up the State sector, the report then considers the factors that determine the capacity of these organisations to perform the tasks set for them. The discussion encompasses the recruitment and role of chief executives, the corps of senior managers, and the government's ownership and collective interest.

Chapter 5 assesses the departments in terms of their capacity to define and implement policies in congruence with the government's strategic objectives. The discussion ranges from the strategic

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and key result areas to the specification of outcomes and the monitoring of results and the allocative efficiency of budget policy.

Chapter 6 examines the method by which resources are budgeted to implement government policy and finance department operations. Questions concerning the adequacy of the resource base include the capital charge, the accounting basis for budget allocations, the situation facing departments with rising workloads, and the carry-over of unused funds to the next financial year are discussed.

Chapter 7 considers the accountability framework for assessing the performance of departments and managers. Internal controls are a vital part of this framework, as are annual reports and audits. The chapter questions the extent to which accountability for non-financial performance is adequate.

Chapter 8 offers concluding remarks on the transformation of the State sector management framework and the further steps that might be taken to enhance performance.

## II. Transforming the Public Sector: Putting Ideas into Practice

In the 1980s, the New Zealand government applied bold ideas and cutting edge theories to reform its economic policies and management practices. Reform was spurred by adverse economic conditions that made continuation of the status quo untenable, accommodating political arrangements that facilitated swift change, and novel economic and management concepts that emboldened political and bureaucratic leaders to prescribe new practices without testing them in advance. This convergence of economic stress, perceived failure in government performance, new political capacity and exciting theories was unique to New Zealand, which is why it alone has transformed the State sector so boldly and comprehensively. If any of these conditions had been missing, reform probably would have been modest and piecemeal; with all in place, New Zealand confidently broke new ground in the management of public organisations.

This chapter explains how the State sector was transformed in terms of the conditions and ideas that drove Ministers and officials to overhaul economic policy and government operations. It analyses the influence of ideas on reform and argues that many of the distinctive features of post-reform New Zealand government were derived from a powerful and largely consistent set of ideas. The chapter concludes with a comparison of these ideas with other managerial theories.

### A Sick Economy Was the Impetus for Reform

Changing economic course is not easy for democratic governments, especially when it entails breaking past commitments and long-established practices. In the face of adversity, politicians are likely to settle for incremental or piecemeal measures. An OECD study of economic policy reversals in eleven countries found that the government took strong action only when existing conditions became unsustainable. Political leaders did "not seriously tackle the root cause of their problems until the situation approached crisis conditions and the need for remedial action . . . became evident and broadly accepted by the unions and the population at large" (*Why Economic Policies Change Course*, OECD, Paris, 1988).

Economic conditions were not sustainable in New Zealand when the reform process was initiated in 1984. The economy was in disrepair and conventional remedies - more fiscal stimulus and more governmental intervention - had not worked. The government faced high budget deficits, and interest rates were soaring while the value of the New Zealand dollar was plummeting. Doing nothing - or as little as politicians could get away with - was not a viable option. When they acted, beginning shortly after the 1984 election and continuing into the next decade, political leaders moved in three overlapping stages. First they freed the private sector from extensive government regulation; then they restructured the commercial operations of government along market lines; and, finally, they decontrolled the State sector and the labour market. Most of this was accomplished in about half a dozen years, though fine-tuning the reforms has been ongoing. Looking back at the exhilarating pace of reform, one can discern the logic of proceeding in this sequence. It enabled politicians to build on success in deregulating the market economy before they came to grips with more contentious changes in the State sector.

The shocks of economic distress were so unsettling because in the post-World War II era New Zealand had one of the most sheltered economies in the Western world. Generous welfare schemes protected households against the financial strains of unemployment, illness, and old age. These and other social expenditures were financed by a protected economy that benefited from preferential ties with Britain which bought just about all the agricultural products that New Zealand wanted to export to it. The economy was heavily regulated. Exports were subsidised, imports were controlled, as were foreign

exchange transactions. Major transport, energy, communications, and other enterprises were owned and operated by government entities. The economy operated in a governmental cocoon that sought to buffer it against competitive pressures. Sheltered from much of the outside, New Zealand probably did not perceive the extent to which it was losing ground. During boom times in the 1960s, as Table 1 shows, the country's real growth was significantly below the OECD average.

Table 1. Comparison of New Zealand and OECD Economic Trends (percent)

	New Zealand	OECD
<u>Average Annual Real GDP Growth</u>		
1960-68	3.3	5.1
1968-73	5.1	4.7
1973-79	0.2	2.6
1979-85	2.9	2.2
<u>Average Annual Unemployment Rate</u>		
1968-73	0.3	3.4
1974-79	0.8	5.2
1980-85	7.6	7.8
<u>Average Annual Change in Consumer Prices</u>		
1960-68	3.3	2.9
1968-73	7.4	5.6
1973-79	13.8	10.0
1979-85	12.8	7.6
Source: OECD, <i>Historical Statistics, 1960-87</i>		

In fact, it ranked near the bottom of OECD countries (22nd out of 24) in the rate of economic growth. But unemployment was negligible and inflation was moderate.

The cocoon economy was brought to an end by two 1973 shocks that have had a lasting impact on New Zealand. One was the entrance of Britain into the Common Market, the other was the OPEC oil crisis. The first deprived New Zealand of its protected market for agricultural exports, the second drove up the price of energy and led to worldwide economic stagnation. Table 1 indicates the sharp deterioration in the country's economic performance after 1973. Growth came to a virtual halt; economic activity declined in four of the ten years between 1974 and 1983 and grew 2 percent

or less in two other years. Inflation soared, as it did in other countries, but it persisted in double digits even after cost pressures moderated elsewhere. The official rate of unemployment was much lower than that of most OECD countries, but the actual rate was higher. Substantial unemployment was hidden in make-work schemes and by padding the work rolls of government enterprises.

The government's initial responses to the bad news were to provide some old-fashioned fiscal stimulus by investing in large energy projects and by adding subsidies for domestic industries and tightening regulations. Because the viability of some public works investments depended on a steady rise in energy prices, the government was left with uneconomic projects and heavy debt when oil prices tumbled in the early 1980s. The government had short-term success with a wage and price freeze introduced in 1982, but this only worsened the structural distortions in the economy. Interest rates spiralled, as did the budget deficit. Most ominous was a run on the New Zealand dollar, which lost more than half of its value against the U.S. dollar during the 1974-83 decade.

The progressive deterioration in the country's economic performance left New Zealand much poorer than it would have been had growth matched the OECD average. In the 1960s, New Zealand's per capita income ranked among the highest in the OECD community; in the 1980's, it ranked among the lowest. This slippage was due to meagre gains in productivity. During the quarter of a century from 1960 through 1985, real GDP per worker advanced at about only one-tenth the OECD average.

This sorry state of affairs might have been permitted to continue for a while were it not for a currency crisis that coincided with the 1984 Parliamentary election. There was a substantial outflow of foreign exchange during the first half of 1984; the outflow accelerated as election approached in July. In the election, the National Party lost its majority in Parliament and was replaced by a Labour government. The foreign exchange market was closed immediately after the election; when it reopened three days later, the New Zealand dollar was devalued by 20 percent.

Devaluation brought some breathing space, but it did not resolve the structural problems that beset the New Zealand economy. Many New Zealanders viewed the election as a mandate for change, though at the time few could foresee how far-reaching the changes would be. The 1984 election signalled a basic shift in attitudes toward government. The intellectual and political consensus which underlay postwar New Zealand policy had collapsed.

### **Political Leadership Was Essential in Transforming New Zealand**

Transformation of the economy and the State sector did not just happen; it was masterminded by political leaders who staked their careers on dismantling the cocoon economy. At first glance, the newly empowered Labour party appeared unlikely to curtail the government's role in economic management. As a centre-left party, Labour was identified with the welfare state; in the past, it had endorsed an enlarged role for government in providing health care and other social programmes. Nevertheless, the postwar generation of Labour leaders that came to power in 1984 were determined to make radical changes in economic management and in government policy. During nine years in opposition, they became convinced that government intervention was the root cause of the economy's poor performance and that across-the-board deregulation was essential for New Zealand to compete in world markets. These views were most insistently argued by Roger Douglas, the Minister of Finance in the new government. Douglas pushed ahead with the reform agenda even when the economy faltered, and even when polls showed voters anxious over the pace of change. "Rogernomics" - the label pinned by the media and others on the new economic order - was used

by some to criticise the new economic order and by others to urge still more reform. Douglas's views were shared by senior officials in the Reserve Bank and the Treasury. The Treasury brief *Economic Management*, prepared for the incoming government in 1984, served as a back drop for the changes that were to unfold in the next several years. This document did not break new ground in economic theory or practice - it extolled the benefits of competitive markets and advocated thorough liberalisation of the economy. The views held by the economic mandarins serving government were also held by incoming senior Ministers. The easy flow of ideas between senior officials and political leaders had a lot to do with the design and speedy implementation of the reforms.

The new Labour leaders were avid reformers. They did not want to settle for as little as they could get away with. Rather, they wanted as much change as the political system could generate, for they were certain that anything less than the full transformation of the government's role in the economy would spell continuing decline for New Zealand. They were guided by faith in the market and the conviction that over time the economy will do well if the government does not interfere, but that it will stultify if the government seeks to restrain or protect it.

Once in power, the Labour government encountered few obstacles on the path to reform. Indeed, it would be hard to devise a more accommodating political system than the one controlled by Labour in the 1980s. New Zealand is a unitary government, and it has a one-house Parliament. With the first past the post-electoral arrangements then in effect, one party typically had a majority in Parliament and did not have to dilute its programme to gain coalition support. Parliamentary committees have some power and independence - at the time of the reforms, most were chaired by backbenchers from the majority party - but their principal role is to fine-tune legislation, not to block passage. On important matters, Parliament typically goes along with the government, though sometimes only after making some adjustments.

These institutional arrangements may have encouraged Labour to proceed via legislation rather than (as has been more common elsewhere) through administrative adjustment in the machinery of government. Legislation had the obvious advantage, in that implementation would be backed by statutory prescription rather than only by political exhortation and administrative regulation. Moreover, it would likely proceed more uniformly if mandated by law than if it were merely urged or ordered by government leaders.

The progress of reform also was facilitated by New Zealand's small size and geographical isolation. (Despite this isolation, New Zealand's economic elites were well acquainted with avant garde concepts, as will be noted in the next section of this chapter.) Most Ministers and the Department of the Prime Minister and Cabinet have offices in the "Beehive," the centre of government, and the other two central agencies - Treasury and the State Services Commission - are a short distance away. There is frequent interaction among central agency officials, as well as between them and Ministers. Through its control of the purse and its intellectual leadership, Treasury had a dominant voice in the reform process. In the decade preceding the reforms, Treasury invested heavily in staff training and in the advanced education of some of its future leaders. These officials acquired new ideas about how the economy and public institutions should be managed. When the opportunity came following the 1984 election, they were eager to put their ideas into practice.

The first tasks of the Labour government were to stabilise the economy and to remove impediments to market efficiency; improvements in the machinery of government had to wait. Shortly after they formed the government, Labour Ministers began the process of liberating the economy by dismantling the wage and price controls, deregulating major sectors of the economy, and ending

most subsidies. Within a few years, the liberalisation programme had transformed one of the most regulated economies in the OECD community into one of the most open.

The initial reforms affected the operation of government only to the extent that they terminated various regulatory and protectionist activities. The second stage, launched in 1986, targeted trading activities of government entities. The State Owned Enterprises (SOE) Act (1986) altered the structure and operation of government enterprises. This Act removed direct governmental control of the operations of these enterprises and reorganised them as companies along business lines. It empowered boards to run the enterprises on a commercial basis; henceforth, they - rather than government controllers - would be responsible for overseeing production and pricing decisions. Managers also were empowered to establish their own industrial relations policies, including pay and working conditions, without regard to Public Service rules.

Many of the corporatised SOEs achieved dramatic gains in productivity as they revamped product lines, changed pricing policies, shed redundant workers, and adapted to the commercial (and, in some cases, competitive) environment in which they now operated. In due course, some SOEs were privatised, though others are still owned by the government. The government has a shareholder's financial interest in these SOEs, but does not meddle in their operations.

The SOE successes spurred reformers to extend the logic of managerial accountability to the core State sector. This final stage of reform is the subject of this report. It was given statutory impetus by the State Sector Act 1988 and the Public Finance Act 1989. (These and other major actions taken during the 1984-89 period are listed in table 2).

### **Reform Was Inspired by Novel Ideas**

In deregulating the economy and establishing the SOEs, reformers were guided by mainstream economic doctrine and by practices in other countries; in reforming the State sector, however, they relied on novel economic concepts as well as on established management theory and on governmental experience. When it decided to open the economy and to put the SOEs on a business footing, New Zealand lagged behind developments in other countries. It suffered from excessive regulation and from undue governmental involvement in commercial activities. In these matters, the adopted remedies broke little new ground concerning the role or structure of government, though implementing them did require leaders willing to take big political risks.

New Zealand's transformation of the State sector was influenced by two overlapping but distinctive sets of ideas, one derived from the vast literature on management, the other from frontier areas of economics. Managerial reform is grounded on a simple principle: managers cannot be held responsible for results unless they have freedom to act, that is, to spend and hire within agreed budgets as they see fit, to make their own choices respecting office accommodation and other purchases, to run their organisations free of ex ante control by outsiders. As simple as this proposition is, it is contrary to the way the New Zealand State sector was managed before reform.

In embracing managerial discretion and accountability, New Zealand reformers drew some lessons from the United Kingdom's Financial Management and Next Steps initiatives, as well as from Australia's Financial Management Improvement Programme. They were acquainted with the precepts of managerial accountability and subscribed to the view that central control of inputs warps managerial incentives and makes it difficult (some would say impossible) for managers to account for their performance. They also were schooled in contemporary accountability mechanisms, such as performance measurement and programme evaluation, as well as with

Table 2. Major Reforms of the Economy and Public Sector, 1984-89\*1984

Deregulation of Foreign Exchange Trading  
 End of Wage/Price Freeze  
 Removal of Controls on External Investment/Borrowing  
 Termination of Interest Rate Controls  
 Abolition of Export Credit Guarantees

1985

Floating of New Zealand Dollar on Foreign Exchange Markets  
 Liberalisation of Foreign Direct Investment  
 Removal of Ownership Restrictions on Financial Institutions  
 Liberalisation of Entry Barriers to Banking  
 Liberalisation of Controls on Repatriation of Profit

1986

Tax Reform Through Imposition of Broad-Based Goods and Services Tax  
 State Owned Enterprises Act Providing for Conversion of Trading Departments into Businesses  
 Liberalisation of the Stock Exchange  
 Progressive Reduction of Import Tariffs  
 Enactment of New Legislation Governing Mergers, Trade Practices, and Consumer Rights

1987

Corporatisation/Privatisation of Various State Owned Enterprises  
 Abolition of Various Quasi Governmental Organisations  
 Removal of Tax Concessions on Savings  
 Introduction of Tight Monetary Policy

1988

State Sector Act Reforming Core Public Service  
 Reform of the Education Sector  
 Reform of Personal Income Tax

1989

Public Finance Act  
 Reform of Old-Age Pension Schemes  
 Reserve Bank Act, with Target of Price Stability

\*Date refers to year reform was initiated; some reforms extended over a number of years before they were completed.

schemes introduced in various countries to give public managers flexibility in using appropriated funds, staff, and other organisational resources. Some had studied Sweden's long-established practice of separating its small policy ministries from the agencies providing services, and thought that this arrangement should be tried in New Zealand.

Managerial doctrine explains many of New Zealand's public sector innovations. But it does not account for the government's recourse to contract-type arrangements, the emphasis on outputs, and other distinctive features of the New Zealand model. To explain these, one must refer to a body of ideas known variously as the new institutional economics, agency theory, and transaction cost economics. Because of their uniqueness and influence, I concentrate on these ideas though they were not the only ones that shaped the reforms, following which we compare them with managerial concepts.

The new institutional economics traces its intellectual roots to a 1937 article ("The Nature of the Firm") by Ronald Coase that sought to explain different forms of business organisation, but it has gained currency in economics circles only recently. The concepts associated with this field provided much of the logic and the blueprint for transforming the State sector. New Zealand is not a country in which ideas moved in one direction and practice in another. Some of the leading architects of the reforms became familiar with these concepts and were eager to apply them. The core ideas account for some of the characteristic strengths and weaknesses of the reforms, for example, the extraordinary reliance on contracts and the emphasis on specifying outputs, as well as the failure to develop the Senior Executive Service and the persistent difficulty in specifying outcomes and the government's ownership interest.

The new institutional economics is grounded on a very old idea: people act in their self-interest. It extends the study of self-interested behaviour beyond market transactions to situations where other values - loyalty, duty, contracts, and other obligations - might be thought paramount. This branch of economics argues that members of a firm are bound together by self-interest, as are the parties to a contract. Self-interest also is a vital motivating force in the Public Service and is as present in the relationship between principals and agents - for example, between Ministers and officials - as among peers. The new institutional economics takes self-interest to its logical conclusion: all economic relations are implied or explicit contracts between parties that have different interests but cooperate for their own purposes. But the very self-interest that motivates parties to contract means that contracts rarely are self-enforcing: one or both parties may seek to implement the bargain in ways that disadvantage the other. That is, they may behave opportunistically. Opportunistic agents may disregard obligations to principals and take self-serving actions at the expense of those they are obligated to serve.

Opportunism flourishes because rationality is bounded - principals and parties to a contract do not have all the information they need to ensure that the bargain is being honoured, and the cost of getting sufficient information may be very high. In fact, possession of essential information often is asymmetrical: agents know more about their performance than principals do. This asymmetry exposes principals to the risk of capture: agents give principals the information that impels them to act in the interest of those who serve them. "Yes, Minister" behaviour is a well-known form of capture.

Opportunism greatly increases transaction costs - the costs of negotiating and enforcing contracts. Transaction costs explain why some firms are vertically integrated (they produce their own throughput) while others outsource their production. In both cases, the firm operates on the basis of contracts - internal contracts in vertically integrated firms, external contracts in outsourcing firms.

A rational firm will structure itself one way or another by analysing the risk of opportunism and transaction costs. These costs are likely to be high when a firm contracts for "specific assets" that have little or no alternative use and when it is difficult to measure performance. In these situations, the firm may internalise production to minimise transaction costs.

New Zealand reformers have been among the first to apply institutional economics to the public sector. They did so in an extraordinary Treasury brief, *Government Management*, submitted to the Labour government following its 1987 election victory. The first part of this document talks about how markets function (and fail). Rather than extolling the virtues of competitive markets, it concentrates on their limitations, especially those deriving from opportunism in contracting. Although it alleges serious deficiencies in New Zealand government, it deduces these from the logic of institutional economics, not from the systematic study of public organisations. The evidence offered of government failure is slim - an incident here and there - as, for example, mention of the error-plagued Maniototo irrigation project - to illustrate the difficulty the existing system imposed on assigning responsibility for governmental actions. The brief also has an undertone of "everybody knows government is inefficient, so there is no need to prove the point".

The theme of *Government Management* is sounded at the outset: "The state is not an omniscient and omnicompetent solver of social problems, but rather is subject to largely the same pitfalls that face private solutions to social problems plus other ones" (p. 10). Private and public institutions are hobbled by bounded rationality, the costs of information, dependence on others, and opportunism. "The fundamental problem then is to discover methods of social organisation that relax or minimise these constraints in order to marshal the activities of individuals towards common or consistent ends" (p. 12). Firms are one such type of organisation; governments are another. It is not the concentration of economic power in the firm but the advantages of internal contracting over external contracting in markets that explains its prevalence in industrial society.

After discussing contracting under opportunistic conditions in the private sector, the Treasury brief considers parallel problems in the public sector. It argues that government is prone to opportunism because it lacks the checks on behaviour that come from the need to satisfy customers. Those who work for the State "have a tendency to pursue their own goals, to shirk and to featherbed, and to pay insufficient care in the use of resources that are owned by the 'organisation' or someone else." Furthermore, opportunism is rife in State entities because they "are frequently given conflicting objectives. As a result monitoring is more difficult" (p. 38). The brief is especially concerned about one form of opportunism - the capture of an organisation's policy-making apparatus by service providers. Ministers are vulnerable to capture because civil servants "may hold better information about how government services actually operate." This asymmetry in information "creates the potential for opportunism or subgoal pursuit by the bureaucracy including shirking, budget maximization and generally inefficient policies for society as a whole" (p. 44).

Clearly, different conclusions might be drawn if the brief were argued from different premises, for example, from the posture that civil servants are motivated by a public or professional ethic. We shall consider the implications of assuming self-interest rather than broader public-regarding values later in this chapter.

After arguing that the government is prone to poor management, the brief sets forth the principles that should guide reform of the public sector. A well-run government:

- (i) should have clear objectives that inform managers of what is expected and enables their performance to be monitored;

- (ii) should be transparent in explicating these objectives and the means by which they are to be pursued;
- (iii) should be structured so as to minimise the scope for capture of policy by service providers;
- (iv) should give managers and others incentives to achieve government's goals rather than their own;
- (v) should ensure the efficient use of information;
- (vi) should have incentives and information that enhance accountability of agents to principals; and
- (vii) should promote contestability of both policy advice and service delivery.

Most of these principles can be found in standard management literature; they do not depend on the assumptions and reasoning of institutional economics. One need not assume opportunism by government officials to argue that managerial performance and accountability would be improved by clear objectives and robust information systems, or that incentives are important to the behaviour of managers. It is only concerning those matters that are unique to New Zealand - such as separation of policy advice from service delivery and the emphasis on explicit contracts - that one must have recourse to contemporary economics theory.

The reforms recommended by *Government Management* can be divided into two overlapping categories: those that seek to enhance managerial discretion and accountability, and those that seek to introduce contract-like arrangements in government. The more distinctive the New Zealand reform, the greater the likelihood that it falls into the second category. Arguably, however, the government could have implemented major changes in managerial practice without introducing these novel features. This is not to say that the contractual reforms do not add value; rather, it is to make the point that not all that New Zealand has accomplished is dependent on theories of opportunism, capture, agent-principal problems, transaction costs, and the like. There is a whole superstructure of argument in *Government Management* that is critical to understanding how the reforms have unfolded, but not necessarily critical to an explanation of what they have accomplished. Another way of stating this point is to argue that a major portion of what has been accomplished has been due to conventional management ideas - freeing managers in exchange for holding them accountable for results - rather than to institutional economics.

The specific changes suggested by *Government Management* pertain to six areas of New Zealand management: the relationship and responsibilities of Ministers and managers; regulation and employment of the Public Service; the structure of government; budgeting and accounting for public funds; means of assessing performance; and the role of central agencies. Many of the findings and recommendations can stand on their own, without the logical prop of the new institutionalism.

Regardless of their conceptual source, the recommendations are important because they influenced subsequent reforms. They also are important because they set forth the perceived shortcomings in New Zealand government before the changes were enacted.

### Ministerial and managerial accountability.

The brief pokes holes in the constitutional doctrine that public servants "act as extensions of the Minister, without having any independent existence and consequently no independent responsibility . . . . The Minister was held to be directly responsible for all departmental activities . . . ." (p. 64). This pretence diluted responsibility: department heads could not be held accountable because any particular action was the responsibility of the Minister; but the Minister could not reasonably be held to account for all the things the department did without his or her direct involvement. To make matters worse, "in most of the public sector the tendency has been to keep managers' discretion to a minimum" by controlling their use of inputs (p. 58). The ex ante control of inputs "reduces incentives to monitor output and performance and creates incentives for departments to withhold information" (p. 59).

The brief proposes the establishment of a clear chain of accountability, running from the Minister who (in addition to political accountability) should have a major role in appointing the department head, through the department head who would serve under a term appointment, to public servants who would be appointed by and responsible to the department head.

### The Public Service.

Before reform, the State Services Commission was the legal employer of all public servants, although it delegated authority to make most appointments to the affected departments. It had legal control of promotions, dismissals, and other personnel actions. This centralised arrangement, the brief argued, impaired the capacity of managers to run their operations. "The ability of managers to recruit, retain, train, and motivate staff is thus a key element in their ability to manage well and thus achieve their organisation's objectives" (p. 70).

The brief suggested that the head of each department be designated its "employing authority," with power to negotiate personnel arrangements, including pay and other conditions of employment. With decentralization of employment decisions, suitable accountability mechanisms should be introduced to ensure that these actions are consistent with the department's budget.

Treasury acknowledged that some might object that this proposal would impair the unity of the Public Service. It responded that the Public Service already was segmented, with professional and technical linkages often as strong as interdepartmental connections. While this undoubtedly was the case, it may be argued that precisely because the Public Service had become increasingly fragmented, care should be taken to reinforce whatever sense of unity remains. This issue has become more compelling in the decade since *Government Management* was prepared because of the failure of the Senior Executive Service and the growing prominence of individual employment contracts.

### The structure of government.

One of the signal contributions of the Treasury brief has been to remind us that the manner in which the work of government is organised matters. The prevailing structure, the brief charged, invites policy capture by sectoral interests. This risk was augmented by the amalgam of policy advice and service delivery in the same agency. Managers were beset by conflicting objectives and had difficulty in serving both the Minister and those benefitting from the department's activities. Moreover, the "conflicting objectives that arise from the combination of policy advice provision and policy implementation within the one organisation tend also to produce a phenomenon known as 'producer capture' . . ." "a service-providing agency whose existence is inextricably linked to the continuation of existing policy is likely to be biased in favour of existing policy" (p. 75).

To avert producer capture, the brief urged that policy advice and service delivery be assigned to separate entities. This separation would give Ministers less biased and more varied supply of advice. In this scheme, small policy ministries would oversee implementation by quasi-independent agencies. But Treasury cautioned against so distancing the two types of entities from one another that policy makers would suffer from ivory tower isolation. "Policy advice divorced from considerations of reality is bad advice"; to guard against ignorance and isolation, policy agencies should "build a sufficiently strong relationship with the operational agencies to acquire the necessary knowledge" (p. 77).

The discussion of structural reform concluded on a tentative note by suggesting a need for flexibility: ". . . a considered approach which addresses particular agency structures on a case-by-case basis in the light of resource constraints and current priorities will be needed" (p. 79). This is precisely how the restructuring of departments has progressed. In some, policy and service provision have been decoupled; in others, they continue to be tied together.

#### Budgeting and accounting.

Cash-based budgeting was developed over generations in New Zealand (as in other countries) as a means of controlling government spending. But although this form of budgeting made it government's paymaster, Treasury found numerous shortcomings in accounting and budgeting pertaining to the information and incentives provided managers. "Our present system of funding government expenditure based on annual cash appropriations does not provide the right incentives for public sector managers to make the best use of the resources available. Nor does it encourage them to provide information on the full cost of activities or the outputs achieved using available resources" (p. 82). Cash-based accounting, Treasury argued, does not provide a full and accurate account of the cost of activities, especially when capital assets are used; it does not take account of future commitments, or of guarantees and other contingent liabilities; it controls the inputs purchased rather than the outputs produced; and it fails to provide information on the government's (or an agency's) financial condition. A cash-based system distorts incentives by encouraging managers to underestimate the cost of programmes; bid for incremental allocations rather than evaluate the use of resources already at their disposal; enter into unbudgeted commitments for future years; spend their full annual appropriation; and to conceal costs by promoting non-cash resources and interventions, such as tax expenditures and regulations.

Treasury's key recommendation was that the budget and appropriations be "based on an assessment of the full resource cost of those decisions" (p. 83). Although it still will be necessary to control cash, the government should manage costs on an accrual basis. In addition to an accrual accounting system, the government "would also need an accrual budgeting system so that actual results can be measured against plans and budget. The accounting system would need to be on the same basis as the budgeting system to avoid the possibility of conflicting objectives" (p. 83-4).

New Zealand has been the only country to move in tandem on both accounting and budgeting reform. Accrual budgeting significantly escalated the stakes in financial management reform, for the basis of decisions had to be altered, not only the form of financial statements. This bold recommendation actually facilitated reform by giving managers a clear message that they must quickly develop information systems to support full cost-based accounting and budgeting.

#### Assessing performance.

The brief identified several impediments to the proper assessment of managerial performance. Managers were given unclear and sometimes conflicting objectives; they were blocked by input controls from using resources to their best judgment; and they had inadequate information on the

volume of outputs and the efficiency with which resources were used. The important point made here, and not always followed in other countries, is that assessing performance is not a stand-alone capability; it must be congruent with an overall system in which managers have authority to act and are appraised on the basis of their actions. Without this framework, assessing performance "will be an end in itself rather than a means to bring about improvement. In this situation managers have little incentive to cooperate in the process by divulging adequate information to allow a reasonable assessment to be made" (p. 86).

A robust performance measurement system, Treasury urged, requires *ex ante* specification of objectives. Performance assessment was seen as part of the incentive structure for managers. Consideration of how well the organisation is doing should be part of the appraisal of the managers' performance. The cognizant Minister should be involved in the rigorous review of department heads; these reviews should feed into the negotiation of employment contracts.

#### The central agencies.

Treasury and SSC administered the input controls that dominated public management before reform. With the dismantling of those controls, the central agencies had to change their roles. The brief had more to say on what Treasury and SSC should no longer do than on what they should do in the new regime of managerial discretion and accountability. It noted that "the extent to which existing controls can be abandoned will depend . . . on the success with which objectives are able to be clearly specified and performance of managers assessed against them" (p. 91). But it concluded that "considerable further analysis is required before the final nature of the control function, and the extent of centralised functions, can be deduced with any confidence. . . . The greater the reform the smaller is the role for central control agencies" (p. 93).

The brief had some difficulty describing where these agencies would fit in once the public sector was transformed. The logic of managerial responsibility dictates withdrawal of Treasury and SSC from most interventions in the operations of departments, but "the fact that the activities of individual agencies may have implications for others suggests that the need for central oversight or co-operation will remain" (p. 91). There is a thin line between assisting and meddling, between letting departments find their own way and steering them in the right direction.

In concluding its recommendations, the Treasury brief returned to an argument it had repeated several times. "No matter what the starting point, achievement of improved management outcomes will only be possible if the system is treated as a whole" (p. 95). The new system will transform public management only if reform is comprehensive and integrated. It will not suffice for change to be piecemeal, as if one were picking from a menu of techniques. The argument is compelling when one considers the inextricable linkage of freeing managers and holding them accountable. The first without the second would open the door to abuse; the second alone would make people responsible for actions they did not control.

The total package approach to reform pointed in the direction of a legislative onslaught on the old order. With strong political leadership, the government could move faster and accomplish more by prescribing a course of action than by having each department set its own pace. Why delay when there is consensus that the system was broken, and exciting, confident theories showed how it should be fixed?

### **Managerial Versus Contractual Approaches to Reform**

The particular changes made via legislation and implementing actions will be discussed in subsequent chapters of this report. Here it is appropriate to conclude the discussion of the ideas that shaped New Zealand reform by analysing their overall impact on public management.

Sixty years ago, in launching the revolution in fiscal policy that bears his name, John Maynard Keynes wrote:

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else . . . I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.

The New Zealand model confirms the power of ideas in transforming the State sector. But one should not lose sight of the fact that two sets of ideas vied for influence when the reforms were on the drawing board. The two converge in many aspects, but they have different roots and point in somewhat different directions. One is the managerial premise that those who are responsible for government programmes and organisations should be sufficiently empowered to act so that they can be accountable for their performance; the other is the contractual theory that government should be organised to minimise opportunism and transaction costs in relationships between self-interested parties.

The two ideas make common cause on some reforms but not on others. Whether one considers the operation of government from a managerial or contractual perspective, efficiency is gained by specifying objectives and measuring performance against them, as well as by freeing managers to use resources as they deem fit and then holding them accountable for what they have done. Both would argue for term chief executives rather than permanent department heads, for making chief executives rather than SSC the employing authority for civil servants, for appropriating on the basis of outputs rather than inputs and specifying expected outputs in advance, and for shifting from cash to accrual accounting and budgeting. The two approaches go their separate ways, however, in the emphasis placed on employment contracts, purchase and performance agreements, in the decoupling of policy advice from service delivery, the emphasis on ex ante specification, the sharp split between purchase and ownership and between outputs and outcomes, and the demanding accountability requirements.

Managerial concepts explain most of the innovations introduced in New Zealand, but not the most conspicuous ones. Arguably, the reforms inspired by a managerial perspective have brought most of the State sector improvement experienced over the past decade. This clearly is the view of the senior and middle officials interviewed for this report. In conversations, they overwhelmingly endorsed the view that the most important change was freeing managers to manage. Some suggested that upwards of 75 percent of the gain has ensued from this change alone.

The difference between managerial and contractual approaches parallels the contrast between "letting managers manage" and "making managers manage." The former assumes that once managers have been empowered, they will take initiatives that improve performance; the latter questions whether managers will be sufficiently tough-minded to make the needed changes unless they are prodded to act. Managerial reform is utterly dependent on the behaviour of managers, some of whom, contractual theory fears, will opportunistically prefer the ease of continuing the

status quo to the difficulties of uprooting established practices and (if necessary) sacking sub-par performers.

Managerial innovation has a soft side which contractual arrangements seek to counter. The former assumes that managers want to do the right thing and will do so if given the chance; the latter assumes that managers are motivated by self-interest, which may take precedence over the organisation's interest. If one subscribes to the latter view, then the hard edge of contracts and other enforcing arrangements would be warranted. Yet if one were to reject the premise that managers habitually pursue the public interest, contractual remedies may nevertheless be inappropriate or insufficient. If managers were self-serving opportunists, it would be naïve to expect the proto-contracts and accountability reports introduced in the public sector would compel them to mend their ways. Even a contractual regime is dependent on the good behaviour of public managers.

There is much evidence of public - not just self-interested - behaviour in government. While it is common to refer to shirking and subversion by civil servants, hardly any mention is made of those whose normal workday is voluntarily extended beyond "9 to 5" and who faithfully carry out the instructions of superiors, even when they might prefer not to. The American political scientist John J. DiIulio, Jr. has written eloquently about "principled agents," public workers who "go above and beyond the call of duty, and make virtual gifts of their labour even when the rewards for behaving that way are highly uncertain at best" (DiIulio; *Principled Agents: The Cultural Bases of Behaviour in a Federal Government Bureaucracy*; Journal of Public Administration Research and Theory; Vol.4 July 1994; pg 277). Public-regarding behaviour is one of the main reasons why managerial discretion improves governmental performance. Without a strong public ethic, contractual remedies would be both necessary and inadequate.

Managerial versus contractual models are not just a battle over ideas. In New Zealand, they have strongly influenced practice as well. Contractual ideas account for (as mentioned earlier) some of the characteristic strengths and weaknesses of New Zealand reform. The strengths include the explicit specification of outputs, the chain of accountability running from Ministers through chief executives to civil servants, the search for increased contestability in public programmes, the fluid exchange of ideas and personnel between the private and public sectors, the strong (but perhaps not strong enough) emphasis on accountability, the challenging review of performance, and the insistence that performance be rated in terms of the personal responsibility of the manager, not merely as an attribute of the organisation.

Institutional economics and the array of ideas that have given rise to contractual theory provide powerful insights into the structure and operation of private and public organisations. They have spurred the infusion of modern business practices into the public sector and have also added muscle to accountability arrangements. They have enabled reformers to comprehend how structure retards or facilitates performance and to view public agencies as contracting - rather than merely as producing - entities. The concepts and techniques of contracting are likely to be in the toolkit of New Zealand public managers for many years.

But hard-edged contractualism also has shortcomings and costs. Four types of costs can be identified in the New Zealand model. The first are the high transaction costs associated with the various agreements and procedures required each year. These include the costs of negotiating the agreements and monitoring compliance, the costs of preparing periodic reports and statements, and the expenses of maintaining relatively large contracting and monitoring staffs. According to some managers, these costs have soaked up a substantial portion of the efficiency gains achieved by their

organisation. Although these costs may be considerably lower than the deadweight costs of complying with central input controls, they are likely to be higher than those necessitated by managerial discretion. Yet transaction costs are not fixed; they can be mitigated by purging the various agreements of excess detail and by regarding them more as understandings than as firm contracts.

The second cost is more difficult to describe but may have a deeper impact. There is considerable risk that the contractual style of management may diminish public-regarding values and behaviour in government. If it is true (as is claimed) that the concept of a unified Public Service, with defined career paths, began to erode long before the reforms were introduced, then rather than interpreting this development as justification for further fragmenting the Public Service and erasing differences between public and private employment, one might argue that reform should seek to combat these trends. Many managers now see the Public Service as a way station between public and private jobs. If "in and out" career patterns seep down from the upper to middle and lower ranks, it may become harder to instill a public ethic among government managers.

The values of the Public Service include the trust that comes from serving others, the sense of obligation that overrides personal interest, the professional commitment to do one's best, the pride associated with working in an esteemed organisation, and the stake one acquires from making a career in the Public Service. To be sure, these values carry certain liabilities. They may discourage initiative and change; they may insulate the institution from outside pressure and from proper regard of those being served; they may lead to expedient incrementalism, in which tough decisions are avoided. But these side effects can be combatted by injecting a heavy dose of managerial values into the organisation.

The third cost is the weakening of collective interest. I believe that regard for collective values remains unusually robust and valued in New Zealand. Moreover in the period since this problem was considered by the Logan Review (*Review of the State Sector Reforms*) in 1991, notable strides have been made through mechanisms such as strategic and key result areas. Nevertheless, contractual arrangements may give politicians and managers a narrower view of their responsibility in the State sector than would be appropriate.

This parochialism arises out of the bilateralism of contractual relationships. Bilateral contracts - between Ministers and chief executive, between department and Minister, between the chief executive and senior managers, between Crown entities and the Ministers, and so on - are favoured because they are clearer, easier to enforce, and less prone to opportunism than multilateral arrangements. Yet, bilateralism does not embrace the whole of public responsibility; there always is a third party in public contracts. That third party may be the electorate, the government in its collective responsibility, the clients or beneficiaries of public programmes, or other interests. The third party is a stakeholder in the actions of the parties contracting bilaterally; its interest is not marginal. One is reminded of Edmund Burke's insistence that society is a contract "not only between those who are living but between those who are living, those who are dead and those who are yet to be born." Even more apt was Burke's challenge to the electors of Bristol (the borough that returned him to Parliament) that his obligation was to the public good as he saw it, not just to serve as their agent.

In bilateral relationships, it is hard for the third party to fit in. In the triangular relationship between the Minister, the chief executive, and SSC, the third party is often seen as an interloper, not as a legitimate participant in the negotiations.

The final set of costs relates to the practices implemented under reform, especially those that have encountered serious problems along the way. This writer does not regard it as happenstance that the Senior Executive Service (SES) provided for by the State Sector Act has not gotten off the ground; that despite expert and sincere effort, the specification of outcomes has not advanced; that despite its strong commitment to managerial discretion, New Zealand restricts transfer of funds between output classes, even those aimed at the same outcome, as well as between financial years; that identifying the government's ownership interest has been difficult. These problems and disappointments - and others - can be traced to the contractual model of reform.

(1) It may be that the SES failed because of apprehension that it would be deployed as a means of reinstating central constraints on the pay of senior officials. But it also is true that the SES did not comport with a two-party world in which chief executives employ senior officials under term contracts. If the new world of managerial accountability rests primarily on a contractual bond between chief executive and senior managers, then there is little scope for loyalty to the broader value of the Public Service supposed to be represented by the SES. (2) Outcomes are externalities in two-party relationships; therefore it is exceedingly difficult to assign responsibility for them. Outputs, by contrast, are internal and, hence, they can be covered in contractual bargains. (3) If output is contracted for at a fixed price (the amount appropriated), then it makes sense to restrict transfers between output classes--the draft legislation tabled in 1989 barred any such transfers but in formulating the Public Finance Act, Parliament permitted up to 5 percent to be shifted to other output classes. Similarly, the logic of contracting dictates that once agreed outputs have been produced, any unspent funds should be returned to the Treasury and not be spent on other output or saved for the next year. (4) Finally, "ownership" is the third party's - the government's - interest in the long-run capacity of the department to invest and innovate, not that of the party purchasing the output. The purchasing party may have little short-run incentive to invest in the capacity of the department (or other entity) to produce future output.

Bilateral contracting sharpens objectives and the terms under which they are to be pursued, provides more benchmarks for assessing performance and fewer escape routes for opportunism. In other words, the contractual model goes further than managerial reform in demanding accountability in the public sector. But, as argued, it exacts a substantial cost for achieving efficiency in output production. The ensuing chapters of this report discuss means of strengthening strategic and collective capacity, the allocation of resources, and monitoring accountability while softening the rigidities of management by contract.

## Conclusion

A recent assessment of State sector reform conducted by the Decision Centre at Victoria University gave management of the change process by the New Zealand government a lower rating than was assigned to any other aspect of reform (Richard Norman, *New Zealand's Re-invented Government: Experiences of Public Sector Managers*; Public Sector; Vol.18, No. 2, June 1995, p. 23). In my view if change had not been mismanaged it would not have been managed at all, but this view may not be shared by those directly affected by the changes. One manager who participated in that study thought that taking a steady approach might have achieved similar results with less bitterness and fallout. Others thought that in a large-scale restructuring, such as New Zealand's, there is need to take account of the sensibilities of those affected, as well as of the individual and social impacts.

That these sentiments may be shared by the public at large is suggested by voter approval of a new "mixed member proportional representation" (MMP) system in 1992. MMP will almost certainly slow future change by making coalition government much more likely. Endorsement of MMP

indicates that voters were fatigued by the pace of change and welcomed the stability that might result from the difficulty of getting coalition partners to agree on sweeping reforms.

If this is so, the compressed period of reform in the late 1980's and early 1990s will be seen in retrospect as a brief interlude during which the conjunction of powerful ideas, weak economic conditions, and strong leadership made possible a transformation that is not likely to occur again. Some will look back and gripe over what has been uprooted; others will look back and celebrate what has been accomplished. My present task is to navigate between these poles and offer suggestions for renewing the spirit of reform while tidying up some matters that were not well decided a decade ago. The ensuing chapters concentrate on these matters, not on the many changes that have been successfully implemented.

### III. Structure of the State Sector

One of the signal contributions of the New Zealand reforms has been to remind us that institutional arrangements can make a big difference in the performance of politicians and public officials and in the effectiveness of the organisations they control or work for. Institutions matter because they influence the incentives and behaviour of Ministers and managers. Institutional arrangements establish the contractual relationships between principals and agents and determine what managers may do and are accountable for.

New Zealand's organisational structure has features that are found in most countries. There is a pantheon of Ministers, each responsible for one or more departments. Each department is headed by a chief executive and has its own sphere of responsibility, for which appropriations are provided. Several central agencies regulate or coordinate the business of government. There also is an array of nondepartmental bodies, which are funded by the government's budget to carry out assigned responsibilities.

A closer look at New Zealand's governmental landscape reveals distinctive features, some predating the reforms, others added by them. New Zealand has a large number of small departments and a small number of (relative to its overall size) large departments. It has many fewer Ministers than departments; some are responsible for more than one department. Some departments are funded out of more than one Minister's portfolio. In each such case, one Minister - generally the one with the largest stake - is assigned responsibility for the department. The Responsible Minister has two roles: one as a purchaser of its output, the other as the "owner" of the organisation. As purchaser, a Minister may opt to obtain output from the department or from alternative suppliers, such as Crown entities or nongovernmental contractors. The many Crown entities differ in their organisational structure and relationships to Ministers and departments. In the aggregate, they are the end-spenders of approximately one-third of total public expenses.

These institutional arrangements give rise to several issues considered in this chapter. One pertains to the role of the central agencies and another to the structure of departments and Crown entities. (SOEs are outside the scope of this report and are not considered here.) Having reviewed these arrangements, I do not see a need for any basic restructuring of New Zealand government. Ministers should continue to have responsibility in their respective domains; the resources and management of government should continue to be entrusted to departments. Despite reform, there remains a need for strong central agencies. Crown entities generally provide governmental services that can be more effectively delivered outside departmental structures. Nevertheless, I argue for certain adjustments in each of these organisational areas. Central agencies should be more clearly focused on vital, government-wide tasks; departments should have the capacity to fulfill their accountability requirements; and the activities and finances of Crown entities should be more transparent and more readily subject to Ministerial responsibility.

#### Departmentalising the State Sector

New Zealand has almost twice as many departments as Ministers, making it common for Ministers to have multiple departmental responsibilities. The thirty-nine departments vary considerably in size; the two largest (Social Welfare and Inland Revenue) account for about 35 percent of State sector employment.

New Zealand departments represent much more than entries on an organisational chart. Departments are the structure in which managerial discretion is exercised and accountability is enforced, whereas the Votes they administer provide the basis for structuring the budget and managing funds. Each department is responsible for a vast stream of reports, financial statements, and other documents prescribed by law, Ministers, or the central agencies. No matter how small it is, each department is headed by a chief executive, negotiates and implements annual performance and purchase agreements, reports monthly on financial operations, quarterly against purchase agreements and half-yearly on chief executive performance, and produces a departmental forecast report and an annual report. Each must handle the flow of paperwork from Cabinet and the informational demands of central agencies and Parliamentary committees, and each must interact with outside clients and other interested persons. A department must vie for its Minister's time, especially if the Minister is responsible for more than one, as typically is the case with small departments. Thus, while all departments have good reasons for being established, they collectively impose substantial running costs on government. These costs account for a large portion of the operating budgets of small departments.

A large department is likely to have more scope in its operating budget to pay for complying with accountability demands than might a small one. Not surprisingly, managers in small units have griped about these demands. Small departments may have another shortcoming. They may not offer ample career advancement opportunities for staff pigeonholed in small organisational enclaves.

Having numerous small departments generates diseconomies of scale. In addition to accountability and reporting burdens, each department must allocate staff resources to internal management, such as running its own budget and dealing with personnel matters. After these and other responsibilities - which may include monitoring Crown entities - have been spoken for, a small department may have meagre resources left over for policy advice. Perhaps this is the reason why some small departments appear to be listless.

The government may wish to explore means of consolidating some departments or converting them into nondepartmental bodies. (The place of Crown entities in New Zealand's organisational structure is considered in a later section of this chapter.) If the number of departments were reduced, some elements may be recast into Crown entities. Alternatively, New Zealand might explore the feasibility of establishing a new form of organisation that is a hybrid between the core departments and Crown entities. One possibility would be to create executive agencies within departments along the lines of the United Kingdom's Next Steps initiative. These types of agencies would have substantial overall freedom but would be accountable to the Minister and chief executive. They would not have independent governing boards and their budgets would be incorporated in departmental output classes.

It would not be helpful to prescribe a maximum number of departments, but a review of the number maintained in other countries suggests that it may be appropriate to retain somewhat more than half the number of departments currently in place.

Regardless of their number, departments still will constitute the core of the State sector. There still will be great differences in their size, as measured by staff, budget resources, and other indicators. Some are small because service provision has been split off from policy advice; others remain large because policy and operations still are joined together. In New Zealand, the case for decoupling has been based on concern that opportunistic service providers may capture policymakers (including the Minister) by selectively feeding them information. Other countries have acted on different

premises in separating the service and policy functions. Sweden long ago separated operating agencies from policy ministries to promote professionalism and political neutrality in the Public Service; the United Kingdom devised Next Steps agencies as a means of freeing service providers from the stranglehold of Whitehall. It wanted operating decisions to be taken by those responsible for providing the services, not by central controllers ensconced in headquarters fortresses. If New Zealand's fear was that Ministers and senior managers would be captured by subordinates (the agent-principal problem), the United Kingdom's concern was that operating managers would be impeded by the top.

In New Zealand, the form of organisation has been decided case by case. For example, the present chief executive of the Department of Social Welfare heads a "coupled" organisation; policy advice and operations are housed in the same department. In her previous post, she divested the Ministry of Transport of its operating units and thereby reduced its staffing from 4000 in 1987 to about 50 now. Justice was a coupled department until it was split into several entities by a 1995 reorganisation; the Department of Labour remains coupled, as are Customs and a few other large departments.

When operations are split off, the surviving department is likely to be involved in much more than advising the Minister on policy. It has ongoing responsibility for internal management and accountability reports and (in some cases) also manages contractual relations between Crown entities and their Minister. This role entails negotiating contracts and monitoring performance, two specialised, labour-intensive tasks.

The reformed State sector relies on written contracts to define organisational responsibilities, allocate resources, programme the work to be done and the priorities to be emphasized, and maintain accountability. Managing these contracts may require a somewhat different mix of personnel skills than has traditionally been found in the Public Service. In some small and medium-sized departments, upwards of one-quarter of the staff is allocated to these tasks and to related activities. The ongoing pressure to retrench running costs gives these departments less room for shifting resources and investing in training than might be available in larger ones. I have been told by managers of some small departments that their operating budgets have been stretched so thin that no money is available for training in newly required skills. Even when per employee operating funds are equal to those of larger entities, small departments may be deterred from making substantial investments in training by the lumpiness of these expenditures.

The large, coupled departments generally appear to be well managed. Some have been reorganised along business lines, with a general manager in charge of each business unit. Each unit has its own performance targets and operates independently of any other units in the same department. The headquarters of these departments have been transformed into corporate offices whose principal responsibilities are to provide policy guidance, monitor the performance of the business units, and manage external relations with the Minister, central agencies, Parliament, and the public. These reorganised departments have achieved many of the benefits of decoupled organisations.

A strong argument can be made either for splitting up a department that is responsible for an array of loosely related activities, or for creating semi-autonomous agencies within it. In these cases, decoupling would give operating units a clearer sense of what their managerial responsibilities are, and they would be able to operate with less interference from headquarters. The old Department of Justice, for example, was a conglomerate in which various activities had little connection with one another. There was no synergy from placing them all in the same department, and some responsibilities lacked adequate attention from policymakers. Transport was another conglomerate

which benefitted from hiving off responsibility for various modes of transportation - such as air, water, and roads - into separate entities. When conglomerates are split up, management can be delayed, the lines of communication and control shortened, and responsibilities more precisely defined. The case for divestiture is even stronger when conglomerates mix together regulatory and operating functions or commercial and non-market activities.

But when a department has homogeneous or closely related operational functions and does not both regulate and deliver services, decoupling may be counterproductive. A number of respected observers have argued that separating the policy functions of the Ministry of Defence from the operational responsibility of the New Zealand Defence Forces has increased overhead and transaction costs. The two units have been compelled to build new organisational linkages, so as to provide policymakers with advice from those who command defence forces. Although I do not take a position on defence or any other organisation, in the future the government should decouple departments only after it has considered the feasibility of clarifying objectives and improving performance through internal reorganisation.

Decoupling does not necessarily separate policy and operations. Service providing units tend to "grow" their own policy capacity after they have been split off from the department. It should not be surprising, for example, that a roads authority would deem it appropriate to advise policymakers on the measures that might be taken to reduce highway fatalities, or that defence forces would want to influence decisions on New Zealand's military posture. When this occurs, splitting service provision into a separate entity may have the effect of expanding the range of advice available to Ministers. But even before the reforms were introduced, Ministers had external sources of advice and were not as captured by providers as some feared. The "Yes, Minister" syndrome pertains as much to the disregard of the Minister's preferences in carrying out decisions as in taking those decisions in the first instance. Adding channels for policy advice in operating entities may be beneficial, but the government should be mindful of the elevated running and transaction costs.

Regardless of whether it is integrated or decoupled, a department must have the capacity to provide strategic guidance to operating units. One cannot expect significant strategic thinking to bubble up from below, nor can one expect a department to thoroughly examine its direction if the top is not engaged in this activity. In fact, questioning programmes and priorities, reviewing the allocation of resources to ensure that they promote achievement of key objectives, and evaluating outcomes to determine whether progress is satisfactory and on schedule are among the key responsibilities of top departmental managers. They must assign time and other organisational resources to this work and not allow ongoing operational tasks to crowd out attention to big questions concerning the department's purpose and effectiveness. This matter is treated more fully in chapter 5.

### **Field Operations**

Most of the research for this study was conducted in Wellington; most of the operations of government are carried out in regional and field offices throughout the country. The State sector reforms have affected these operations by devolving responsibility to line managers, eliminating or curtailing regional offices, separating policy advice from service delivery, and requiring timely feedback on outputs and other indicators of performance. The reforms have given field managers considerable flexibility in spending their office budgets, but it also has made them accountable for what they do.

I urge that attention be given to the organisation and operation of these units. There can be far greater political risk to the government in the actions of field managers than in the policy decisions taken at headquarters. Field workers - especially those in outlying areas - may have a weak understanding of the logic of reform and what is expected of them. It is much easier to explain to them that they now have freedom to spend operating funds than it is to get across the message that they are accountable for what they do. The deregionalisation of departments has lengthened the organisational isolation of some field units, which may not appreciate the risks associated with their actions or know how they are to be accountable for their own performance.

While there may be strong justification for the delayering that has occurred in many departments, devolution of operating responsibility must be accompanied by clear guidance to field managers, robust training efforts to disseminate governmental and departmental policies, and effective oversight to guard against damage to the collective interest because of the ignorance of field workers. It would be appropriate to examine regional and field organisations to ensure that managers understand the logic of accountability.

It is especially important to review the role of operations of regional offices. Many have been eliminated, and staff have been reduced in most of the remaining offices. The functions of regional offices in the reformed State sector is uncertain. These offices do not provide much policy advice, and they generally do not deliver services. Most exist to manage the two-way flow of information between department headquarters and field units. They transmit department guidance to field managers and monitor compliance, and they transmit performance information from the field to headquarters. Some also provide assistance to field units. Delayering is premised on the expectation that these informational flows can be maintained via direct contact between headquarters and field offices.

Advances in information technology definitely facilitate the easy and efficient transmission of information among geographically dispersed units. But this technology may be more useful in those instances where all field units provide standardised services. When, however, the services are not uniform, it may be difficult for headquarters to monitor the performance of field units. In these circumstances, regional offices can play a positive role in assisting field managers.

In the education sector, great reliance has been placed on the capacity of community schools to manage their own operations. There is good reason to believe that some schools cannot do an adequate job on their own and would benefit from assistance provided by re-invigorated regional offices.

### **Managing from the Centre**

The role of central agencies continues to be an issue after reform, just as it was before. The three central departments - Department of the Prime Minister and Cabinet (DPMC), Treasury, and the State Services Commission (SSC) - have divested most of the central controls they previously exercised. Central agencies no longer select the accommodation to be occupied by departments, nor do they dictate the personnel or other management actions taken by departments and other entities. Despite these changes, the question of whether the centre should exert any control at all irritates relations between the central agencies and some core departments. Some department managers complain that Treasury is too powerful, others that SSC is too meddling. The chorus of complaints that decentralisation has not gone far enough leaves one wondering exactly what the role of the centre should be in managing the State sector.

I take the view that there is a continuing need for strong policy and managerial leadership from the centre. The central departments must prescribe and enforce accountability requirements, and they must deal with matters that cross departmental lines as well as with issues that individual departments cannot handle on their own. The transformed State sector has as much need for policy guidance as it had before reform and an even greater need than before to assure that matters affecting the collective interest are given due attention. Some central functions are carried out differently than they once were, and relations with line departments have changed, but it would be naïve to argue that managerial freedom is incompatible with central direction.

When the State sector reforms were introduced, some departmental managers pleaded for central guidance to assist their transition. They had to make big changes quickly and wanted detailed instructions on how to proceed. Treasury, however, issued minimal guidance and prodded departments to find their own way. Now that the reforms have been successfully implemented, some departments want to be left alone. They regard any substantive involvement by central agencies as intrusive and as an infringement of their freedom to manage. But despite the complaints, one should not lose sight of how far devolution has progressed. There is no comparison of today's central management with that practised less than a decade ago. Moreover, with greater freedom to manage comes the need for greater management of accountability processes and performance monitoring at the centre of government.

In arguing that the central departments should have a strong role in New Zealand management, I do not claim that these institutions are in perfect working order. Some adjustments should be made in these departments, but each should continue to have approximately the same sphere of responsibility. DPMC's main assignment should be strategic management and policy coordination, Treasury's financial management and policy, and advice on economic policy, and SSC's employment of chief executives and advice on the machinery of government. Because these portfolios overlap, it is important that the work of the three departments be closely coordinated. Senior officials from the three departments meet on a regular basis, and consultation among middle and lower officials is frequent and friendly. I see no advantage in formalising relationships that appear to work well on an informal basis.

#### Department of the Prime Minister and Cabinet (DPMC)

DPMC is a small department with a large responsibility. It handles the flow of papers between the Prime Minister, the Cabinet and its committees, and the departments. Cabinet generally meets weekly, with a full agenda of the documents to be considered or noted. A substantial portion of DPMC's staff resources goes into managing this paper flow, leaving in my judgment insufficient opportunity for strategic policy development. Treasury appropriately considers policy from a financial perspective, and SSC does so from an organisational and human resources view. DPMC's vital niche is to look at policy in terms of the Government's strategic interests. A modest augmentation of its staff would be appropriate, provided that the additional resources were earmarked for broad policy issues with medium term (and longer) consequences. Care would have to be taken to deter DPMC from drawing any new resources it might obtain into the deadline-sensitive chores that now dominate its workload.

In chapter 5, I urge Ministers to promote strategic planning in their departments. It would be appropriate for drafts of these plans to be reviewed by the three central agencies in the context of Strategic Result Areas (SRAs) and Key Result Areas (KRAs). DPMC would have lead responsibility for coordinating this activity and obtaining input from the Prime Minister and Cabinet. This role might be assigned to a section in DPMC, staffed by a small corps of professionals, some of whom would be seconded from other departments and possibly from nongovernmental

organisations. This staff would support departmental planning efforts and would be drawn into Cabinet Committee work when strategic issues were on the table.

In recommending an expanded policy capacity, I am mindful that DPMC's staff should continue to be small and unobtrusive. But it is important to strengthen the institution whose primary responsibility is to define the course that policy will take in the future. Inevitably, the Prime Minister's interest will have a strong bearing on how DPMC operates and what it does. A "steady as she goes" Prime Minister will deploy staff differently than might a Prime Minister seeking to reshape national policy. Nevertheless, even a Prime Minister bent on maintaining the status quo faces strategic decisions.

#### Treasury.

Treasury is a high-performance organisation that effectively leverages its power of the purse to influence a broad swath of public policies and management practices. Over a period of years, it has invested in upgrading the education and job skills of its managers and analysts, and these investments have paid off in Treasury's intellectual and organisational leadership of the reforms.

Some chief executives and senior managers have urged that Treasury take its own organisational medicine and split into two entities, one advising the government on economic and financial policy, the other managing the budget and accountability processes. I believe that both functions should continue to be operated by a unified Treasury. The government does not need a weaker Treasury; rather it needs a Treasury that is sufficiently powerful to maintain financial discipline and managerial accountability. It is highly unlikely that Treasury would be able to tender credible and defensible advice if it were not engaged on a continuing basis in operating the central financial system and overseeing the finances of departments and other entities.

Chief executives and senior departmental managers regard Treasury as the powerhouse of New Zealand government, and some feel inadequately matched against its analytical and organisational resources. But if there is an imbalance of power at the centre of government, the solution should be to strengthen the other organs - DPMC by augmenting its staff and role, and SSC by giving it a clearer focus - not to cut Treasury down to size.

It is difficult to disentangle discussion of Treasury's role from the tough stance it has taken on operating expenditure during the past decade. With support from the government, Treasury has been demanding before recommending any spending increases, even when departmental managers have thought that additional funds were justified by rising workloads. Department managers also argue that Treasury Vote analysts get involved in operational details that should be left to the discretion of the affected departments. These complaints may reflect disappointment over the allocations made in the budget rather than the process itself. Treasury has been demanding and persistent in applying downward pressure on resources; in view of the lack of objective allocation criteria - a matter discussed in chapter 6 - it probably has been somewhat arbitrary in constraining running costs. Allocational rules that do not adjust running costs for inflation, that impose across-the-board percentage cutbacks, as has been the case in several years (but not the most recent ones), or that do not take adequate account of rising workloads, may be especially onerous on small departments that have little room for manoeuvre.

Much of the abrasion in its relations with departments arises out of Treasury's role in defining output classes and in managing the process by which the government allocates resources among the various classes. These are core functions of budgeting, and there is nothing untoward in Treasury involvement. Nevertheless, many chief executives thought that Treasury had stepped over the line

several years ago in demanding access to draft purchase agreements to assist in preparing the budget. Treasury took the position that in view of the fact that appropriations are made by output classes, it should be informed on the outputs each Minister intends to purchase; chief executives argued, however, that detailed output decisions were matters between themselves and their Vote Ministers. This issue is part of a much larger question: to what extent are relations between individual Ministers and chief executives (or their departments) of interest to the government? Throughout this report I take the position that the government has a legitimate interest in these matters. It may be the "third party," but it pays the bills and bears the risks. It makes sense, therefore, for Treasury to advise the government on these matters. Fulfilling this responsibility requires that Treasury has adequate information on which to base its advice. In this case Treasury retreated and no longer asks for draft purchase agreements.

In recent years, Treasury has taken steps to clarify its relationship with departments. These year-round relationships go beyond the interactions that occur in compiling the annual budget and the supplementary estimates, and they pertain to the ongoing work and performance of each department. The relationship is specified through two instruments:

- C Core performance expectations common to all departments; and
- C An annual relationship letter setting out the matters Treasury will review in assessing a department's performance and an annual feedback letter reviewing performance on the matters specified in the relationship letter.

The core performance expectations set out the mutual obligation of Treasury and departments to maintain open and trusting channels of communication, purchase and ownership requirements of all departments, and statutory obligations. The list is quite extensive, and is revised each year to incorporate new developments.

The relationship letter is a confidential communication from Treasury to the chief executive specifying the matters to be given special attention during the year. This letter is drafted by Treasury and finalised in negotiations with the affected department. The feedback letter comments on the department's performance in those matters specified in the relationship letter. In effect, it serves as Treasury's audit on assessment of the department's performance in selected areas. A copy of the feedback letter is provided to the State Services Commissioner as input to his assessment of chief executive performance.

As part of the process of vitalising the State sector, it would be sensible to both initiate periodic reviews of Treasury-department relations, and also enhance the current relationship management system. Any change in Treasury-departmental relations should be made only (a) as part of a review of the overall budget and financial management system and (b) in ways that do not weaken the government's control of expenditure totals.

#### State Services Commission (SSC).

Few departments have been as dramatically affected by the reforms as has the SSC. The Commission is a much smaller department than it was a decade ago, and most of its responsibilities as the employing authority have been terminated. SSC has acquired a critical role in the recruitment and evaluation of chief executives, and it has expanded its machinery of government activities. Despite these and other changes, some critics argue that SSC hardly has changed at all; others characterise it as an organisation in search of a mission. I part company with those who would terminate the Commission and urge instead that it be invigorated and focused on a small number of important responsibilities.

It is widely accepted that managerial control and accountability must reside in departments and other entities where the work of government is carried on, not in central agencies. But although the rationale for withdrawing SSC's operational control is convincing, the extent to which SSC hovers over departments has been greatly exaggerated. SSC does not intervene in daily departmental business, nor does it shadow everything they do. Critics have been slow to acknowledge SSC's progress in focusing on core activities. Some traces of its old culture survive, as do some of its old responsibilities, such as those pertaining to industrial relations in the educational sector. This particular task is assigned to SSC by law, so it has no choice but to devote some resources to collective bargaining.

SSC is responsible for four output classes: policy advice on governmental management; personnel management services; industrial relations; and management services. I would curtail SSC's involvement in industrial relations and personnel management, except to the extent it pertains to the employment of chief executives and senior managers or to broad management issues.

SSC is the appropriate institutional home for two important responsibilities that have to be discharged at the centre. One is to provide advice on the machinery of government; the other is to manage the employment of chief executives. Ministers and chief executives are responsible for the performance of their departments, but they are not well deployed to deal with general issues affecting all departments. SSC does and should continue to provide guidance on government-wide issues. The list of current issues on which its advice would be appropriate is quite long: developing concepts and techniques for specifying outputs and outcomes and for measuring performance; reviewing performance and purchase agreements and recommending government-wide standards; studying the potential impact of MMP on government; recommending changes in the structure or operations of certain departments; evaluating the EEO/good employer performance of departments; assessing the governance and management arrangements for Crown entities. Some of these matters also are considered by Treasury in the course of managing public finance, but the government needs advice that is not framed only by a financial perspective.

The second SSC role has irked some chief executives. SSC is the hub of the process by which chief executives are recruited, employed, and evaluated. Quite a few chief executives have argued that their performance should be the Minister's concern, not SSC's. In their view, if the Minister is satisfied with their performance, that should be sufficient. I argued earlier, however, that the government also is a party to this relationship. SSC represents the collective interest in negotiating terms of employment with chief executives and evaluating their performance. Perhaps SSC should limit its involvement in other personnel matters. But in view of concern over the future supply of senior managers it probably will have to be involved in this matter as well.

I argue in chapter 4 that the chief executive's performance should be evaluated in the light of the department's performance. This means that SSC must have sufficient resources, including information, to evaluate how well departments are doing. A full-blown review of each department's performance should be conducted at least once during the chief executive's term; these reviews should feed into decisions on reappointing chief executives. But SSC also must assess chief executive performance each year, and this responsibility has nudged it to monitor departmental operations somewhat more closely than chief executives would like.

SSC has taken steps to regularise its monitoring and assessment of departmental performance. It issues a standard letter to all departments outlining its performance expectations for the year ahead. The current version of the letter concentrates on progress in achieving departmental KRAs (especially those related to the ownership interest), matters affecting the collective interest, human

resource management, and systems of management control. SSC also issues a statement of principles and protocols governing the relationship between it and departments.

Focusing on core responsibilities should allow some shrinkage and reallocation of staff. SSC should be cautious in taking on new assignments, especially those pertaining to the internal management of particular departments. It must be available, of course, for trouble-shooting assignments, but it should remain focused on core activities.

### **Crown Entities: Balancing Independence and Risk**

Major functions of New Zealand government, particularly in the health and education sectors but also in transport, economic development, and scientific research, are carried out by Crown entities rather than by departments. In contrast to departments, which are directly responsible to Ministers, Crown entities are owned by the Crown but are legally separate. The status of each entity is spelled out in legislation that specifies its functions and governance. The typical arrangement provides for a board (appointed by the Responsible Minister) that appoints the chief executive and has powers similar to those held by the boards of private enterprises.

The Public Finance Act (PFA) defines the minimum level of reporting that each Crown entity must provide to Parliament. All Crown entities (listed on the 4th schedule of the PFA) must provide a set of audited annual financial statements. Those Crown entities from which the Minister also purchases services (listed on the 5th schedule) must also provide a statement of service performance that sets out the services actually supplied as compared with specifications established at the start of the year. Those Crown entities presenting a significant ownership interest or purchase contracting risk (listed on the 6th schedule), must prepare a statement of intent at the start of each financial year that includes information on the objectives of the Crown entity, the nature and scope of activities, performance targets and measures against which the entity can be judged, accounting policies, and other matters as appropriate. Additional reporting or accountability requirements may be outlined in each entity's enabling legislation, or trust deed if it is a trust. Each Crown entity must also submit an audited annual report including financial statements and comparisons of financial and service performance against the targets set in the statement of intent.

There are presently more than 2,700 Crown entities, including 2,600 school boards of trustees, 23 Crown health enterprises, 4 regional health authorities, 21 business development boards, and various other bodies. Collectively, Crown entities spend approximately two-thirds of the resources budgeted for the operation of New Zealand government and one-third of total Crown expenses. These monies are made available to Crown entities through funding agreements or similar arrangements negotiated with the Vote Minister. Some Crown entities also derive substantial revenue from user charges or commercial activities.

The Crown entities are a diverse lot and have been established for a variety of reasons. Some (such as those in transport) were established pursuant to the separation of operations from policy; some (such as the school boards) were established to give parents and other stakeholders a stronger voice in deciding the services to be provided; some (such as the regional health authorities) serve as purchasing agents for the government; some (such as the Crown health enterprises) are suppliers of services. At least one (the Law Commission) provides independent policy advice; another (the Lotteries Grants Board) is a transfer agent. These examples show that Crown entities are a catch-all category for the many institutions that are neither departments nor State-owned enterprises. Although they share a common label, the Crown entities are not homogeneous in either form or function.

Thoughtful consideration has been given by Treasury and others to the possibility of developing principles to determine whether a particular institution should be accorded Crown entity status. What is lacking, some have argued, is a theory of organisational design that would promote consistency in structuring public institutions. But in view of the variety of Crown entities, it is unlikely that available theoretical tools would provide a sufficient basis for selecting among alternative institutional arrangements. A report commissioned by SSC has recommended a number of criteria for designing Crown entities (*Crown Entities: Categories and Principles*; McKinlay Douglas Limited, 1994). The primary recommendation is that each entity be single purpose: regulatory, policy, and purchase functions should not be commingled. The report also suggested that an institution would be suitable for Crown entity status to the extent that (1) the output to be contracted for could be specified and measured; (2) giving the entity independence would diminish the risk held by the government; (3) independence and objectivity were important; (4) the government needed specialised expertise; (5) it wanted to enhance stakeholder input; (6) outputs or services were contestable; and (7) the cost of transitioning to Crown entity status was modest.

In view of the wide disparities in the types and functions of these entities, it may be of little value to seek consistency in design. A more productive approach may be to examine, on a case by case basis, the effects rather than the causes of conferring Crown entity status. The most important effect is that public risk and public expenditure are separated. The government holds the risk, and Crown entities spend much of the money. In designing institutions, the government must balance its financial and political risk against the value of giving the entity legal independence. Even when the entity is independent, the government still may be liable in case of negligence or default, and it may bear political onus for perceived inadequacies in services. When the government owns the Crown entity, supplies all or most of its capital and operating funds, and makes most of the key policies, it cannot escape responsibility by claiming that the entity is independent.

I previously argued that in separating policy from operations, it should not be presumed that the new agency will be a Crown entity. The government may be best served by a variety of organisational forms including Crown-owned companies that operate in contestable markets, Crown entities that are financed by public funds, and other types of non-departmental bodies and executive agencies that have operating flexibility but not legal independence. The last is the route favoured in the United Kingdom's Next Steps initiative. If the United Kingdom system were adopted, the chief executive of each such agency would be appointed by the Responsible Minister or the government, not by a governing board. The Minister would negotiate an understanding with the chief executive, setting forth the managerial flexibilities that the agency would be given. The Minister would take the initiative in establishing financial and service targets for the agency and would assess its performance against the targets. This assessment would enable the Minister to fine tune the agency's operating discretion to its managerial capability. The Minister and the agency would negotiate an annual funding agreement that would specify the resources to be provided and work to be done. Each agency would prepare an annual report including financial statements.

Executive agencies would give the government an additional option in designing institutions. In some cases, it may opt for the independence afforded Crown entities, but in others it may prefer the executive agency model or some other arrangement.

Balancing risk and independence also entails review of the accountability framework within which Crown entities operate. Although they are not subject to the same requirements as are imposed on departments, Crown entities are accountable for their finances and performance. In addition to the statement of intent and annual report which are tabled in Parliament, some Crown entities negotiate funding or purchasing agreements with the Minister setting forth the performance expectations and

conditions under which it will operate during the year. The Cabinet decided in 1992 that each Crown entity must enter into a purchase agreement with the Minister, but this was not applied until recently. All non-departmental suppliers, including private sector suppliers, must now have a purchase agreement with the Minister. Some Ministers issue formal policy guidelines announcing the priorities to be followed by the Crown entities under their purview. Some Crown entities are closely monitored by the relevant department to ensure that public funds are well spent and that the government's policies and objectives are carried out. Monitoring is especially rigorous in health and education, the two largest sectors in which Crown entities operate. The Education Review Office audits the management and service performance of community schools, the Ministry of Health monitors the performance of the regional health authorities, and the Crown Company Monitoring Advisory Unit and the Treasury monitor the performance of Crown health enterprises. The extensive accountability requirements arise out of the need to manage risk while giving the entities legal and operational independence. Striking this balance entails substantially higher transaction costs than would be incurred by comparable entities operating within departments.

Despite the vast accountability apparatus, the operations and finances of Crown entities are not as transparent as they should be. In the course of the year, an enormous amount of data is generated on the past performance of Crown entities and expectations for the future. However, very little of the data is reported in the budget and related documents. These documents contain estimates of appropriations for each output class, but they do not indicate the volume of services to be provided or priorities to be emphasised in the financial year to which they pertain. The inadequacy of performance information affects the entire budget, but the problem may be even more severe when Crown entities are the end spenders of public funds.

The format and contents of the Estimates have been revised almost every year since the reforms were introduced. The overall trend has been to make the Estimates more accessible and the cost of government programmes more transparent. The clumsy and confusing POBOCS (Payments on Behalf of the Crown) category has been discarded, and the Estimates now distinguish between departmental and non-departmental output classes. But in the case of Crown entities, the current format still fails to provide a clear and comprehensive account of where the money is going and what it will buy. Crown health enterprises (CHEs) illustrate the deficiencies in the budgetary treatment of Crown entities. Reading the budget documents, one would not know that almost all hospital services used by New Zealanders are provided by the CHEs. The Estimates do have a separate Vote for the CHEs, but it only covers capital contributions to these enterprises and the cost of providing policy advice by a specialised unit in Treasury. No mention is made in the explanation of this Vote that the bulk of financial resources are provided via the Health Vote. The estimates pertaining to this Vote do not even mention the CHEs, but they do indicate that approximately \$4 billion is to be provided to the regional health authorities.

Transparency is one of the values promoted by the reforms enacted during the past decade. By this measure, the estimates and other budget documents fall far short of the mark with respect to some Crown entities. It is just about impossible to get a full picture of what particular Crown entities are doing or spending. The budget documents should be formatted to provide more information on those Crown entities that are the end users of public funds.

But the issue of Crown entities goes beyond the form of the budget to the substance of Government policy. Crown entities lengthen the chain of accountability from policies made by Government at one end of the chain to the delivery of services at the other end. The longer the chain - it has more links in the Health Sector than in any other - the weaker the Government's confidence that the

priorities it establishes will be fully reflected in the services provided. Solving this problem may require fundamental changes in the status, funding, and management of some Crown entities.

### **Conclusion**

The ideas and recommendations set forth in this chapter would modify the structure of the State sector. But the basic architecture would remain intact. Whether the proposed changes improve public management will depend more on the manner in which departments and other entities are managed than on the organisational boxes into which they are arranged. The next chapter considers the managerial capacity of government departments and entities.

## IV. Organisational Capacity

The structure of public institutions is important because it affects the performance of government. But designing the right organisation is only one element of governmental effectiveness; managing the departments is another.

Government departments and other public organisations are entities in which money, people, legal authority, and other resources are concentrated. The basic responsibility of managers is to organise and use these resources in ways that enhance the organisation's performance. Management is the value added through leadership, strategic guidance, the skilful use of physical and human resources, the mobilisation of outside support and the maintenance of organisational morale, the prudent investment of capital and other resources to ensure the organisation's continuing effectiveness, and the strength and willingness to change what the organisation does and how it goes about its work. An effective manager makes a difference by shaping the organisation to his or her will. Strong managers are leaders who monitor the outside environment, identify changes in demands on the organisation and in the opportunities they face, and make appropriate adjustments in policies and operations. Managers put their stamp on the organisation by giving it a sense of purpose and direction and by creating a collective capacity that is greater than that of the individuals who work in it. These managers often confront an organisational culture which, if not challenged, can limit their effectiveness.

The New Zealand reforms are utterly dependent on robust, entrepreneurial, risk-taking managers. At every turn, the reforms are built on the expectation that empowered managers will take initiative in revamping operations, reallocating resources, and pointing the organisation in new directions. Further, top managers will actively recruit others who are willing and able to take charge and will shed workers who shirk responsibility or are unproductive. Without strong management, New Zealand departments would be about the same after reform as they were before, but with high transaction costs and greater risk to the government. With capable leadership, departments should be poised to efficiently perform today's responsibilities while preparing for tomorrow's as well.

The State Sector Act reflects the importance accorded effective management by providing for chief executives the broad authority to run their organisations. Precisely because it relies on managers to lead, the Act hardly says anything about how departments are to be operated; instead, it leaves these matters to the discretion of the chief executives, who are given authority to recruit senior and middle managers, use appropriated funds and organise operations to produce agreed outputs, decide on the mix of inputs, and report on what they have accomplished.

Arguably, the New Zealand model places undue reliance on the performance of chief executives. After all, even in a pool of highly talented and motivated persons, some chief executives will seek to uproot the inherited organisational culture, while others will accommodate to it; some will impose a strategic perspective on the departments, while others will see themselves principally as the producers of current outputs; some will have the drive to purge low performers, while others will tolerate less-than-the best workers. It is essential, therefore, that assessment of the performance of chief executives and other managers be rigorous. Otherwise the New Zealand reforms would be a prescription for unevenness in organisational performance.

But the role of the chief executive is not the whole story in organisational capacity. Other elements include the organisation's culture, the strategic direction given it by the government and its Responsible Minister, attention to the government's ownership and collective interests, and internal

management controls. In fact, many of the elements of New Zealand reform, and most of the issues discussed in subsequent chapters of this report, pertain to the question of how well departments are prepared for the tasks expected of them - now and in the future. This chapter considers organisational capacity from the perspective of the government and the Responsible Ministers who represent its ownership interest. As owner, the government monitors the capabilities and performance of the departments. These ownership responsibilities are considered in the present chapter. Others pertaining to strategic direction, financial resources, and accountability are reviewed in subsequent chapters.

### **The Minister's Responsibility**

Each department has a Responsible Minister who is custodian of the government's ownership interest. When more than one Minister purchases output from the department, the Responsible Minister is the one with the greatest stake in its performance. The Responsible Minister thus has both a purchase and ownership interest. Ownership can be measured in terms of an organisation's capacity to perform the tasks set for it. This encompasses both the production of current output and the performance of what might be expected of it in the future. Ownership also encompasses the government's collective interest, to which departments contribute.

From the outset, New Zealand reform has accepted that although management actions may entail considerable political risk, Ministers should not be drawn into the day-to-day operations of the departments. Their responsibility reaches to policy guidance, the provision of resources, monitoring performance, and enforcing accountability. Responsible Ministers steer departments by (1) participating in selecting chief executives and in overseeing their performance, (2) developing strategic objectives and policies; (3) negotiating annual agreements for the chief executive's performance, including the key result areas; (4) allocating appropriated funds for the purchase of outputs; and (5) taking responsibility for the overall capacity of the department.

The dual roles of Minister and chief executive sometimes make it difficult to define precisely where one's responsibility ends and the other's begins. This has been a concern since the start, but it becomes especially pertinent when there is serious deficiency in the department's performance. The conceptual distinctions drawn by the reform are amply clear on paper, but break down in practice. In design, the Minister is accountable to Parliament, and the chief executive is accountable to the Minister; the Minister is responsible for policy, the chief executive for operations; the Minister is accountable for outcomes, the chief executive for outputs. In practice, distinctions get blurred, for some operational shortcomings may result from policy mistakes, and some policy failures may derive from operational defects. Who is responsible, for example, when policies do not produce expected outcomes: the Minister who made the purchase decisions, or the chief executive who provided the policy advice and produced the services?

Fuzziness is inherent in an arrangement that assigns political risk to the Minister and managerial discretion to the chief executive. The solution recommended by the reforms - that the Minister should be a demanding evaluator of the chief executive's performance - does not resolve the dilemma, for the Minister's review cannot possibly consider all aspects of the department's performance. Perhaps the division of responsibility will be clarified over time by the evolution of departments into entities that truly have an arms length relationship from the Minister, as agencies have in Sweden. But as long as both the Minister and the chief executive have their hands on the rudder, one or both may be called to account, even when one has limited control over the other's actions. What should not be acceptable, however, are situations where the two sides point the finger of blame at one another and responsibility falls between the cracks.

In this fuzzy relationship, it would be appropriate to clarify, to the degree feasible, the Minister's responsibility as regards the department. Although the reforms recognise Ministers as both purchasers of departmental outputs and owners of the organisations, the former role predominates. The Minister's responsibility as purchaser is reflected in the prominence accorded the annual purchase agreement; no comparable document or process covers ownership. Annual performance agreements now have a standard annex that references the "Government's collective ownership interest," but this section does not have the same stature or detail as the purchase agreement.

The purchase and ownership roles pull the Responsible Minister in opposite directions. As purchaser, the Minister should be at arm's length from the department; as owner, the Minister must take a proprietary interest in the department. Ownership inevitably recedes in the face of the short-term influence garnered by allocating resources and contracting for the next year's outputs. A Gresham's Law is in effect: purchase drives out ownership.

It is important that ownership be given greater scope, even at the risk of making the Minister a somewhat less independent purchaser of outputs. Of course, Ministers should drive hard bargains to ensure that the government is getting value for money and that the services provided by the departments are those they contracted for. But Ministers must also be mindful of the organisational strength of their departments; they should be institution builders, and they should forbear from demanding so much by way of outputs and from pushing the purchase price down so far as to jeopardise the department's long-term capacity to perform. For example, a low purchase price or excessive work demands might deter the department from investing in the training of employees or in upgrading management control systems. When (as typically is the case) outputs are not truly contestable and there is no market or benchmark price for determining the adequacy of the department's budget, the Minister must take an interest in whether sufficient funds are available for training, systems improvements, and other determinants of departmental capacity.

Ministers should behave in this manner because as much as they can influence departments via purchase, they have the capacity to be vastly more influential by building the capacity of their departments and steering them in new directions. Ministers should see departments as their most valuable resource for accomplishing the purposes of government and for implementing their strategic vision. A Minister without effective control of organisational resources is like a general without an army, free to set out on any course but not likely to get very far. How the Minister exercises his/her ownership responsibilities will determine whether a department's plans are hollow statements or genuine objectives. A Minister is more effectively empowered by having a robust department than by having the option to contract for outside advice and other services. The ideal of contestability notwithstanding, Ministers obtain most of their outputs from the departments and Crown entities they own, and they will continue to do so for the foreseeable future.

Separated from departmental resources, most Ministers are weak policymakers, despite their nominal control of appropriated funds and their contracting powers. Most have only a few aides who assist on Cabinet and Parliamentary work and typically spend little time on departmental matters. A small, growing number of Ministers retain advisers to assist them in negotiating the annual purchase agreements. Some of these advisers serve their Minister year round on departmental matters. Some Ministers have gone outside their departments for policy advice and other outputs. Even with those outside resources, Ministers depend on departments to get the job done.

The elements of ownership.

Ownership is not represented by the capacity of the department to produce this (or the next) year's contracted outputs, but in the outputs that may be wanted in the future. In assessing ownership, the important questions relate to the future capacity of the department. Does it have the skills, resources and initiative to change as the market for its goods and services changes? Is it enhancing the morale and skills of its staff so that the department will have a cadre of motivated and capable workers? Does it have the strength and vision to look beyond the near term to the different organisation it may become in the future? Is it making the right investments in physical and human capital to prepare for the tasks it may face in the medium term and beyond?

These questions point to strategic and managerial dimensions of ownership that cannot be expressed solely in financial statements. However, the initial formulations of ownership concentrated on financial condition. Thus, a 1990 Treasury memo averred that the government's primary interest as owner is to achieve satisfactory financial performance. The memo barely mentioned other elements of ownership, such as management practices.

Financial condition is not a sufficient measure of the government's ownership interest. Even in business, ownership is not measured exclusively in terms of net financial worth. If it were, shares in public corporations would trade at book value. Often, however, they trade above book value, reflecting the value added by goodwill, management capacity, expected future performance, and other intangibles. Of course, no convenient metric such as share price is available for evaluating the government's stake in its departments. One might try to assess ownership in terms of a department's skill base, employee morale, managerial systems, and expected future outputs. But I am not confident that measuring ownership this way will be of much use. This type of assessment is difficult to make and does not often lead to corrective action.

A more promising approach might be to identify the elements of ownership and consider the resources needed for each. A significant step in this direction was taken by the Interdepartmental Working Group on Ownership. Its June 1995 report, aptly titled "Taking Care of Tomorrow, Today," takes a broad view of ownership. "The Government's purpose in owning departments is to achieve its social and economic objectives, in a manner reflecting the value and ethos of good government and the requirements of public accountability . . ." (p. 2). The group distinguished four elements of ownership, two pertaining to an organisation's productive capacity, one to its strategic direction, and a fourth to its accountability. The four elements are: aligning the government's strategic objectives and those of its departments, and ensuring the congruence of goals within and between departments; ensuring the integrity of the Public Service, so that departments act in a legal and ethical manner; ensuring that departments can deliver on expected future demands; and ensuring their capacity to produce future outputs efficiently.

In my view, improvement is needed in at least two of these areas. I will argue in later chapters for strengthening managerial accountability and for reviewing the adequacy of departmental resources. These concerns lead me to suggest three possible steps to bolster the government's ownership interest: (1) a realignment of Ministerial portfolios and departmental jurisdictions; (2) more detailed specification of ownership issues in performance agreements; and (3) examination of expenditure on critical inputs.

My first suggestion is that the relationship between departments and Ministers should be simplified. At present, some departments "sell" their outputs to more than one Minister. One department has purchase agreements with half a dozen Ministers; others may have similar arrangements. Although chief executives indicate that multiple purchase relationships have not impaired managerial

flexibility or made departmental operations unduly complex, these arrangements may weaken the Responsible Minister's interest as owner. It may be difficult for the Responsible Minister to take a strategic interest in a department or be concerned about its capacity when she/he has only a small stake in its output. In some cases, the Responsible Minister may be responsible in name only. To be truly responsible, the Minister must be able to shape the department's future direction. If this direction is determined by purchase relationships, the influence of the Responsible Minister may be weakened. Although it may be appropriate for some departments to maintain multiple purchase relationships, these should be fewer than are presently maintained. Achieving this objective may require that some departmental jurisdictions be redrawn or that the structure of Votes be realigned.

Second, the standard performance agreement incorporates the government's collective ownership interest through an annex to the agreement issued by the State Services Commissioner. This annex sets forth government-wide requirements for internal control, human resources management, financial management, and other practices. These "boilerplate" references may not be sufficiently targeted to spur corrective action or to enable SSC or the Responsible Minister to assess progress in remedying deficiencies. I regard it as sensible for the performance agreement to set forth the improvements or actions to be undertaken by the chief executive during the year. For example, if a department's Equal Employment Opportunity (EEO) process or management controls were judged to be deficient, the chief executive would have to agree on the specific actions to be taken. The Responsible Minister and the central agencies would then be able to hold the chief executive accountable for taking specific corrective actions.

Third, the Responsible Minister should be given certain information by the chief executive on the inputs used by the department. Clearly, Purchase Ministers have no legitimate interest in the inputs used to produce agreed outputs. Arguably, however, the Responsible Minister does have an interest in those inputs that affect the department's future capacity, such as expenditure on training and information systems. I offer this suggestion with some hesitation, because extending Ministerial interest to these inputs runs counter to the managerial logic of the reforms. Nevertheless, Responsible Ministers may be unable to independently assess their department's capacity without knowing how much is spent on certain critical inputs. Accordingly, the chief executive should inform the Minister on human resource development, including recruitment, staff turnover, morale, as well as other investments affecting the ownership interest.

#### The collective interest.

An important feature of ownership is the government's interest that departments act in ways that are congruent with its collective interest. In the five years since the 1991 Review of the State Sector Reforms (the Logan Report) aired this issue, significant steps have been taken to bolster the government's capacity for coherent action. These include the development of strategic and key result areas. Nevertheless, concern persists that chief executives are so beholden to Ministers, and managers to chief executives, that they are not sufficiently attentive to broader governmental interests.

This concern is not shared by the Ministers and chief executives interviewed for this report. Nor do I consider it a major problem. I believe that formal procedures and informal networks have made chief executives and their departments supportive of government objectives and priorities. These executives and senior managers generally see themselves as contributing to the government's strategic and operational interests, not only to those of their own department.

Collective responsibility is promoted by the Cabinet, which provides guidance on government-wide matters as well as on matters affecting individual departments. There is a continuing flow of information and advice within Cabinet and among departments and between departments and the central agencies. The government's capacity to allocate resources in accord with its priorities has been enhanced by the SRAs and KRAs. These "result" statements and indicators have encouraged a more integrated approach to policymaking and programme management and have become the backbone of the annual performance agreements. The three central agencies also promote policy consistency and integration, as discussed in the previous chapter.

Formal policy coordination is reinforced by networks that make for more cohesion and cross-fertilisation than is found in most countries. New Zealand's small size and Wellington's village atmosphere foster the rapid diffusion of information and ideas. News travels fast, and managers have a lively interest in what is happening elsewhere in government. New Zealand is not a country in which public managers work in isolation. Interdepartmental work is valued; chief executives and senior managers do not shirk this responsibility, nor do they regard it as unproductive or unrelated to their own departmental interests. In addition to the various task forces and working groups on which many serve, the chief executives meet regularly to discuss current issues.

In collective matters, as in all other aspects of public management, those authorised to act must be held accountable for what they do. When it occurs, disregard of the collective interest should weigh heavily in assessing the performance of chief executives. But there is as yet little basis for regarding this as a serious or widespread problem.

### **The Chief Executive: Superperson as Manager**

Chief executives have been given virtual *carte blanche* to run their departments. New Zealand chief executives must do certain things that career managers in the Public Service generally have not been accustomed to doing. They must weed out weak managers, shed redundant workers, reexamine or sever long-standing relationships with suppliers, actively recruit from outside the Public Service, negotiate the wages of senior managers, revamp operations, abandon low-priority activities, manage their assets, commit in advance to output and cost levels, take responsibility for the volume and quality of services, negotiate employment, purchase and performance agreements, respond to numerous inquiries from Parliamentary committees and central agencies, represent the department to the media and public, be responsive to the Minister, and more. They must drive the department to be more efficient, productive, and responsive. They must act as if their own job is on the line and their own money is being spent. They must treat agreements on outputs and other aspects of performance as firm commitments, not just as plans. They must take personal - and organisational - responsibility for how well the department is doing. In sum, they must be accountable for what they have promised and for what they have done.

The State Sector Act establishes a trilateral process for appointing chief executives. It provides for the State Services Commissioner to "appoint chief executives of departments and to negotiate conditions of employment," and for the relevant "Minister to inform the Commission of any matters that the Minister wishes the Commission to take into account." The actual involvement of the Minister varies from case to case, but the principle is accepted that a candidate should not be appointed against the objection of the Minister and that a chief executive who has lost the confidence of the Minister should not remain in the post. The Minister cannot unilaterally decide to appoint or remove a chief executive, but the Governor-General in Council (in practice, the Cabinet) can unilaterally decide to appoint a chief executive. The Minister does negotiate an annual

performance agreement that emphasises the key results the chief executive is accountable for. Performance under this agreement typically is reviewed in quarterly reports to, and meetings with, the Minister.

The appointment process and periodic assessments are the principal formal means by which the Minister obtains assurance concerning the chief executive's stewardship of the department. There may be informal means as well, for a chief executive is expected to be responsive to the Minister's demands for information and advice. In interviews, chief executives indicated satisfaction with these arrangements, but some are troubled by what they regard as SSC's intrusion into the relationship. Some see no need for SSC assessments when they already are subject to review by the Minister, and others wonder whether the employment contract should be negotiated with the Minister rather than with the State Services Commissioner. There may be some justification to these complaints, for the arrangement does make it possible for a chief executive to be pulled in one direction by the Minister and in another by SSC. But this trilateral relationship is preferable, in my judgment, to one in which SSC was excluded and the collective interest was thereby weakened. Responsibility to the Minister should not detract from the equally fundamental principle that the chief executive also is responsible for carrying out broad governmental policies and for coordinating the work of the department with related activities conducted by other entities. The trilateral relationship denotes that the performance of chief executives and departments is a legitimate interest of the government.

During the past eight years, New Zealand has had some outstanding chief executives and many very good ones. These have left a positive imprint on the departments they have led. It also has had a few weak leaders who have been reluctant to make the hard choices needed to whip their departments into shape. Chief executives have differed in their operating styles; some have aggressively challenged the status quo, others have preferred a more cautious approach. Some have had a high profile and have actively projected their department onto public attention, others have looked inward and have attracted little public notice for themselves or their department. Arguably, the departments showing the most dramatic improvement have been led by chief executives who have welcomed the opportunity to uproot established practices and habits. Rather than taking the organisational culture as fixed and unalterable, they have sought to recreate the department on an entirely new basis. It would be foolhardy to judge the effectiveness of chief executives in terms of their ability to stir things up or to draw attention to themselves. Unfortunately, in New Zealand's court of public opinion, this sometimes is the basis on which chief executives are sized up by their peers and others.

Fortunately, this is not the process used by the State Services Commissioner in carrying out that position's statutory responsibility to review the performance of chief executives. The process is demanding and time consuming; it takes place every year, not only when term appointments are about to expire. The recruitment process has more than forty steps; reappointment has almost as many. It is for good reason that a separate branch handles the Commission's many activities in this area.

The performance of chief executives is evaluated on the basis of three fundamental accountability principles: (1) the chief executive should be personally responsible for the department's performance; (2) performance expectations should be specified in advance; and (3) actual performance should be compared to the ex ante targets. These principles require that performance expectations be sufficiently defined to permit results to be measured against them. The ex ante specification is contained in the performance agreement between the Responsible Minister and the chief executive. This accountability regime does not preclude a broader review covering matters

not specified in the agreement. In fact the chief executive must be accountable for all departmental operations, including those she/he are not directly involved in. But for the system to work as intended, the assessment must give weight to those elements of performance specified in advance.

The form and content of the performance agreements are now standard across departments. In the first years of the process, fewer than half of the chief executives had completed agreements. Pursuant to a 1992 Cabinet edict, all now have annual agreements. The current practice is to structure the agreements around the SRAs and KRAs. The standard agreement begins with a list of the relevant SRAs, after which it specifies the key results for which the chief executive will be responsible during the next year (in some cases, the following two years as well). The text makes clear that the chief executive accepts personal responsibility for each of the results set forth in the agreement. The chief executive also pledges to produce the outputs contracted for in the purchase agreement and to uphold collective ownership responsibilities.

Most chief executives welcome the KRAs as a positive development because they now have a much clearer picture of what is expected of them. Not only are the KRAs highlighted in the performance agreements, they also are prominent in assessing the performance of chief executives. In fact, many chief executives prepare quarterly and annual checklists of progress in implementing the KRAs and producing the agreed outputs. These checklists are a convenient means of indicating that some progress has been made or that the objective has been met.

This pattern of behaviour may be a mixed blessing. On the positive side, it indicates that chief executives take their performance agreements seriously; they do not regard the agreements as scraps of paper that can be ignored without penalty. Many chief executives use the performance agreements as road maps for plotting the departments' work and measuring progress. On the negative side, however, the road may be a bit narrow, for chief executives now have a strong incentive to go by the book and ignore promising detours. This checklist behaviour affects the entire range of accountability requirements, and is the subject of further discussion in chapter 7.

The State Sector Act conceives of chief executives as strong managers who have full responsibility for departmental operations. The performance agreements impel them to narrow their perspective to those activities that give evidence of achieving the KRAs and outputs. Broader aspects of management - leadership, strategic perspective, interpersonal skills, organisation-building, investments that have long-term payoffs, innovation and risk taking - are ownership qualities that may be undervalued by the performance agreements and the assessments made pursuant to them.

The temptation to "manage by the agreement" is reinforced by the demanding assessment process. The annual review takes up to six months, meaning that one year's assessment follows on the heels of the last. Current procedure assigns the burden of proof on chief executives to document (or certify) that they have met the requirements of the purchase and performance agreements. Chief executives also have to compose a self-assessment, which is supplemented by assessments from relevant Ministers, the central agencies, and outside referees. The Prime Minister also may offer an assessment. The cost of operating this process is substantial not only in financial terms, but also in terms of the attention given it by the State Services Commissioner and the chief executives. Not the least of the benefits of a reduction in the number of departments would be lower transaction and human costs.

I regard both types of evaluation as necessary, but both need not be conducted every year. A strong case can be made for an annual review of performance in terms of KRAs and outputs - after all, these are commitments agreed by the chief executive. But it would be impractical to

comprehensively evaluate leadership and other vital elements of managerial performance each year. It may be more sensible to have a basic accountability review (focusing on KRAs and outputs) after each of the first two years (assuming an initial five-year term) and an in-depth evaluation after the third year, and possibly after the fifth year as well. The full assessment would go beyond the measurable targets and milestones to consideration of the chief executive's performance in leading the department in light of the government's ownership interest. SSC would need flexibility to adjust this schedule to different situations. The in-depth review might be accelerated if the Commission were concerned about subpar performance, or it might be waived if the chief executive gave notice of early retirement. Many permutations are possible; it should not be difficult to devise flexible rules.

Some observers have suggested that progress in reforming New Zealand government has been uneven, because SSC has not been sufficiently demanding in reviewing the performance of chief executives and has been reluctant to dismiss weak performers or to use pay differentials to reward strong managers and penalise weak ones. The problem, however, may not lie with the Commission but with the system for appointing and remunerating chief executives. In private firms, the chief executive typically has an indefinite term and continues in the post until she/he retires, voluntarily leaves, or loses the confidence of the board. In New Zealand government, by contrast, the chief executive has a fixed term, and a decision must be taken near the end of the term to continue or replace the incumbent. This arrangement places a great deal of pressure on the State Services Commissioner, especially in the case of middling performers who may have done well enough for a full term but do not merit reappointment. In these circumstances, formal evaluation may be a rigid tool that forces the Commissioner to point the finger of blame at executives who, while competent, may not have done all they could to reshape the department. Perhaps a less formal process, in which the Commissioner quietly encourages such persons to depart without putting them through the wringer of public review, would yield better results. It would be easier for the Commissioner to act in this manner if chief executive terms were indefinite, but I see no prospect of shifting to such an arrangement, for it would be seen as a return to the discredited system of permanent heads. Nevertheless, SSC should consider the feasibility of more flexible terms than the current system allows.

It is unrealistic to expect SSC to approve large pay differentials in response to differences in chief executive performance. The Commission is likely to be constrained for the foreseeable future by both government policy and public opinion in its ability to award superior performers with substantial pay increments, though bonuses may be more acceptable. In practice, pay differentials tend to correlate more with departmental size than with performance.

Because of the high turnover in chief executive posts and the complex appointment and evaluation procedures, the "chief executive system" is rigid and costly. It is highly desirable that the Commission explore means of making the process more flexible so that the New Zealand government can continue to recruit, motivate, and retain a corps of talented chief executives.

### **Senior Executives: A Community of Individuals**

Recruiting able and motivated senior managers is one of the most important responsibilities of the chief executive, especially in the large, diversified departments. Many senior managers are civil servants who have moved up the ranks; others are persons brought into government from the private sector in mid career. New Zealand has an interesting blend of both types: those who bring institutional memory to public management, and those who bring business management practices into government. Thus far, departments have had little difficulty recruiting skilled managers, but

high unemployment during the early years of reform, a large pool of experienced managers trained in the old system, and the excitement of working in a new regime have ensured an ample supply of qualified candidates. Whether they will be as successful under other conditions remains to be seen.

There is good reason to expect that public employment will increasingly resemble the structure of the private work force, with more temporary, part-time and seasonal employees, and with more persons moving in and out of government. This trend is being driven by the Employment Contracts Act 1991 (which terminated most differences in the conditions of public and private employment), the fragmentation of the Public Service, and State sector reforms that have put government operations on a more commercial basis. It certainly is easier than in the past to make mid career moves between the public and private sectors. This mobility has a number of consequences, one of which is that government departments may sense less need to develop their own managers from within and more opportunity to purchase personal services in the marketplace. If this attitude spreads, the services provided by employees may come to be regarded as a commodity that can be purchased as needed.

This attitude may have been a contributing factor in the unsuccessful effort to launch a Senior Executive Service (SES). The State Sector Act envisioned the SES as a pool of management talent, an incentive for developing management careers in the Public Service, and as "a unifying force at the most senior levels of the Public Service." In fact, however, senior managers saw SES as a constraint on their pay and work opportunities. Many believed they could get a better deal in individual employment contracts than would have been possible under SES.

Despite the failure, the objectives of SES are as valid today as when the State Sector Act was written. The SES can be an effective means of signalling to selected managers that they can expect to advance in the Public Service, perhaps to the very top of departments. A viable SES would also encourage mobility among departments, enhance training opportunities, and provide recognition among peers. It would be worthwhile for SSC to reopen the SES question and to consider more flexible arrangements than those devised in the past.

Regardless of the disposition of SES, consideration should be given to the overall supply of senior managers. These managers typically are employed under individual contracts that run for up to five years. The contracts can be renewed, but in view of the turnover of chief executives and the age of many senior managers, these often function as terminal appointments. In meeting with senior executives, I encountered considerable anxiety over their future in the Public Service. As they near the end of term appointments, senior managers must decide whether to continue (if the option were open) under a new chief executive or to start a new career outside government. Many have moved into consultancies where their skills can still be made available to departments on a contract basis. I am not sure that this has been a passing phenomenon. A career manager above the age of forty-five or fifty may see more rewards and fewer unknowns outside government.

Reviving SES might facilitate a solution to this predicament, for it would enable senior managers to return to an SES pool at the expiration of term contracts. Within the pool, these managers could seek new employment in the public sector or serve as short-term consultants to departments and Crown entities. The period of time in this status might be limited to two to three years, after which managers would either retire or obtain new term contracts. Alternatively, upon reaching a certain age, senior managers might be given the option of continuing in their post under indefinite term contracts until retirement.

In reconsidering SES and terms of appointment, the vital objective must be to ensure a continuing supply of trained and public-spirited managers. It is not enough to rely on the market, though recruitment from the private sector is a healthy development that should be encouraged. Government departments invest in their future capability by "raising" their own managerial talent; this should continue to be their objective now that reform has given them additional means of recruiting from outside the Public Service.

### **Can Departments' Culture Be Changed?**

In New Zealand, as in other countries that have sought to reform public management, much emphasis has been placed on the need to change the operating culture of government organisations. The assumption of reform is that the inherited culture gets in the way of responsive, high-performing organisations. Culture, however, also can be a positive force, as when new employees are socialised into the values of public service. Efforts to fundamentally change organisations should be undertaken with due consideration to what might be lost.

Culture is distinctive; it distinguishes one organisation from others. It may be manifest in everyday routines, such as when and how workers take tea or coffee breaks, as well as in weightier matters, such as how workers are supervised and their performance assessed. The cultural manifestations that concern me here are patterns of behaviour that are said to stand in the way of reform. These include emphasis on compliance with *ex ante* rules that restrict managerial initiative, norms that discourage innovation and risk-taking, the tendency to spend up to available resources, rigidities that impede the shift of resources to new priorities, the focus on inputs and inattention to outputs, and other "baggage" of traditional public administration. The New Zealand reforms rest on confidence that these tendencies can be purged by strong leaders armed with new management tools.

To the extent that managerial culture is anchored in rules and procedures, it is easy enough to change behaviour by installing new management and information systems. But even when formal practices have been modified, everything really important about an organisation may remain the same. The culture of an organisation is transmitted from one generation of employees to the next, from those who shaped the organisation at its inception to those who continue in it years later without quite understanding why things are done the way they are. Culture is what persists even when a department has been reorganised, new techniques introduced, its leaders and managers replaced.

New Zealand uses three approaches to uprooting the old administrative culture. First, it has brought in new leadership with a clear and strong mandate to overhaul operations. Second, it has shocked government departments with an avalanche of change, not just isolated innovations, but a critical mass of new procedures that can break old habits. Finally, many departments have been rearranged or broken into pieces, so that the old organisation is no longer recognizable in the new.

How would one determine whether a department or other governmental entity has been truly transformed? Productivity rates and measures of service quality might provide some clues, as much as surveys of customer and employee attitudes. But the changes have to be dramatic; small improvements can occur without penetrating organisational bedrock. Moreover, unless improvement is truly dramatic, it is prudent to defer judgment until compelling evidence has been gathered. When it comes to culture, staying power is the all-important indicator. Only after a lapse of years can one ascertain whether the reforms have become the new operating culture or merely the passing fashion of public management.

My sense is that measured against the cultural upheaval in the state-owned enterprises, change in most departments has been significant but not revolutionary. Many departments have become more efficient, but the old operating culture has not been completely vanquished. Yet, in some departments, or units within them, the signs point to a transformed organisation. These typically are headed by a wilful, hard-driving chief executive and managers who have been unafraid to uproot established practices. These transforming leaders have left their mark in the self-image of the department and those who work in it. But even in these instances, the chief executive may have great success in transforming some operating units and encounter enormous resistance in change in others. Final assessment of how much New Zealand departments have been transformed must be reserved, for it remains to be seen whether the new management style will survive one or more changes in leadership.

When culture is purged, there is some risk that positive features will be lost. It is essential to keep in mind that culture fosters a sense of common purpose, a professional ethic, and public-regarding values. I wonder whether in the rush to change, departments have been sufficiently sensitive to established values. I have no basis for judging what has been surrendered, but the issue should not be shoved under an organisational rug by assuming that reformed departments are superior in every regard to the entities they replaced.

## V. Strategic Capacity

It was emphasised in the previous chapter that as owner the government is interested not only in current outputs but in each department's potential to produce the services that may be wanted in the future. This capacity requires the department to plan for the future, adjust its objectives, priorities and resources to meet the opportunities and demands it may face, and make necessary changes in its organisation and operation. "Strategic capacity" refers to this process of purposeful, directed change.

Strategic capacity is the capacity of the government or a department to anticipate and plan for future changes in its environment, recast its objectives and programmes accordingly, define and specify desired future outcomes, reallocate resources to achieve them, evaluate results, and measure progress. The model used in this chapter divides strategic capacity into five elements:

- (1) orienting the department to the future by planning and other processes;
- (2) developing a multi-year framework so that current decisions can be taken in the light of medium-term (or longer) objectives;
- (3) allocating resources in a manner consistent with that framework and planned objectives;
- (4) specifying wanted outcomes and their means of achievement; and
- (5) assessing the effectiveness of programmes and, when indicated, taking corrective action.

Ideally, these elements should feedback to one another, so that, for example, plans would inform budgets and results would influence plans. In practice, however, the elements often are somewhat disconnected.

The lack of attention to the question of strategic capacity was a serious flaw in the original design of the New Zealand reforms. The design flaw was not an oversight but derived from the strong emphasis on operational efficiency and accountability. This emphasis led to a sharp distinction between the political accountability of Ministers and the managerial accountability of chief executives, and between outputs and outcomes. The problem was recognised by the Logan Report, following which significant progress was made by the issuance of long and medium-term plans, enacting the Fiscal Responsibility Act, which prescribes a medium-term fiscal strategy, and by introducing the strategic and key result areas which have become effective means of articulating the government's priorities and channelling the performance of chief executives. Despite these welcome innovations, the New Zealand system still is geared more to the short-term production of outputs than planning for the long haul, and to account for what has been produced than to evaluate progress in achieving major policy objectives.

It is important that efforts to upgrade the strategic capacity of government be accompanied by changes that ease the informational and reporting demands on departments. This is not a case where strategic capacity can be grafted onto the existing management system. Transaction costs already are substantial; care must be taken that they not become even more burdensome.

## Strategic Perspective

Strategic alignment is a critical element of ownership, for if a department's objectives and policies are not congruent with those of the government, real damage may be done to the capacity for collective action. At present, misalignment often is due to the failure of departments to allocate resources in accord with the government's priorities. Misalignment typically arises out of drift and inaction - the momentum of past decisions - rather than purposeful disregard of the government policy intentions. Misalignment occurs when the government fails to formulate and communicate its aspirations for the future in ways that can shape departmental actions. The government knows where it is headed, but it has not expressed these aspirations clearly or in actionable form.

Aligning the plans and budgets of departments to the vision and objectives of government requires, at the very least, that the government articulate its goals before departments go forward with their plans. In the early years of reform, strategic alignment was impossible because the new arrangement relied on annual routines revolving for the most part around the financial year for which the estimates were compiled and appropriation voted. Over time, these annual exercises have been reinforced by other requirements tied to the financial year, in particular annual purchase and performance agreements, annual (though now optional) corporate plans and annual reports.

In the years the new arrangements have been in place, the government has taken three major initiatives to lengthen the time horizon for public policy to provide a more strategic perspective. It has developed a planning capacity at the centre of government; it has executed and implemented the Fiscal Responsibility Act 1994; and it has introduced a strategic policy stage as the start of the annual budget preparation cycle. These moves have provided an ongoing means of linking the plans and budgets of departments to the policies and objectives of government.

## Strategic and Key Result Areas

Few elements of the New Zealand reforms have attracted as much favourable comment from Ministers, chief executives, and senior managers as have the strategic and key result areas. The SRAs and KRAs have been so rapidly and fully integrated into the reformed public sector that it is easy to forget that they were added only a few years ago, when it became apparent that the original design gave inadequate attention to strategic and collective capacity. The SRAs and KRAs are the best evidence of the malleability of the reforms and their capacity to adapt to fresh ideas and reconsideration of old ones.

Ministers like the SRAs/KRAs because they can more easily align their priorities to those of the government, and they can also lay claim for additional resources on the argument that they are responding to the government's initiatives. Chief executives welcome SRAs/KRAs because they have a clearer notion of what is expected by way of their performance, and managers because they can organise operations to optimise achievement of the specified results.

The SRAs/KRAs were introduced in response to perceived shortcomings in the original reforms, in particular, apprehension that the collective interest was slighted, difficulties in specifying and assessing outcomes, and the short-term orientation of policy. They unfolded in three stages which, in retrospect, appear to have been more logically connected than was apparent at the time. The first stage was publication of the government's vision statement, *Path to 2010*, in 1993. This document pointed in the direction that the government hoped to move the New Zealand economy and society over the long term, but it did not spell out the actions that would be needed or taken to implement the vision. The second stage was formulation of strategic result areas as an expression of the

government's medium-term ambitions. The Prime Minister's foreword to the 1994-97 SRAs (issued in February 1995) describes the result areas as "the link between the Government's long-term objectives and the operational activities of departments. They aim to bridge the gap between the broad vision of a future New Zealand as stated in the 1993 document *Path to 2010* and the one-year focus of existing departmental budgets and chief executive performance agreements." The third stage has been the formulation of departmental KRAs that are linked to the SRAs and form the basis for the performance agreements.

In the few years they have been in circulation, the SRAs have been effectively incorporated into governmental decision making. Publication of the SRAs has been advanced so that it now coincides with the release of the Budget Policy Statement and is available before detailed examination of the Estimates commences. Moreover, the SRAs have been worded so as to sharpen their focus and to indicate the activities or priorities on which particular emphasis will be placed. While the SRAs inherently are broad statements, they nevertheless signal the government's priorities and interests over the next several years. One might wish for more specific statements, but given the size of the Cabinet and the scope for public policy, the SRAs must be cast in general terms to obtain consensus.

The government has enunciated nine strategic areas; a close look at one of these shows how the statements may affect policies and budgets. SRA #2 "Enterprise and Innovation" communicates the government's intention to reinforce "a successful enterprise economy through maintaining and progressing an open trade environment that:

- C is conducive to the fair and efficient conduct of business;
- C is conducive to the efficient operation of markets;
- C rewards work, enterprise, and innovation;
- C enhances investor confidence."

The SRA then identifies eight matters of particular emphasis, including policies that promote the open flow of goods, ideas, and services between New Zealand and other countries; establishment of legislative frameworks for the fair and efficient conduct of business; development of a simplified and viable fisheries management regime; completion of gas and electricity reforms; programmes to enhance the performance and capabilities of small to medium-sized businesses; policies for the sustainable growth of the tourism sector; and ensuring that public investment in science and research is well targeted. As broad as some of these interests are, they leave little doubt as to the direction the government is heading.

The SRAs (and KRAs discussed in the next paragraphs) have had a marked, and generally favourable, influence on budget decisions and managerial accountability. Ministers and chief executives use the SRAs/KRAs as talking points in support of budget bids and to show how their requests promote the government's priorities. Given the broad sweep of some SRAs, it is not hard for most Ministers to demonstrate that their initiatives are justified by the government's strategic result areas. A few Ministers feel excluded because their departments do not directly contribute to the SRAs, but this situation is inevitable in any priority-setting process.

The SRAs strive to define outcomes; the KRAs that serve them generally resemble output measures. SSC guidelines for the 1995/96 performance agreements advise chief executives to identify the major contributions they and their departments will make to the government's objectives over a three-year period. These KRAs should identify the goods and services to be provided in support of the SRAs, along with critical aspects of departmental management. Although the KRAs also are somewhat broadly stated, progress toward achieving them should be expressed in observable and verifiable milestones. The milestones (which, like the KRAs, have a three-year focus) should

outline the results expected, target dates, and wherever feasible the qualitative and quantitative standards to be achieved. SSC advises large departments to have five to seven KRAs and small departments to have fewer. A few have many more. Treasury had sixteen for 1995/96; Justice had fourteen before the department was reorganised. All told, departments have more than two hundred KRAs and more than three times as many milestones.

My review of a sample of performance agreements confirms that the KRAs and milestones are cast in actionable terms. These agreements give readers a clear idea of the actions chief executives pledge to take in implementing the KRAs. For example, in response to the government's Enterprise and Innovation SRA, the Ministry of Foreign Affairs and Trade specifies enhancement of the international trading system, resisting protectionism and building on the Uruguay round agreement as one of its key result areas; Customs specifies increasing the efficiency of its tax collection system; Fisheries agrees to develop and implement environmental standards to sustain utilisation of New Zealand fisheries; Agriculture will amend arrangements which inhibit primary sector performance; and so on. With so many departments contributing to the same SRA, the process gives the government a much clearer picture than before of how the various activities relate to one another. The process may also become a tool for examining duplication or inconsistencies in public policies.

This potential has been enhanced by efforts of the central agencies to review departmental KRAs and milestones. The KRAs and milestones are drafted by chief executives in consultation with their Ministers. They are then reviewed by the central agencies, at which point the process has become somewhat controversial. The chief executives of these agencies closely review the KRAs and assess their linkage to the SRAs as well as to KRAs agreed by other departments. SSC in one recent year used a twenty-eight-item checklist, since simplified, for assessing the KRAs in terms of strategic alignment (linkage to the SRAs and to the Minister's key objectives); significance (evidence that the KRAs were derived from a strategic planning process and reflect departmental priorities); specification and assessability (whether the KRAs are clearly defined and the milestones are measurable in terms of quality, quantity, and time); coherence (determination whether each KRA is consistent with other KRAs); consultation (evidence that the relevant Vote Ministers and chief executives have been consulted); and collective interest (assessment whether the collective interest has been advanced, or at least not compromised, by the KRAs).

In addition to reviewing each performance agreement, the central agencies have developed a rating system for assessing the quality of the KRAs, as well as a matrix for linking the KRAs to the SRAs. For example, they identified at least forty-five KRAs that contribute to the Enterprise and Innovation strategic result area and comment on the quality and suitability of the KRAs. A typical comment is the one recorded for a certain department: "Although well specified, all [their] KRAs would benefit from the addition of measurable targets in the milestones."

The analysis conducted by the central agencies found a number of deficiencies in the KRAs. But perhaps the most consequential finding was that there are difficulties in using the KRAs for both chief executive accountability and linkages to the SRAs. "If departments are encouraged to continue refining KRAs for CE accountability purposes, the KRAs selected are likely to become less . . . meaningful from a SRA/KRA linkage point of view."

Some chief executives and senior managers complain that the central agencies have become too eager to intervene and substitute their judgment to that of the parties to the performance agreement. They evidently feel that the KRAs should serve more as an instrument for accountability to their

Ministers than as a means of ensuring that departments promote the government's strategic priorities. The other side of the argument, however, is that inasmuch as contemporary management doctrine holds chief executives accountable for results, they should produce the results sought by the government. In balancing the claim of chief executives for discretion in managing operations and of the central agencies for the need to represent the collective interest, I would urge some forbearance by the central agencies. They should intervene only on an exceptions basis, when there is substantial risk that the government's interest will be ignored or impaired. The central agencies should continue to have a prominent voice in managing the government's strategic interest, but they should assume that departments do take care to align their KRAs with the government's objectives. My own assessment is that the current arrangement works rather well. The performance agreements and the chief executives are mindful of the government's interests and priorities. If the SRA/KRA link were made too tight, the process would rigidify and become less useful. A bit of slack allows the KRAs to contribute to accountability as well as to strategic objectives.

### **Strategic Planning in Departments**

The SRA/KRA process cannot be the sole source of strategic capacity in government. The result areas have to be derived from exploration of how the course of policy might be changed to accomplish long-term objectives. Strategic planning has become in recent years the instrument with which some departments chart their future course and signal the changes they wish to make.

Strategic planning offers some opportunity to bring departmental actions into line with governmental aims and purposes. But there also is risk that in defining its future, a department may seek to move in directions that run counter to the government's interests. A balanced approach would encourage strategic planning by departments under arrangements that provide for guidance from relevant Ministers, review and input by one or more of the central agencies, and notice or consideration by Cabinet. In other words, strategic plans should be seen as expressions of the government's interests, not of the affected department's alone.

Departments are required to prepare strategic business plans when they seek a capital contribution; they are not required to do so at other times. Nevertheless, strategic planning has gained momentum in recent years, spurred by the government's own long- and medium-term plans and the successful formulation and use of strategic and key result areas. Some Ministers have instructed their departments to prepare strategic plans; in other departments, the chief executive has taken the initiative. Some plans are more programmatic than strategic; they set out desired initiatives but do not assess the department's capacity to deliver on its ambitions or the changes that may be needed in policy or operations. Nor do they generally discuss the hard choices and trade-offs that may be necessary to achieve planned objectives. They stake out claims on future resources, but the strength of these claims often is diminished by failure to connect the plan to the budget.

There are some notable exceptions, however: departments where the strategic plan is not just a document but a force for change, where planning is a transforming process. For example, New Zealand Customs' Strategic Plan, published in 1994, was linked to action plans that specified the strategies and operational targets to meet departmental goals. The strategies and targets were stated in a form that facilitated monitoring progress in achieving them. The Department of Social Welfare also has invested heavily in strategic planning. Day-long workshops involving the chief executive and senior managers were held in September 1993 and February 1995. In addition to discussing the structure of the department (in particular, whether certain functions should be transferred to

Crown entities), the second workshop explored the policy and organisational implications of moving from benefit dependency to self-reliance and positive contributions to society. The workshop (and ensuing strategic direction documents) acknowledged that this overriding goal would not be achieved without major changes in policy and operations. Other departments that have given serious attention to strategic planning include the Ministry of Education, Inland Revenue, and (what was then) the Ministry of Agriculture and Fisheries. This list is not complete; it is meant to indicate the extent to which strategic planning has taken hold in New Zealand departments.

Despite the growing popularity of strategic plans, I would be wary of requiring all departments to issue plans on a fixed schedule. Genuine strategic planning is costly. It demands a great deal of attention at top levels, considerable expense in gathering and interpreting data, and time-consuming work in reconciling different perspectives and forging a coherent consensus that is more than the compilation of various wish lists. In view of the already burdensome demands on departments, it would be imprudent to add yet another requirement. Moreover, routine is the enemy of strategic thinking. Effective planning is opportunistic, undertaken willingly when conditions are favourable, not when the calendar dictates that another round of plans is due. The SRA/KRA components of the strategic process have been routinised because they feed into annual resource and performance decisions; there is no need to routinise the overall planning process.

Although strategic plans should continue to be optional, it may be helpful for the central agencies to provide guidance on their preparation and use. As the lead agency in strategic management, DPMC should take an interest whether departmental plans are congruent with the government's interests; Treasury should examine the economic and financial implications of plans; and SSC should be concerned with the capacity of the department to pursue and implement its objectives. Strategic plans should not be longer-term versions of annual corporate or business plans but should concentrate on objectives, the means of achieving them, and the changes to be made in the department. Their main focus should be the department itself - how it is to be changed to achieve the vision and purposes set for it. Strategic planning that merely promotes the department and campaigns for a bigger budget is not of much value. The substantial investment of attention and other resources is justified only when strategic planning generates bold thinking and willingness to change.

Ideally, strategic statements should bear the imprint of the Responsible Minister; it should not be the chief executive's alone. The Minister should be sufficiently engaged in preparing the plan to ensure that it reflects her/his strategic perspective. But the role of the Minister cannot be standardised; some will actively participate in the planning process, while others may get involved only to ensure that the plan gives priority to their objectives.

Some regard the role of the Minister for the Environment in preparing *Environment - 2010 Strategy* as a model for other Ministers. In this case, the Minister drove the planning process and had significant involvement in defining goals, actions, and priorities that span the responsibilities of several Ministers and departments. The document is a cogent, coherent, and powerful statement of the directions that environmental policy might take over the next fifteen years. But because it lacked a short to medium-term action component, the plan was not followed up with as much action as some might have hoped.

This and other strategic planning exercises indicate that what happens after a plan has been prepared may be as important as the plan itself. It is not uncommon for plans to be ignored after they have been published or to be taken off the shelf only during budget season to justify a bid for additional funds. I believe the stature of plans, and the likelihood that they will guide policies and budgets,

would be enhanced by having them reviewed at the centre of government. There is substantial difference between documents floated by individual Ministers or chief executives and those vetted through the machinery of government. In some cases, it may be appropriate for DPMC and the other central agencies to review draft plans, or for these documents to be considered by Cabinet. I would not go so far as to suggest express Cabinet endorsement (or rejection) of proposed plans, but it would be a good idea for Cabinet to take note of what Ministers and departments are doing to prepare for the future.

In fact, Cabinet already is involved through its own planning activities and its issuance of strategic result areas. It would be foolhardy for strategic plans and SRAs to operate in entirely separate tracks; what happens in one should inform the other. Some departments have taken steps to link their plans to relevant SRAs; all should do so in the future.

### **Applying a Multiyear Budget Framework**

In New Zealand, as in most other countries, the year is the standard time frame for budget decisions, operations, and reporting. This short frame does not preclude strategic thinking, but it does mean that there is no assured link of future plans and current actions. Without this connection, well-intentioned plans often turn into hollow promises.

Because strategic plans cost money to implement, the most obvious link is to the budget. Using the budget to finance planned objectives is especially important when initiatives have to be paid for by reallocating resources rather than by spending more money. Past attempts to link plans and budgets, such as the planning-programming-budgeting systems (PPBS) tried in the 1960s and 1970s, were unsuccessful, and there is little basis for expecting more favourable results if they were tried again. PPBS and similar approaches sought to forge programmatic links - the budget was to be the process for financing the programmes agreed in the plan. Recent innovations indicate that it may be more fruitful to link plans and the budget in financial rather than programme terms. By establishing a multi-year budgetary framework, the government could reserve funds in future budgets for approved initiatives.

The Fiscal Responsibility Act (FRA) 1994 establishes a procedure for medium-term budget planning. The FRA requires the government to present its medium-term fiscal strategy in a Budget Policy Statement that is published several months before the budget is submitted to Parliament. The FRA does not commit the government to any particular fiscal posture, but it does enunciate principles of responsible fiscal management pertaining to operating revenues and expenses, Crown debt and net worth, management of fiscal risk, and tax policy. The Budget Policy Statement announces the government's intentions over the next three years regarding these principles and explains any deviation from them. It also assesses medium-term intentions in the light of long-run objectives. The government updates its fiscal strategy when it issues the annual budget and explains any variance from the previous statement. An economic and fiscal update is also issued one to two months before national elections.

The Budget Policy Statement deals with macro-budgetary policy; it does not discuss particular estimates or Votes except where these may be affected by major policy initiatives. One of its objectives is to provide for debate on fiscal strategy before detailed examination of the budget. While this aggregated framework is appropriate for fiscal strategy, it also provides a starting point for linking budget allocations to strategic objectives and policies, and a transparent and authoritative means of allocating resources on the basis of the government's priorities.

To do so, however, requires that the fiscal strategy be disaggregated into categories by which resources are allocated and controlled. The bridge between the aggregate fiscal strategy and particular votes is the baseline. The government maintains a rolling baseline that covers the budget year and the following two financial years. This baseline is not merely a projection; it sets out, by Vote, the agreed budget amounts for each of three years, and it is rebased each 6 months in the light of new economic forecasts and changes in government policy. Annual budget preparation revolves around bids to change the baseline or to reallocate spending within it. Any changes to the baseline must be consistent with the medium-year fiscal strategy. Thus, even though the estimates are prepared and appropriations made annually, these decisions are taken within a multi-year framework.

### **Reallocating Resources**

In some circumstances, strategic priorities can be fulfilled by allocating incremental funds to policy initiatives. But if this practice were continued for an extended period, it would lead to rising expenditures and (unless the economy were robust or the government were willing to raise taxes) chronic deficits. In the current New Zealand political and economic climate, the government's responsiveness to policy changes depends on its capacity to reallocate resources from lower to higher priorities. Reallocation is linked to the three-year rolling baselines.

New Zealand encourages reallocation through the annual budget process, in the course of which Ministers can bid for additional resources and Vote Ministers' propose shifts in funds among output classes. This arrangement is designed to protect the government's interest by ensuring that (a) funds are allocated or reallocated in accord with its priorities, and (b) the amounts spent are congruent with its fiscal strategy. Nevertheless, more priority shifts are likely to occur when the relevant Ministers make their own reallocations than when they are imposed by the government. Centrally dictated reallocations often fail because they are resisted by the losers. It makes sense, therefore, to give the affected Ministers the tough job of taking money away from some of their activities in order to give them to others.

Cabinet guidelines encourage reallocations that are fiscally neutral. These reallocations can be made within or between Votes, but the former predominates. Fiscally neutral changes, which are consistent with the baseline and have no impact on the Crown's financial position, may be agreed jointly by the relevant Vote Minister and the Minister of Finance. Changes that are not fiscally neutral generally require Cabinet action. Moreover, each year, during the "strategic" stage at the start of the budget preparation process, Cabinet may consider and direct reallocations across the State sector.

The guidelines encourage Ministers to seek reallocation before they bid for new resources. Nevertheless, there is some evidence that reallocation is not as common in New Zealand as in some other countries that have baseline systems. Australia, for example, operates a forward estimates system that is similar to New Zealand's baseline, and is said to generate significant reallocation each year. Relative to the Australian system there are two factors which might lead to a lower level of reallocations in New Zealand. One has been inattention to programme evaluation. The other is the large number of departments and Votes. In Australia, the government has adopted an evaluation strategy that impels departments to assess the programmes that operate and to shift resources from less to more effective activities. Moreover, Australia reorganised departments in the late 1980s to give Ministers a broader portfolio of activities. Portfolio budgetting encourages reallocation because Ministers have a broad scope of responsibilities. In New Zealand, by contrast, Vote Ministers generally operate within a narrower sphere.

### Accounting for Outcomes

The SRAs have assisted the government to deal with one of the most difficult requirements of the reforms - the specification of outcomes. Although many of the SRAs are too broadly drawn to qualify as outcome statements, substantial progress has been made, but the quality is uneven. Moreover, the Estimates contain numerous outcome measures and link them to both the Votes and to output classes. I have not closely reviewed the hundreds of such measures, but a general conclusion is that while there has been substantial improvement, more work needs to be done in this area.

My main concern, however, is not about measurement but about the conceptual distinction between outcomes, which are the responsibility of Ministers, and outputs, which are the responsibility of chief executives. This distinction leads to a further one: the political accountability of Ministers versus the managerial accountability of chief executives. The latter can be formalised in agreements and other contract-like arrangements; the former depends on elections and public opinion. Both, however, demand transparency with respect to what has been committed and what has been accomplished.

The Public Finance Act 1989 defines the relation of outputs to outcomes in causal terms. Outputs are “the goods or services that are produced by a department, Crown agency, Office of Parliament, or other body”; outcomes are “the impacts on, or the consequences for, the community of the outputs or activities of the Government.” In other words, outputs produce outcomes. These definitions are meant to establish accountability for government performance. In my view, however, the definitions mistake the relationship of outcomes and outputs. There is no inherent causal link between the two types of measures. Some outcomes may derive from specified governmental outputs, many do not. Alternatively, producing the right outputs does not ensure that the desired outcomes will materialise.

I prefer an alternative definition of outcomes along the following lines: outcomes are measures that indicate progress, or the lack thereof, in achieving public objectives. Outcomes can be stated in absolute terms, such as the rate of low-weight births or the incidence of infant mortality, or they can be stated in terms of change, the difference in low-weight birth or infant mortality rates between one time period and another. Changes in the rate of either indicator may be due to government action or exogenous circumstances or (most likely) a combination of both.

The issue is not one of definition but of cause and effect and, derivatively, of credit and blame. In my view, a system that would hold politicians accountable for conditions they only partly control invites loose definitions and evasions of responsibility. If outcomes were reported as the causal results of the outputs purchased by Ministers, politicians would be positioning themselves to be blamed for matters that are not truly their doing. In this situation, they are likely to devise expedient escape routes; one of the most popular is to define outcomes vaguely so that progress cannot be measured.

Outcomes should be seen not as measures of impact but as indicators of direction. They should be employed more for formulating policy than for maintaining accountability. They are powerful directional signals: are things getting better or worse? Have the initiatives taken by the government moved it closer or further from achieving stated objectives? Is the government progressing toward the conditions it favours? Particular outcomes may or may not be the product of outputs, but even when they are not, the government should take notice of them, analyse their significance, seek to

explain what has (or has not) happened, and develop appropriate policy responses. Even if it is not accountable, the government should take outcomes into account.

Suppose, for example, that birth weights were declining or infant mortality rising? Even if government action did not cause these developments, it should respond to the problem. One response might be to change the mix of outputs; another might be to fundamentally reexamine its objectives and policies; a third might be to thoroughly evaluate its programmes and the assumptions on which they are based. Sometimes there are no solutions, but government still cannot walk away from the problem.

The output-outcome nexus has another defect: it bifurcates government into two compartments: management and politics. It is with all the capacity and intelligence it can muster that government defines and pursues outcomes. Politicians contribute to the mix, as do managers, analysts, and others. When managers tender advice, they do not desist from commenting on outcomes, nor should they. Public policy is enriched by the continuing iteration and feedback between policy and operations, outputs and outcomes, politicians and managers.

### **MMP and Strategic Capacity**

The adoption of Mixed Member Proportional (MMP) electoral system (beginning with the 1996 elections) is likely to have enormous impact on the conduct of government, but perhaps nowhere more than in strategic capacity. I expect the capacity of government to think strategically - develop and implement coherent plans over a period of years - to be diminished by MMP. If the 1996 (or a subsequent) national election were to result in a minority government or a multiparty coalition, it might be difficult to obtain agreement on objectives and priorities and even more difficult to stay the course throughout the term of government. In coalition governments, the most expedient course might be for each ministry or department to unilaterally define its strategic direction. There might be a multiplicity of loosely drawn, somewhat contradictory SRAs, especially if, as sometimes happens, the finance ministry were entrusted to one party and the social welfare or health ministry to another. Paradoxically, it is when government is fragmented and strategic coherence is at risk that steps are most needed to ward off a babble of plans that pull the government in contradictory directions.

The Fiscal Responsibility Act is partly an outgrowth of the adoption of MMP. When FRA was under consideration, some proposed that the government be bound to preset fiscal norms. This idea was abandoned in favour of three concepts that may be applicable to other aspects of government policy and strategy. First, a set of guidelines to influence but not restrict government policy; second, a medium-term perspective; and, finally, transparency in public policy. These may be useful building blocks for making policy in the new world of MMP.

## VI. Managing Public Money

Financial management has been successfully reformed in New Zealand. Within a short period, all departments shifted budgeting and accounting from cash to an accrual basis and applied commercial accounting principles in preparing budgets and financial statements. The shift from input to output budgeting was also implemented as part of this process, though some difficulty was encountered in defining output classes. Departments learned a new vocabulary and new techniques, and they took responsibility for managing their own bank accounts. The Estimates were reformatted from 1994/95 to distinguish between Ministers' Votes and departmental resources. A capital charge was imposed on the net asset base of departments, and though it stirred considerable confusion and some anxiety when it was introduced, most of the start-up problems have been overcome and the concept is now accepted as a sensible means of encouraging the efficient management of physical and financial assets.

The study did, however, encounter a pattern of complaints concerning the adequacy of operating resources, the barriers against carrying forward unused funds to the next fiscal year, limits on shifting funds among output classes, and the authorization of Mode B net appropriations. This chapter examines these concerns, beginning with a fundamental question that must be faced by all governments, regardless of their financial management practices. How much should be provided for operating government departments? In New Zealand, pricing operations in terms of input costs has been discredited, but the new system of pricing outputs remains underdeveloped. The discussion then moves to two special pricing problems: the capital charge and the suitability of Mode B net appropriations for noncontestable trading revenue. The chapter concludes with consideration of efficiency savings and limits on carrying funds over to the next financial year.

Each of these issues boils down to a matter of incentives. Getting financial incentives right is essential in New Zealand management reform. In government, no less than in the marketplace, money is a powerful signal; it prods entities to produce more or less, to care about costs or to ignore them, to be more or less efficient, to take risk or to avoid it. The old command-and-control system gave managers the message that risk would not be rewarded, that inefficiency would not be penalized, that what mattered most was complying with preset rules and restrictions. The reformed system intends to reverse these incentives by encouraging and rewarding efficiency, letting managers take risk and initiative, giving them discretion to get the job done the best way they know how.

Getting the incentives right means getting the price right, that is, providing the amount of money that enables managers to efficiently produce what is required of them. This is the first and most important issue considered in the chapter. The capital charge and criteria for Mode B net appropriations also raise incentives questions: whether charging for net assets might lead to under-capitalisation of departments and whether strict criteria for Mode B net status might discourage departments from generating trading revenue. The last issue considered in the chapter also stirs up questions about incentives. Does the rule barring departments from carrying surplus funds into the next financial year give them the message that if they don't spend the money they will lose it?

Certain aspects of financial management are considered in the next chapter because they pertain to the accountability framework. These include the ex ante specification of the outputs to be purchased and the ex post reporting and auditing of performance.

### **Budgeting for Operating Expenses**

The capacities discussed in the previous chapters can be actualised only if departments have sufficient resources to operate. Although operating costs are a small portion of total State sector expenditure, they have a significant impact on the performance of government departments. Paying too much for operations would promote inefficiency; paying too little would risk shortfalls in current or future outputs. In conventional public administration, the price is set by fiat and there rarely is a direct or transparent relationship between the amounts paid by government and the volume or quality of outputs. There is substantial probability that before reform, the price was too high; in the reformed New Zealand State sector, by contrast, sustained downward pressure on resources may have increased the risk that some prices are too low. Lack of robust cost information means that it is not possible to conclusively determine whether prices are too high or too low. Getting the price right is one of the outstanding challenges facing Ministers and managers; it is not an easy task.

Governments set the price they pay through formal budget procedures. In conventional budgeting, the price paid for operating departments and other public entities is equal to actual or authorised input costs. When a department offsets some or all of its expenses through user charges, price still equals cost, except that other parties rather than the government pay part or all of the price. Price must equal cost even when, as typically is the case, the price is set too high or too low. If the price is too high - that is, the government appropriates more than is needed to efficiently provide the outputs - the department will either raise costs by spending the extra money or return the operating surplus to the government. If the price is too low, the department will either produce less or reduce the cost of production. The equation "price equals cost" means that the more departments spend, the more government pays. Government can spend less by purchasing fewer inputs or by arbitrarily limiting what it pays for the inputs. In either case, the impact on the volume and quality of outputs might not be known at the time the decision is made.

Public sector reform in New Zealand aims to put the pricing of outputs on a basis that is more akin to market transactions than to standard government operations. In the market sector, price is independent of cost; it is the amount the parties to the transaction agree to accept or pay. Price is linked to outputs rather than to inputs and it can be higher or lower than cost. Nevertheless, the price is deemed to be right because it was set through voluntary exchange; either party can refuse to make the transaction if it is not satisfied with the price.

Getting the price right in the public sector is vastly more difficult because transactions typically are not voluntary, the goods and services purchased by the government typically are not contestable, benchmark prices often are not available and there is a strong political-legal tradition of paying at cost. According to the logic of New Zealand reform, government should negotiate a price for outputs, as is done in market exchanges, and pay on the basis of the volume of goods and services to be supplied. This logic has led it to mirror the market by budgeting and appropriating for outputs. But the applicability of the market model often breaks down because the price paid by government is fixed and therefore may be insensitive to changes in the volume of outputs. Fixed-price budgeting is universal for the operating expenditure of government and, in New Zealand - unlike some other countries - also is applied to certain statutory obligations such as entitlements. When the price is fixed by budget decision, it is not likely to be optimal; that is, it will be higher than is needed to efficiently produce the budgeted outputs, or lower than is required to produce the expected volume or quality.

While inefficient pricing is endemic in government budgeting, the budgeting decisions taken in the reform period may have increased the probability that the price is too low. The reforms may have contributed to the inclination of governments to make these pricing decisions. This tendency can be attributed to several conditions associated with the reforms. First, when the government shifted from budgeting for inputs to budgeting for outputs, it ostensibly freed price from cost, so that the amount it pays no longer explicitly covers the cost of the inputs needed to produce the outputs. Departments are unlikely to bid for additional resources merely by claiming they need more money to pay for inputs. Second, reform of public management has been accompanied by sustained downward pressure on operating expenses. The government has assumed that departments were so inefficient in the past that they can now operate with lower staffing levels and without compensation for inflation. Third, this “doing more for less” in real terms would be more reasonably justified if the government had adequate cost accounting systems to analyse the cost of producing outputs. In most departments, however, managers do not know what the unit cost of outputs is or should be. They have little basis for estimating how these costs vary with changes in the volume or mix of outputs. Fourth, most public outputs are not contested; they are supplied by monopolistic departments. The government does not have benchmarks or competitively bid prices against which departmental operating costs can be compared. Finally, departments are not assured of being compensated for workload increases, including the supply of outputs in excess of the volume anticipated in the budget or the purchase agreement, although there are baseline update processes which provide an avenue for seeking compensation. When the volume of outputs is demand driven the budget and purchase agreement are *de facto* open-ended contracts for departments to supply as many outputs as are demanded of them at a total fixed price.

What happens when the budget does not get the level of funding right? In some cases, the purchase agreement can adjust for the shortage of resources by contracting for a lower volume or quality of outputs than might be provided if funds were more ample. For example, the chief executive might agree to conduct fewer studies or to reduce the number of inspections carried out at the department’s discretion. But when outputs are demand driven and the budget is fixed at an inadequate level, there may be some erosion in the quality of services, such as increased waiting times at airports or less effort put into producing reports for the Minister. Another possibility is that departmental personnel work harder to cope with the demands made on them. One final possibility, and the one anticipated by reformers, is that departments will re-engineer their work processes to increase productivity. But there is no assurance that financially stressed departments will behave in this manner.

Under-funded budgets can adversely affect the government’s ownership interest. When the price paid by the government does not cover ongoing costs, a chief executive might make ends meet by deferring maintenance or by spending less on employee development or systems upgrades. The adverse side effects of these adjustments might not be immediately apparent, but they can take a toll in the department’s long-run performance.

Although I have not examined whether the government underpays for departmental operations, in conducting this study I met a number of chief executives and senior managers who strongly feel that their department’s operating resources were inadequate. When asked how their department had adjusted to this predicament, few responded that services had been curtailed or degraded. The most common complaint was that managers now have to work longer hours to get the job done. The “9 to 5” workday is now several hours longer, with no compensation for the extra work. The complaints seem to be concentrated in small departments where there is limited opportunity to improve efficiency by rearranging work processes.

All departments have reaped significant savings by eliminating deadweight costs of the old central controls. In the afterglow of reform, it is easy to forget that not long ago vast resources were devoted to the ex ante input controls. Operating efficiency has been improved by giving managers discretion in purchasing inputs. Yet it also is true that the reformed system has introduced new operating costs. It is not costless to prepare performance and purchase agreements and to report on performance. Although the new accountability costs may be lower than the old compliance costs, they nevertheless can burden small departments.

Treasury has given serious attention in recent years to costing methods in the State sector. It has worked closely with Customs to develop a new system for pricing various services and it expects to introduce a new system of output pricing for this department that will be sensitive to changes in workloads. Treasury also commissioned a review (*Review of Costing Systems and User Charges*; Coopers & Lybrand; September 1995) of costing systems and practices in New Zealand departments. While the study focused on cost allocation issues, its findings are relevant to the cost basis for budget decisions. The study found numerous shortcomings in costing systems, but it also identified good practices that have been adopted by some departments and might be suitable for others. Recently new processes were agreed for handling output price increases.

### **Input Cost Versus Output Price Budgeting**

Inadequacies in costing systems raise an important question: on what basis should the government decide how much to spend on operating its departments? The old practice was to base these decisions solely on the cost of inputs, but the New Zealand reforms had good cause for rejecting this method. If, as explained earlier, the price paid by the government equals the cost of inputs, managers have incentives to be inefficient budget maximisers by consuming more inputs. In shifting to output budgeting, some reformers made the heroic assumption that the government could set the price it pays without basing its decision on the cost of inputs. This assumption may be valid where the provision of outputs is contestable, and budget decisions can therefore be made by paying the lowest price bid by a reliable supplier. When outputs are contestable, the government has no more need to know the structure or cost of inputs than a private buyer has in a market exchange. Even when it purchases the contested outputs from its own departments, government can be a demanding buyer and get the best price consistent with its specification of quantity and quality.

The original Public Finance Act (PFA) 1989 distinguished three modes of appropriation: inputs, cost, and price. Mode A (inputs) appropriations were “for the acquisition of goods and services of a non-capital nature relating to a specified class of outputs or a programme”; Mode B (cost) appropriations are “for the costs to be incurred in the supply of a specified class of outputs”; Mode C (price) appropriations are “for acquiring a specified class of outputs required by the Crown.”

Mode A was a transitional form of appropriation; it was discontinued by the end of the 1990/91 financial year. The PFA contemplated that as departments improved their accounting systems and as an increasing proportion of outputs became contestable, many output classes would be shifted to Mode C appropriations. This hasn't happened. No output classes are appropriated on a Mode C basis. The only types of output class appropriation now in use are Mode B and Mode B net.

Most of the outputs currently purchased by government are not contested. Perhaps more should be, but the plain fact is that they are not. In these cases, the purchaser (whether it is the government or a buyer internally contracting for outputs in a vertically integrated firm) needs to know how the supplier has priced the inputs. The time-honoured (but reform-dishonoured) practice has been to

calculate the cost of authorised inputs. In practice, the Treasury and departments resort to this practice whenever they lack sufficiently robust costing systems to establish a price on a basis that is independent of input costs. In reviewing departmental bids, Treasury Vote analysts explicitly consider the cost of operations. This method of budget preparation offers some protection against getting the price unduly low. There is nothing wrong in these circumstances with Vote analysts' examining the amounts estimated to be spent on key inputs such as personnel, training, information systems, and so on. Only in this way can government satisfy itself that the amounts to be spent are approximately right.

More consideration is given to line items in preparing and reviewing budgets than is commonly thought to be the case. Certain outputs, such as policy advice, are budgeted in input terms, and managers indicated in interviews that their departmental budgets often are examined by Treasury Vote analysts in these terms.

However, using input costs as building blocks for compiling the budget is not an optimal practice. Although there is no inconsistency in giving managers broad spending discretion while still using inputs as cost elements for budget decisions, this practice is undesirable because it opens the door to reestablishing central budget control of the details of expenditure and because it offers little incentive to improve efficiency in the provision of public services. Moreover, focusing on inputs diverts attention from outputs which should be the all-important driver of budget decisions.

As necessary as it may be that Treasury and departments take account of input costs, there is some risk that this approach may undermine the system of output budgets on which the new accountability regime is predicated. Care must be taken, therefore, that analysis of input costs not mean a return to line item or input budgeting. I can suggest three ways of guarding against this relapse. First, Treasury and departments can develop input cost models without delving into all the items of expenditure. Second, Treasury should seek to expand the use of benchmark prices for public services. Finally, Treasury should invest in cost accounting and analysis systems that give it a stronger assurance that the price paid is right and that make it feasible to pilot test variable budgeting in selected output classes.

The first approach would be to develop cost models that subsume the various inputs required to produce outputs. For example, Treasury and departments might develop input cost models that estimate the total cost attributable to each full-time equivalent employee or square metre of office space. The cost model would encompass numerous line items (travel, wages and benefits, training, information services, etc.). With a well-developed input cost model, the government can obtain reasonable assurance that training needs are being met, maintenance is accorded proper priority, and information technology is advancing. Ideally, these cost factors would be apportioned among activities by means of an activity-based cost system or some other accepted cost allocation method. Government would then be in a position to intelligently decide on the amount to be spent for each activity without controlling each of the inputs. Second, Treasury should actively develop and apply benchmark pricing in public expenditure decisions. Benchmark prices have two advantages: they generate pressure for efficiency and they provide confidence that if operations are well managed, the price will be right. Benchmarking would be facilitated by increasing competitive tendering where appropriate for public services. Finally Treasury should break new ground in the pricing of outputs. Budgeting on the basis of inputs should be regarded as, at best, an interim measure to be used until departments acquire competence to budget on the basis of output prices.

Moving from input to output prices as envisaged in Mode C appropriations would require major improvements in cost accounting, allocation, and analysis. The accounting and financial

management innovations were introduced to comply with external reporting requirements; the next frontier in New Zealand financial management will be to devise systems and practices for internal management needs. This will be a tougher challenge, not only because cost accounting systems are as yet undeveloped, but also because these systems will have to be tailored to the needs of each department. While certain principles and practices can be standardized, no single size fits the conditions faced by all departments. A few departments already have made laudable progress, and some good practices were identified in the Coopers & Lybrand report. This is not the place to discuss the various approaches and technical issues in cost accounting and analysis, but it would be appropriate to set out some of the steps that might be taken. Significantly, these steps generally correspond to the pioneering work underway in Treasury and Customs in pricing outputs.

(1) An early step should be the desegregation of outputs into standard, measurable units to which cost data would be attributed. Although output classes may be suitable categories for compiling the Estimates and maintaining accountability, they are too broad and variegated for analysing costs. Arguably, the main categories should be the activities which drive costs. To be useful, these have to be more finely decomposed than is currently the practice in constructing the output classes.

(2) For outputs that can be broken down into standard units, such as processing superannuation claims or clearing international passengers arriving in New Zealand, benchmark prices based on cost analysis, comparison with similar operations, or best practices should be more widely developed. These prices would not be directly linked to input costs.

(3) For outputs that cannot be standardised, strong effort should be made to establish benchmark prices based on analysis on the cost of efficiently providing the service. Doing so would require full cost attribution and close examination of work processes to assess the impact of changes in the process on cost.

(4) Once price is set independently of cost, managers have renewed interest to be efficient. However, there is risk that a budget based on output prices may not cover input costs. In the private sector, money-losing producers go out of business, but this option is not open to most government departments. It is essential, therefore, that periodic analysis be undertaken to measure price against cost and, when indicated, necessary adjustments should be made in the volume of and/or payment for services.

(5) The purchase agreement should be negotiated with the same benchmark or output prices as are applied in the budget. This would more closely integrate the purchase agreement into the decisional process, rather than just having it adapted to fit the department's budget constraint.

(6) With appropriate cost accounting and benchmark prices, it should be feasible to compile a true performance-based budget in which the volume of outputs is directly linked to the volume of financial resources. Ideally, this type of budget would indicate the increments in outputs that would be obtained by providing increments in resources.

(7) The final step would entail a great leap forward in budget practice - a move from fixed to variable budgets. Doing so would require reliable apportionment between fixed and variable costs, with the amount appropriated varying with changes in the volume of outputs. The appropriation would be for a fixed amount but the department would be permitted to spend an additional amount - up to a predetermined limit - if outputs exceeded the specified level. Mode C provides a basis for this type of appropriation. Inasmuch as variable budgets would break with generations of budgetary

tradition, it would be appropriate to move in this direction cautiously and only to the extent that all of the following conditions were satisfied:

- (a) the department has a robust and reliable cost accounting system;
- (b) the outputs are demand driven, so that the department is paid more only because more is required of it, not because it is adept at drumming up more business;
- (c) unit output prices have been agreed with Treasury; and
- (d) the department demonstrates that it can cope with variable budgets when outputs fall below target. Variable budgeting should not be a method for allowing only upward adjustment.

These steps entail an ambitious programme of financial management improvement. The basic message is that financial data should become means of managing the cost of operations, not merely means of complying with external reporting requirements.

### **Charging for Capital**

Getting the price right refers not only to the amounts appropriated but also to the costs that go into the calculation of price. The capital charge is one such cost element; to my knowledge, New Zealand is the only country in which it applies to the central government. The charge is levied on the net worth (assets minus liabilities) of departments and some Crown entities. The assets are assessed on the basis that they are valued in financial statements and may include buildings and other fixed assets, cash appropriated for depreciation or held as working capital, inventory, or receivables. The capital charge represents the opportunity cost of money - what the government can expect to earn in alternative investments entailing similar risk. It may be thought of as an internal rate of return on the government's investment in its own entities. The standard charge was initially set at 13 percent, but is recalculated annually, and at the time of writing was about 11.5 percent.

The capital charge has a dual purpose: it signals that capital is not costless and should be managed as would any other cost of production, and it spurs managers to include the cost of capital in comparing the cost of outputs produced by government entities with the cost of obtaining the outputs from outside suppliers. The charge puts internal contracting on the same footing as contracting out and encourages full cost recovery of outputs sold to governmental or private users.

When it was introduced in 1991, the capital charge generated much confusion, undoubtedly because it was so novel and unfamiliar. Many tough issues had to be confronted in valuing assets and in computing the charge. Within a few years, however, the charge was widely accepted by chief executives and headquarters managers. There appears to be less appreciation of it in field and regional offices, where the charge tends to be viewed as a bookkeeping exercise rather than as an incentive to manage assets.

On introduction, departments were compensated for the charge; their appropriations were increased by an amount equal to the charge. (No compensation was provided for the charge apportioned to outputs sold to third parties.) Since then, changes in the capital charge due to changes in net worth (other than through revaluation of assets) has not been automatically compensated. If a department disposes some assets, and returns capital to the Crown, the charge will be reduced accordingly. Inasmuch as the charge is part of the pool of operating funds that can be used at the discretion of the chief executive, the money saved by having the capital charge reduced can be used for other operating purposes. This rule gives departments a strong incentive to divest surplus assets, to maintain working capital and inventories at efficient levels, and to consider renting rather than buying office accommodations and other facilities. Surveys conducted by the Treasury and outside

consultants confirm that the capital charge has spurred departments to actively manage their assets and to incorporate the cost of the charge in setting user charges.

I have some concern, based on the incentive structure rather than on empirical evidence, that the capital charge may lead over time to the under-capitalisation of some departments. When the charge was introduced, the presumption was that inasmuch as capital had previously been a free good, some departments were overcapitalized. Treasury should monitor departmental behaviour to guard against the pendulum swinging in the opposite direction. My concern is based on two perverse incentives: one for departments to avoid the capital charge on the value of their cash accumulation due to depreciation by returning cash balances to the Crown; the other is that departments may see little advantage in making cost-saving investments that add to the capital charge.

In assessing the impact of the capital charge, it should be noted that the assets of most departments are in the form of cash or the value of IT equipment, not in buildings or facilities. At the end of May 1996, cash balances of all departments totalled \$800 million, more than half of which were held by the New Zealand Defence Force and the Ministry of Education. These two departments may require substantial cash balances because of the value of their physical assets; other departments that have few fixed assets maintain small cash balances.

In view of the continuing rapid fall in the cost of IT, Treasury can have reasonable assurance that the capital charge does not discourage departments from investing in new technology. Even with the capital charge, departments have incentives and resources to upgrade their systems.

### **Mode B Net Appropriations**

Incentive problems may also arise in the appropriation of funds. The standard appropriation is on a gross basis, with a specified amount provided for each output class. However, the Public Finance Act 1989 authorizes net appropriations for output classes that earn trading revenue. These Mode B net appropriations authorise departments to spend up to the forecast trading revenue as long as this does not exceed the actual revenue earned. The Minister of Finance may direct the departments to spend a lesser amount. The more trading revenue the department earns, the more it can spend. The rationale of these appropriations is that departments should be permitted to cover the costs of producing outputs sold on a commercial basis.

The Act's definition of trading revenue excludes situations where the department has a legal monopoly in supplying the goods or services or where there are no competing sources of supply. As enforced by Treasury, Mode B net appropriations are made only when the outputs are contestable (inside or outside government) and when the costing system demonstrates that there is no cross-subsidization. In other words, the sales price of some outputs is not lowered by shifting part of their cost to other outputs. Treasury must approve all Mode B net appropriations, and it has done so sparingly. During the 1996/97 financial year, only eight output classes were on this basis. About 15% of the third-party revenue generated by departments is appropriated Mode B net. A large number of former Mode B net classes are no longer supplied by departments, having become the domain of more commercial organisations like Crown Research Institutes (CRIs).

Some departmental executives complain that the rules are too restrictive, that when they generate trading revenues, the amount available for expenditure still is limited by the amount appropriated. Appropriating on a gross basis discourages departments from generating trading revenue and thus diminishes contestability in the provision of outputs. It may also discourage them from seeking to

recover full costs from purchasers of their outputs. The other side of the argument is that if the sale of outputs is not contested, the price will be set arbitrarily by the department rather than by market competition. In these circumstances, if the department were budgeted on a net basis, it could set prices well above cost and use the additional revenue as it saw fit.

It would be appropriate, I believe, to relax the rules slightly without opening the floodgates to abuse. Wider use of Mode B net would spur entrepreneurial behaviour by managers to develop markets for their outputs, recover costs, and increase the use of internal contracting and pricing within government. The change to Mode B net would be supervised by Treasury and subject to its approval, as is presently the case. Before authorising net appropriations, Treasury would have to be satisfied that the costing systems were sufficiently robust to guard against cross subsidies. In some cases, Treasury might establish hybrid modes, with only a portion of the trading revenue netted against the appropriation.

### **Operating Surpluses**

In most regards the New Zealand reforms go further than those of any other country in breaking with conventional practice. One major exception, however, is that New Zealand still is more locked into annual financial control than are some of the other countries that have reformed their public sectors. New Zealand does not permit departments to carry over unused operating funds from one financial year to the next. Australia and Sweden, by contrast, permit departments to retain unused funds and to pre-spend a small portion of the next year's appropriation during the current year. To guard against the hoarding of money, they limit the amount that can be carried over to the next year.

The differing concepts of reform discussed in chapter 2 lead to different practices on unused appropriations. The managerial model views retention of savings as an incentive for managers to be efficient; the contractual model may see it as a breach of the agreement between the government and the affected department. From a managerial perspective, when a department loses the money at the end of the fiscal year, it has a strong incentive to spend the entire appropriation, whether or not it needs the funds. This is not a difficult task for resourceful managers who can find all sorts of good uses for the money. Permitting departments to hold on to the funds may assist them in meeting unanticipated demands on future budgets, while easing some of the rigidities inherent in the annual budget and appropriations cycle.

The contractual approach begins with a different premise, that unused funds are not savings but a surplus. The Public Finance Act states that, except as agreed between the Minister of Finance and the Responsible Minister for a department, no operating surplus should be retained at the Department. The PFA defines an operating surplus as "The amount by which departmental revenue exceeds the expenses of a Department". This provision has a simple rationale: the surplus belongs to the Crown, which provided the funds in the first instance, not to the department, which produces the outputs. If spending departments were allowed to unilaterally retain surplus funds, they rather than the government would decide what to do with the money. This decision should be made by the owner, not by the spenders.

Whatever the theoretical basis of this position, its application has several adverse side effects. Barring departments from retaining unused money shortens the budgetary perspective of managers, abrades relations between departments and the Treasury, and fosters a "use it or lose it" attitude in the departments. Moreover, it does not distinguish between a surplus that is due to efficiency savings or one that results from failure to complete all planned work. Whatever the cause, every unspent dollar reverts to the Crown.

Departments have a variety of tactics that enable them to spend just about all of the funds in the year for which the appropriation was provided. As year-end approaches, they can spend projected operating surpluses by purchasing equipment, shifting funds among output classes, undertaking minor building repairs, spending on discretionary activities such as employee training, and accelerating some payments. Adept managers can take advantage of accrual accounting rules to use surplus funds. One chief executive explained how his department has exploited accrual accounting to spend all available funds. His department takes the position that if it has met output targets for the year, any operating surplus is due to the performance of its managers. Hence the surplus is distributed as performance bonuses. Even if it is paid out early in the next financial year, it may be expensed in the year the bonus is earned.

There may be nothing wrong with managers spending just about every dollar they have, except that it calls into question the pristine logic that operating surpluses belong to the Crown. These surpluses exist because the funds are saved by managers; they tend to be small because current rules give managers little incentive to save.

To its credit, Treasury does not penalise underspending departments by lowering baseline expenses. When a department has an operating surplus, its baseline for the next several years is maintained at the same level as if the money had been spent. In such instances, however, the government may demand more outputs in future years without providing additional funds.

It would be sensible for Treasury to explore means of permitting the limited carryover of operating surpluses. If the rules were liberalised, Treasury would have to deal with a slew of issues, such as: should the amount or use of carryover funds be limited? Should departments retaining operating surpluses be expected to produce more output in the next year? Should they pay a capital charge or earn interest? These and other technical issues have to be addressed, but they should not stand in the way of giving managers the right incentives to use public funds efficiently.

## **Conclusion**

Some of the issues discussed in this chapter may appear to be technical and of little consequence in the overall development of management capacity. To my mind, however, getting the price and other incentives right is essential to effective public management.

Why has New Zealand, which has been bolder than any other country in liberating managers, been more restrictive in some financial management practices? The somewhat unsettling answer is that New Zealand reform has been driven by a separation of the Crown from departments and of purchase from ownership. The premise is that the Government should stand in relation to its departments as a buyer would to a seller in a market exchange. This separation leads to the logical conclusion that the government should get what it bargained for, that operating surpluses belong to it, that funds should not be transferred between financial years or between output classes.

I am troubled by the concept of a split-personality government that has influenced financial management and other reform practices. It is likely, however, that as the New Zealand model progresses from innovation to standard operating procedure, it will increasingly be shaped by the exigencies of practice rather than by the dictates of theory.

## VII. Accounting For Results

In exchange for giving managers broad discretion in using public resources, the New Zealand reforms, as do those in a few other countries, seek to impose new accountability requirements. This trade-off is often applied unevenly, for it is much easier for the central agencies to surrender *ex ante* control than to enforce strict accountability. In some countries, therefore, the introduction of new accountability rules has lagged behind the removal of input controls. "Letting managers manage" has held greater sway than has "making managers manage" by holding them accountable for what they do, spend, and accomplish.

This has not been the case in New Zealand, where making managers responsible for their performance has been a guiding principle in the effort to improve the efficiency and quality of public services. New Zealand gives managers enormous freedom to act, but it closely monitors their financial and substantive results. Accountability has not been an afterthought; it was designed into the new system at the outset, and as gaps in accountability have been identified, additional requirements have been imposed. In fact, the most distinctive features of New Zealand management reform - the performance and purchase agreements, appropriation by output classes, the split between funds voted to Ministers and money provided to departments, and accounting and budgeting on an accrual basis - have been due to efforts to ensure full accountability for results. In other countries, the concern is that not enough attention is paid to accountability; in New Zealand, some complain, the costs of maintaining the accountability regime are too high.

Accountability revolves around the *ex ante* specification of both financial conditions and outputs and the *ex post* reporting of results. Ministers and managers must agree in advance on financial performance and the outputs to be produced, the money to be spent on the agreed outputs, and the quality and timeliness of the work to be performed. This advance specification of performance enables Ministers and managers to compare the volume, cost, and quality of the outputs actually produced to planned levels. This is the essence of managerial accountability - doing what was contracted at the agreed price and explaining any variance between planned and actual performance.

The New Zealand version of accountability currently has more to do with purchase than with ownership, more with producing outputs than with the overall capacity of the department, more with whether managers are meeting specified targets than with whether public programmes are effective. Policy outcomes are outside the managerial accountability framework; they are considered matters of Ministerial responsibility and political judgment.

This model of accountability is patterned on the relationship of buyers and sellers in commercial transactions. Matters that are external to this relationship fall outside the accountability system. This problem is not unique to New Zealand, but it is aggravated by the purchaser-supplier split and the sharp focus on outputs. In other countries, certain actions and outcomes fall between the cracks of the accountability system because managers are unsure of what they are responsible for; in New Zealand, they sometimes fall between the cracks because managers know precisely what they are responsible for.

This chapter discusses five related accountability issues: (1) the output relationship of Ministers and managers; (2) the advance specification of outputs in the Estimates, departmental forecast reports, (DFR's) and purchase agreements; (3) reporting and assessing results in annual reports and other documents; (4) the adequacy of internal management controls; and (5) the cumulative burden of

complying with the various accountability requirements. The financial aspects of accountability - delivering the outputs at the agreed cost, maintaining the financial health of the department, and achieving financial targets - appear to be functioning quite well and are not discussed in this chapter. This study has not reviewed the work of Parliament or the Audit Office, though both have important roles in the accountability system. Brief consideration is given, however, to Parliament's demands for financial data and other performance information.

### **Accountability for Outputs**

Accountability is predicated on a sharp distinction between the government's role as the purchaser of outputs and the department's role as supplier. The government's responsibility is to specify the outputs it intends to purchase and to decide what it will pay; the department's responsibility is to supply the specified outputs at the set price. This distinction explains why the government maintains two sets of accounts: the Estimates detail what the government intends to spend in purchasing specified output classes; the Departmental Forecast Reports specify what each department expects to spend in producing the outputs. There is both duplication and differentiation in these documents: duplication because much of what the government buys is supplied by the departments; differentiation because the government purchases some outputs from nondepartmental sources.

Outputs are the common interest of Ministers and managers; they are the linchpin of the New Zealand accountability system. The focus on outputs is in contrast to both its previous input-based appropriations and the outcome-oriented system favoured in much of the management reform literature. The Public Finance Act defines outputs as the goods and services produced by a department or by any other public or private supplier.

New Zealand focuses on outputs because they provide a reliable basis for enforcing managerial accountability, not because they are the most important indicator of government performance. Accountability is facilitated because the supply of outputs can be directly attributed to the performance of chief executives and their departments; outcomes, by contrast, tend to be influenced by many factors, some of which are likely to be beyond the control of the relevant department. It often is difficult to trace a particular outcome to the activities of a given department, but it usually is comparatively simple to determine whether a department has supplied the specified outputs. An outcome-based system would dilute accountability by purporting to make managers responsible for results they do not control; an output-based system strengthens accountability by limiting responsibility to the results that managers do control.

The output relationship between Ministers as purchasers and managers as suppliers is intended to replicate the arms-length relationship between buyers and sellers in competitive markets and to thereby mitigate "producer capture," the proclivity of managers to impose their interests and agendas on Ministers. But this relationship opens the door to fundamental questions that relate to the ownership-purchase issue discussed earlier in this report. Should purchasers and producers be institutionally separated so as to facilitate truly independent decisions by the government on what it buys and spends, or should the two sides strive for a cooperative relationship that recognises their joint interests? Furthermore, to what extent is the gain in accountability expected from separating Ministers and managers dissipated by high transaction costs? The New Zealand reforms give a clear answer to these questions. The greater the distance between Ministers and managers, the more independent and demanding the government can be as a purchaser of outputs and enforcer of accountability.

I am not persuaded that this approach is suitable in all the purchase situations facing government. It is most appropriate when there is genuine competition among suppliers, and the government has no incentive to give preference to public entities. In these circumstances, it can bargain for the best terms by having suppliers bid against one another, and it can vigorously enforce contracts for the delivery of specified outputs. However, the rarity of Mode B net appropriations indicates that this is not the normal purchase situation.

The typical condition is one in which the government owns the departments and obtains noncontestable outputs from them through budget rather than market decisions. The relationship is not arm's-length, and pretending that it is does not make the government less vulnerable to capture. Some Ministers have been tough, involved negotiators who have sought the best deal for the government and have taken an active role in specifying the outputs to be supplied by their departments. This posture has been strengthened by the retention of purchase advisers to assist in the negotiations. But many Ministers are discomfited by this quasi-adversarial arrangement, and they have preferred instead to maintain a closer, less formal relationship with chief executives and departments. In some cases, the Minister has agreed the outputs specified by the chief executive without reviewing the details or suggesting changes. Formal accountability is maintained even when the Minister abjures an independent role, but the heavy costs of maintaining pseudo-arm's-length accountability may not be justified in these circumstances.

### **Ex Ante Specification of Outputs**

Chief executives and their departments are accountable for supplying the outputs specified in the Estimates, purchase agreements, and other authoritative documents. Departments supply many thousands of outputs to the government each year, far too many to use individual outputs as the basis for appropriating funds or, in my view, maintaining accountability. It would not be in the spirit of the New Zealand reforms to target only a few key outputs, as some countries have done.

The solution prescribed by the Public Finance Act is for appropriations to be made by output classes. An output class is defined by the act as any "grouping of similar outputs." Much effort has gone into defining and refining the output classes, and while some adjustments still are made each year, the structure has stabilised. Pursuant to 1992 amendments to the Public Finance Act, considerable effort has been given to define non-departmental output classes, and they now generally are specified in the same form as departmental output classes. Most of the output classes represent the activities conducted by departments and other entities in serving government. They describe the work performed for government, not the outputs produced. Many departments set aside an output class for policy advice and another for major administrative responsibilities such as managing contracts.

The output classes are categories of convenience; they are intermediate categories, more specified than Votes but more aggregated than discrete outputs. The Estimates and several other authoritative documents publish detailed output data within the various output classes. The output classes are important because appropriations are made to them, and departments manage and account for financial resources in terms of these classes.

Efforts to make the output classes informative categories has led to a proliferation of appropriation heads. The Logan Review (*Review of the State Sector Reforms*; 1991) reported that the shift to output class appropriations had increased the number of separate appropriations from 56 in 1988/89 to 774 just three years later. Logan recommended that the number of separate appropriations be reduced but that the Estimates and annual reports continue to publish detailed output information.

But judging from the output class data presented in Appendix III, no progress has been made in this direction. The Estimates now have almost the same number of appropriations as they had when the Logan Review was conducted.

Three factors account for the large number of appropriations. One is the need to distinguish between departmental and nondepartmental outputs; another is the practice of itemising the various capital contributions, grants, and other payments; and the third is the effort to ensure that funds are spent on particular activities (such as managing contracts) and are not pooled with other administrative expenses. Regardless of the reasons, however, the fact remains that many of the output classes hold very small amounts of money. Moreover, there is a truly extraordinary disproportion between the largest and smallest output classes, even in the same Vote. Although each output class must meet a materiality test, the test does not seem to be strictly applied.

The large number of small output classes erodes managerial flexibility and complicates the task of allocating overhead and other indirect costs among the various classes. It also fosters the same kind of compliance mentality and budgetary gamesmanship that flourished under input budgeting. When managers are restrained (arbitrarily, in their view) from spending funds as they deem appropriate, they learn how to outwit the controls.

The output classes provide the decision and information structure for the accountability system. The same output class structure is used in the Estimates, Departmental Forecast Reports (DFRs), annual reports, and other documents. Some complications arise because the amounts recorded for appropriations in the Estimates are inclusive of GST, while those in documents generated by the departments themselves exclude GST, in accordance with generally accepted accounting practice. It is not difficult, however, to reconcile the various documents or to trace an output class from the Estimates, through its DFR, to the annual report. The format is accessible, transparent, and easy to use. One does have to navigate through thousands of pages to assemble the many pieces of the accountability puzzle, but it is an effort rewarded by the ease with which performance outturns can be compared to targets.

#### Output Specification in the Estimates.

Every department specifies output targets in at least three documents: the Estimates, the annual purchase agreement, and DFRs. Some departments also specify their outputs in corporate and strategic plans and in internal documents. As noted above, the various documents use the same output class structure.

Almost five hundred output classes are described in the Estimates submitted to Parliament each year. Specification in the Estimates on an output class basis proved to be a difficult task. Unlike inputs, which are standardised across departments, most outputs are unique to the department producing them. The necessary steps included identifying the outputs, organising them into output classes, developing qualitative and quantitative indicators of performance, and succinctly describing them in a manner that conveys useful information without overloading the Estimates. These steps entailed considerable negotiation between each department, the Minister, and central agencies, along with sometimes contentious wrangling over the best way of describing what the department was producing. It was also necessary to develop information on outputs supplied by third parties. The format of the Estimates has been changed several times during the 1990s, but with the introduction of the DFRs (beginning with the 1995/96 financial year) Treasury officials believe that a stable format has been attained which conveys a great deal of useful information. They anticipate only marginal adjustments in the future, no major overhaul, subject to accommodating legislative amendments due to changes in the preferences of the principal users - Members of Parliament.

It takes but a few minutes to learn how to work through the Estimates, because the same schedules and format are used for every Vote. As a result, a disproportionate amount of space is devoted to relatively minuscule amounts of money. The \$4.8 million budgeted for Sports, Fitness, and Leisure Vote in 1996/97 takes up eleven pages in the Estimates; the \$355 million budgeted for Corrections has sixteen pages. In general, the amount of output information presented in the Estimates increases with the amount of money allocated to the Vote.

I noted in chapter 3 that less information is provided on the output classes supplied by Crown entities than on departmental output classes. Nondepartmental entities are the end-users of two-thirds of the money appropriated for output classes. One should expect, therefore, that sufficient information is provided on nondepartmental outputs to permit monitoring of the use of these funds.

Much effort has been expended by departments in developing detailed output information. Most adhere to Treasury guidelines for specifying outputs in terms of quantity, quality, timeliness, and cost. Inevitably, however, the quality of the information is uneven, but almost all departments have made enormous progress in specifying outputs. A comparison of the 1995/96 Estimates with those tabled several years earlier indicates significant improvement in the coverage and usefulness of the information. Moreover, the recent Estimates give evidence of considerable care and effort in identifying the outputs to be produced in the next year. The information appears to be fresh and up-to-date; it is not simply a repeat of the previous year's entries.

Nevertheless, there is ample room for improving the output class information in the Estimates. I believe that the usefulness of the information would be enhanced by using a tabular format (where appropriate) rather than or in addition to narrative descriptions, by comparing the outputs specified for the next year with those budgeted or produced for the current or past year, by presenting some of the information by output subclasses, and by linking the volume and quality of the outputs with the amounts to be appropriated. Part A2 in the Estimates highlights some of the initiatives or changes to be made in the next year, but I believe Parliament and the interested public would benefit from additional information.

Without trend or comparative data, it is hard to interpret or analyse the output information. If all that is wanted is specification of outputs, so that actual performance can be compared to targets, the present arrangement is satisfactory. But if one wants to come to an informed judgment on the amount of money that should be spent, then information on the previous financial year(s) would be useful. Moreover, efforts should be made to provide cost data on major output subclasses, so that one can analyse what the government intends to buy with the appropriated funds.

The lack of trend data on outputs in the Estimates has been a contributing factor in the substantial informational demands made by Parliament each year. The Finance and Expenditure Committee (FEC) issues a "standard estimates questionnaire" each year, and select committees examining individual Votes address "supplementary questions" to particular departments. The FEC has revised the standard questionnaire for 1996/97 to focus on Ministerial responsibilities rather than on departmental operations, thereby reinforcing the concept that the Estimates reflect the Minister's perspective. The new approach reflects each Minister's accountability to Parliament for appropriation requests. In previous years, the standard questionnaire requested each department to report on its plans to improve operational efficiency, financial management, and other aspects of the department's management. It also instructed departments to explain year-to-year changes in

appropriations due to (among other things) changes in the volume of activity and outputs. In contrast to the Estimates, which provide only one year's output data, the standard questionnaire requested trend data on each department's output classes. The new standard questionnaire asks Ministers to discuss critical issues faced by the Government in preparing the Estimates, and significant changes in appropriation requests, including new policies and significant increases and decreases in the amounts appropriated. It also requests Ministers to indicate the key mechanisms used to evaluate the impact of outputs in achieving the stated outcomes.

The supplementary questions generally inquire concerning functions or services to be introduced or curtailed during the year. They also request a considerable amount of input information (for example, on travel, consultancy and personnel expenses), indicating that despite the reforms, the Parliament has not lost interest in this type of information.

I do not believe that inserting cost and trend data on outputs into the Estimates would make this document too unwieldy. Considerable economy in space can be achieved by rearranging some of the information currently provided in the Estimates. The key issue is not the number of pages, but whether the Estimates should enable Parliament and other users to make informed judgments on the amounts to be appropriated, or whether they should also provide performance targets against which actual results can be compared. I believe the Estimates can efficiently serve both roles.

#### Departmental Forecast Reports (DFRs).

These reports are the most recent additions to the accountability regime. They were first prepared at about the time interviews for this study were conducted with chief executives and senior managers. Undoubtedly, the attitudes expressed in these interviews were coloured by the initial experiences that departments had in complying with this new requirement. Many managers saw the DFRs as make work that duplicated information readily available in other documents and as an indication of insensitivity to the burdens placed on departments. They particularly resented the government's failure to compensate them for the additional work required to prepare these reports. Small departments felt the pinch the most.

Against these complaints, the reasons that led to introduction of the DFRs merit mention. These reports replaced the departmental budgets previously included in the annual Estimates. They enable the government to sharpen the distinction between the resources appropriated to Ministers as purchasers and those provided departments as producers. They give each department an opportunity to describe what it plans to do and spend, in its own words and numbers, though these have to be consistent with the Estimates. It was anticipated that the DFRs would lessen Parliament's demand for information via the standard and supplementary questionnaires. Finally, the DFRs would provide benchmarks for enforcing accountability; the annual reports compare outturns to the results forecast in the DFRs.

The DFRs add up to more than 1,500 pages. Although the size varies greatly among departments, all are required to include the provisions prescribed by the Public Finance Act. Section 34A of the Act provides that each department should forecast its financial position at the beginning and end of the year; its revenues and expenses for the year; projected cash flows; the performance of each output class; and financial performance. Each DFR also contains statements of responsibility, significant assumptions and accounting policies, and certain other information. Treasury has provided an indicative format which is followed by most departments.

These guidelines urge that the output classes be specified "from a departmental/provider perspective . . . that differs from the form and purpose of departmental output-class specification in the

Estimates.” The Treasury guidelines also stress the link of the DFRs and annual reports. The DFR’s statements of objectives must be included in the annual reports as a reference point for auditing the statement of service performance.

The DFR is a free-standing document that is intended to be used independently of the Estimates, but should be consistent with them. A Treasury review of the first crop of DFRs concluded that some departments had merely repeated the output information published in the Estimates, but most had made some effort to describe the outputs from their perspective. My own sampling of the DFRs indicates substantial overlap with the Estimates, though the former tend to be more detailed. Like the Estimates, the DFRs concentrate on the year ahead and do not provide year-by-year trends on the mix, volume, or cost of outputs. Standing alone, the DFRs appear to be well designed and useful documents; read in tandem with the Estimates, one may question whether the additional work might be reduced by cutting down on duplication.

In reviewing the DFR output information in the light of the parallel information contained in the Estimates, I am not sure what is meant by the difference between the Minister’s and the department’s perspective. In terms of the outputs themselves, there should be no difference between the two. The department sells what the Minister buys. In fact, the two sides must agree on common outputs in the purchase agreement. It is of little consequence that the Estimates read, “This class of outputs involves the purchase . . .,” while the DFR states, “This class of outputs involves the provision . . . .” Many DFRs provide more detail than is published in the Estimates, including information on the volume and cost of outputs, but there is no reason (other than space constraints) why some of this detail cannot be inserted in the Estimates.

There is one important difference between the Minister’s purchase and the department’s provider perspective. As purchaser, the Minister should be indifferent as to how the outputs are produced, but this must be a matter of substantial concern to the department. In late 1995, the chair of Parliament’s Finance and Expenditure Committee urged departments to enhance ownership-type information in the DFR’s, such as information on management developments and the capacity to produce. I am not sure, however, that the DFR is the appropriate vehicle for discussing the department’s capacity to efficiently produce the outputs or broader ownership issues.

#### Purchase Agreements.

These agreements were not part of the original management design. They were introduced (beginning with the 1993/94 financial year) pursuant to a recommendation by the 1992 interdepartmental working party on output definition that chief executives specify the outputs to be supplied in agreements with Vote Ministers. The purchase agreements gained quick acceptance, and only three years after being introduced, they have secured a niche in New Zealand public management.

Although these agreements are welcomed, practice has not been standardised. As noted, some Ministers sign agreements after protracted negotiations aided by purchase advisers; others sign with little or no discussion. Some Ministers use the agreement as a vehicle for reviewing all the outputs supplied by the departments; others regard it as an opportunity to impress their priorities on the department. The most common pattern is one in which the chief executive drafts the agreements, most of the outputs specified in the signed document are those proposed by the chief executive, but the Minister inserts some matters that she/he is concerned about. Seen in this light, the key test is not whether Ministers influence the entire agreement - they rarely do - but whether they succeed in getting the department to accord priority to those outputs they care about. Most Ministers regard their influence on specific priorities as sufficient.

Purchase agreements are negotiated during the period that the budget is being prepared. Thus there are parallel discussions between the Minister and chief executive on the outputs to be purchased and between the Minister and the Minister of Finance and Treasury on budget expenditure decisions. There is inevitable spillover from one set of negotiations to the other, if only because the purchase agreement cannot be finalised until the Estimates have been settled. Early in the purchase agreement process there was consideration whether the parallel negotiations should be formally linked. Treasury met resistance from chief executives when it requested copies of their draft 1994/95 purchase agreements while the 1994 budget was being formulated. Treasury considered that even in draft form these documents would assist Vote analysts in reviewing departmental budgets; chief executives saw the request as an inappropriate intrusion by Treasury into their relationship with Ministers. Facing strong opposition, Treasury retreated, but it nevertheless remains an issue whether the purchase agreement should be wholly a bilateral matter or of broader interest to the government. Departments do provide purchase agreements, sometimes in draft when the agreement has not been finalised, to Parliamentary select committees for their Estimates examinations. I believe they should also be provided to Treasury. These agreements should enrich the analysis of whether departments have sufficient resources to produce projected outputs.

An important ongoing issue pertains to the level of detail in the agreements. Some consider the agreement a firm contract (subject to renegotiation during the year) on the services to be delivered; others view it more as an opportunity for periodic discussion between the Minister and chief executive on what the department is planning to do. The more the purchase agreement is perceived in contractual terms, the more likely that it will specify the outputs in great detail. In fact, some purchase agreements list just about every task the department expects to perform.

Although there may be considerable benefit in planning the work to be performed during the year and the tasks to be completed, I am sceptical about the value of trying to specify all work in advance. Departments have to be sufficiently supple and have sufficient slack to deal with the shocks and surprises that occur during the year. Overspecifying outputs runs the risk of generating the same “managing by the book” behaviour that characterised input budgeting. Particularly in policy advice and similar output classes, it makes little sense to specify every report or study to be undertaken; the list will almost certainly change as the year unfolds. Better, therefore, to emphasise those matters of priority to the Minister (as some purchase agreements do) and to leave some of the other details open ended. It is encouraging that an increasing number of purchase agreements describe the overall service to be provided to the Minister and do not itemise individual projects or studies.

### **Monitoring and Assessing Results**

Monitoring performance against target is a vital part of the New Zealand accountability system. In contrast to some other countries where ex post assessments take the form of programme evaluations and the annual reports discuss the entity's work in broad terms, in New Zealand the paramount question is whether the department has delivered the agreed services at the specified costs.

Monitoring does not wait until the year is over. Every purchase agreement has a monitoring and reporting provision that sets out the dates by which the chief executive will report to the Minister on progress in producing the specified outputs. Typically, these are quarterly reports which identify and explain variances between agreed and actual performance and, where appropriate, propose corrective action or modifications to the agreement.

The monitoring arrangement exerts enormous influence on the behaviour of chief executives and their departments. As the year progresses, chief executives pay attention to the terms of the purchase agreement and organise the department's work to maximise achievement of the performance targets. Many managers keep checklists that show the status of each item in the agreement. Typical entries are "completed," "in progress," and "to be started." By year's end, most chief executives can report that they have accomplished almost all of the agreed tasks.

This checklist mentality is welcomed by those who see it as evidence that managers are indeed accountable for what they do. The purchase agreement (and the Estimates and DFRs on which it is based) is not simply a wish list that managers disregard whenever it is expedient for them to do so. More important, Ministers are effective purchasers of the goods and services they want. Without denying these gains in accountability, I wonder whether management-by-checklist unduly narrows managerial perspective and responsibility. Some managers seem to take the view that if it is not on the list, it is not their responsibility. Of course, chief executives should comply with the agreement and produce the specified outputs. But the most valuable asset that chief executives bring to their relationship with Ministers is not compliance but judgment and leadership. I am concerned that checklist managing is yet another reinforcement of purchase at the expense of ownership.

#### Annual Reports.

The annual report and audit complete the annual accountability cycle. Section 35 of the Public Finance Act requires a series of financial and service performance statements that mirror the statements now included in the DFRs. As mentioned earlier, this arrangement greatly facilitates the comparison of planned and actual performance.

The annual reports examined for this study were for the 1993/94 financial year or earlier; hence they do not reflect any changes that may have resulted from the introduction of the DFRs or other changes in the accountability system. The typical annual report consists of a narrative discussion of the department's operations during the year and the required financial and service performance statements. Only the statements are audited. Understandably, the descriptive material seeks to portray the department in a favourable light, but one wishes that some of the problems and choices faced by during the year would also be aired.

Financial reporting is one of the major success stories in New Zealand public management. The financial statements are of high reliability, few are qualified, and they enable the government to prepare audited Crown Financial Statements. New Zealand's financial reporting is designed to meet external requirements, though they also make departments responsible for managing their balance sheets, cash flows, financial operations, and accounts. My concerns in this area pertain to matters raised in the previous chapter. Cost and managerial accounting have lagged behind progress in financial reporting, with the result that one cannot always be certain that the costs have been fairly allocated among output classes. Auditors might probe more closely how it is that departments manage to spend just about every dollar appropriated to the various output classes. Hitting the financial bull's-eye should be harder in output budgeting than when resources are accounted for by inputs. Yet managers seem to do it with great regularity. What might warrant investigation are not so much the accuracy of the financial statements but the cost allocation practices that underlie these statements and (more importantly) the incentives departments have in managing their finances.

### Internal Management Controls

Preparing and auditing financial statements depend on robust internal controls that provide reasonable assurance that the data are accurate. Thus an effective accountability regime must encompass the internal controls on which the financial reports are based. These controls pertain to much of the management capacity of departments: their information and data processing systems; the maintenance and safeguarding of inventory and other assets; assurance that applicable laws and regulations are adhered to; and more. Internal controls affect the capacity of departments to deliver outputs at agreed price; even more fundamentally, they relate to the government's ownership of its departments.

The 1992 Guidelines for Internal Control Standards issued by the International Organisation of Supreme Audit Institutions (INTOSAI) defines internal control as "a management tool used to provide reasonable assurance that management's objectives are being achieved." It vests each country's audit institution with responsibility for reviewing the internal control structure and for assuring that the controls are working as intended and are adequate to achieve the desired results. The guidelines set forth the following standards for appraising the adequacy of internal controls:

- C All transactions and significant events are to be clearly documented, and the documentation is to be readily available for examination.
- C Transactions and significant events are to be authorised and executed only by persons acting within the scope of their authority.
- C Key duties and responsibilities in authorising, processing, recording and reviewing transactions and events should be separated among individuals.
- C Competent supervision is to be provided to ensure that internal control objectives are achieved.
- C Resources are to be periodically compared with the recorded amounts to determine whether the two agree. The asset's vulnerability should determine the frequency of the comparison.

The guidelines characterise these controls as "the minimum acceptable standards that organisations follow when instituting internal controls and provide criteria for auditors when auditing the internal control structure." Nevertheless, these standards must be balanced against the drive to free managers to manage. An excess of controls would dampen managerial initiative and responsibility; too little control would open the flood gates to abuse and mismanagement.

It would be wrong, however, to see managerial flexibility and strong internal controls as incompatible. In fact, these controls are preconditions for removing external controls on managers. It is in this light that the management controls of New Zealand departments warrant attention. The performance and purchase agreements and the annual reports generally refer to these controls, but they rarely itemise the standards applied, how the effectiveness of the controls is tested, or the measures taken to improve them. Although this study has not examined internal controls, one should not be surprised if they were found to be stronger at the centre of departments than in field operations, more effective in dealing with financial transactions than with other aspects of performance, and more closely reviewed for those elements of performance specified in advance than for other management practices.

Ownership and management control are inextricably related. Internal control is about managers taking responsibility for the organisations they lead, not because particular tasks or outputs have been specified, or because purchasers will be displeased with the goods and services provided, but because they are in charge. In the New Zealand model, managers are not the owners, but they should see themselves as the owners' agents in ensuring that the department's work is carried out

efficiently, with due regard for legal obligations, and in a manner that upholds the ethic of Public Service.

The spirit and practice of managerial responsibility must radiate through every department, and from headquarters to staff down the line. If it doesn't, sooner or later the enormous accomplishments of New Zealand reform will be challenged and possibly discredited - not by great failures of policy or strategy, but by ordinary missteps that call into question the adequacy of internal control and generate demands for reimposing external controls. To guard against this, departments must inculcate and train their employees and contractors on the legal and ethical requirements of acting according to the rules.

### **The Costs of Accountability**

The argument just made can be restated to say that robust and efficient management controls are essential because they obviate the need for burdensome internal controls. The situation is more complicated than this statement suggests, however, because New Zealand relies on a potent combination of internal and external controls to maintain accountability. Thus, the external controls on inputs have been lifted, but new external controls on outputs (in the form of performance and purchase agreements, financial reporting and auditing, service performance reporting requirements, and so on) have taken their place. New Zealand is not a country where anything goes in public management.

The heavy reliance on external controls is not accidental; it derives from what is referred to as the "accountability relationship":

a relationship between two parties - where one party (the principal) confers resources and authority on and exercises accountability over another (the agent).  
. . . The exercise of accountability requires the provision of high-quality information on the discharge of those responsibilities.

Report of the Working Party to the Advisory Group on  
Accountability Requirements, October 1994, p. 10.

New Zealand's accountability requirements entail substantial transaction costs. These requirements were catalogued in 1994 by the Working Party (quoted above) which found no "fundamental problems with the underlying elements of the accountability system," but set out six principles to guide the central agencies in operating and refining the accountability system. These were (1) the clear indication of the purpose of, and justification for, the information required; (2) consistency of the purpose with the responsibilities and accountabilities of Ministers, chief executives and the central agencies; (3) use of the most efficient and effective information processes to achieve that purpose; (4) proper consideration of materiality and risk; (5) minimisation of duplication and overlap; and (6) reasonable assurance that benefits exceed costs and that overall costs are minimised. The working party recommended, and the Government agreed, in accordance with SSC guidelines, that chief executives should decide how best to meet public information requirements. This would have permitted departments to dispense with corporate plans. Many continue to publish these plans but some ceased to produce them and now rely instead on DFRs or a combination of strategic directions documents and DFRs.

I am not persuaded by the Working Party's conclusion that the current accountability regime does not overload departments. Not only are the costs quite substantial, they have escalated as additional requirements have been imposed. Chief executives must allocate many more resources to operate

the accountability system than was required five years ago. Because New Zealand allocates overhead costs among each department's output classes, it probably would be impossible to calculate the full cost of the system. There is no separate output class for accountability outputs, such as the purchase agreements and DFRs, nor should there be. Nevertheless, one should not be surprised if the transaction costs of the system represented a significant portion of total running costs, especially in small departments.

Arguably, these costs are lower than the costs of operating the old input controls. But even if this were so, the comparison is inapt. The issue is not whether today's transaction costs are higher or lower than the costs of complying with the input controls, but whether these costs are higher than necessary to provide reasonable assurance that managers account for their performance. It would be appropriate for Treasury to study the total financial costs of maintaining the accountability system. Only with data in hand would it be possible to assess compliance costs in the light of departmental resources.

Money is not the only cost borne by departments. The multiplicity of informational requirements and procedures can induce compliance behaviour, the attitude that the most important measure of performance is adherence to preset rules. It should be of little comfort that compliance now is oriented to producing outputs and meeting other contracted obligations. Whether it concerns inputs or outputs, a compliance mentality breeds passivity, reluctance to take risk and initiative, dependence on detailed specification, and an inclination to work by the book. This face of compliance may not be evident yet in New Zealand because the rules are relatively new and there is widespread appreciation of the reforms. But it will not be long before the next generation of managers and civil servants inherits rules and procedures they did not create, and are required to do things a certain way without fully understanding the logic of the New Zealand model.

There is a tendency in organisations for accountability requirements to be added as new situations and problems arise. This already has happened in New Zealand, and I doubt that the process of accretion has run its course. Indeed, some of the issues raised in this report may spawn additional requirements. Care must be taken that the cumulative burden of the accountability system not overwhelm the departments and induce even more compliance behaviour.

## **Conclusion**

Development of new means of accountability has been one of New Zealand's most conspicuous and important contributions to public management. The accountability relationship of purchasers and providers has stimulated the invention of new forms of contracting for and assessing performance. This relationship can be labelled, with only slight exaggeration, as accountability by specification. No other country has accomplished what New Zealand has in building accountability into the framework of government. None of the problems discussed in this chapter would arise were it not for New Zealand's strong determination that as agents and producers, managers must be fully accountable for their performance.

In this report, as in the literature of public management, accountability and responsibility are sometimes used interchangeably. But the words lead down very different managerial paths. Responsibility is a personal quality that comes from one's professional ethic, a commitment to do one's best, a sense of public service. Accountability is an impersonal quality, dependent more on contractual duties and informational flows. Ideally, a manager should act responsibly, even when accountability does not come into play. As much as one might wish for an amalgam of the two worlds, the relentless pursuit of accountability can exact a price in the shrinkage of a sense of

responsibility. Responsibility itself is not sufficient assurance of effective performance; if it were, there might have been no need to overhaul public management. Yet something may be lost when responsibility is reduced to a set of contract-like documents and auditable statements. In the new world of New Zealand management, it is urgent to uphold the old-fashioned tenets of managerial responsibility, while strengthening the modern instruments of managerial accountability.

## VIII. The Spirit of Reform

This report has focused on various concerns pertaining to the reform of public management in New Zealand. My aim in these concluding reflections is to step back from the elements of the system and to discuss whether the Government should consider reversing the process of reform that was launched almost a decade ago. My answer is an emphatic “No”. Scrapping the reforms would be foolhardy because they have greatly improved the efficiency and quality of public services. Going back to the old ways should not be regarded as a viable option, for managers would once again be judged in terms of compliance with *ex ante* controls, not by their performance. The challenge facing New Zealand’s State sector is to extend the reforms while remedying some of the shortcomings that have been identified.

The reformed State sector is testament to the power of ideas and the inventiveness of its architects. It is a singular accomplishment in the development of modern public administration, and it will influence the future course of management both in New Zealand and other countries. It is worth briefly reviewing the roll call of some of its pioneering accomplishments. New Zealand has been the first country to fully adopt cost based accounting and budgeting; the first to successfully implement techniques of output budgeting; the first to give managers full discretion in using inputs; the first to introduce strong incentives for the efficient use of capital; the first to require advance specification of the outputs to be purchased; the first to establish a comprehensive accountability regime.

Being first means that certain deficiencies will emerge as reform takes hold. One should think of the problems discussed in this report as akin to the “bugs” found in state-of-the-art technologies after they have been introduced. There is now a need to “debug” some of the reforms, but that is a far different matter than getting rid of them altogether. In fact, the bugs have emerged only because of the extraordinary leaps forward in transforming the New Zealand State sector. There would be no problem in costing outputs if the budget were not output-based; accountability would not be burdensome if accountability was not taken seriously; no one would have to worry about the incentive effects of the capital charge if capital were free. The list goes on and on. Every issue identified in this report sheds light on the enormous progress made in transforming the State sector.

Three clusters of concerns were identified in the opening chapter and discussed in the report. One pertained to the strategic capacity of Government entities, another to the costing of Public Services, and the third to the accountability system. Great strides have been made in addressing the first problem. Through the SRAs and KRAs, the medium (and longer) term perspective mandated by the Fiscal Responsibility Act, and increased planning, the strategic capacity of Government departments has been upgraded. What is most pleasing about this development is that it has been accomplished in ways that comport with the logic and practice of the New Zealand model. The SRAs and KRAs emphasise the *ex ante* specification of objectives, as do other elements of the New Zealand system, and the Fiscal Responsibility Act upholds the value of transparency in public policy. Undoubtedly, more work will be done in the years ahead in defining and applying outcome measures and in evaluating results. But advances in strategic capacity demonstrate the elasticity of the reforms and their openness to new ideas.

The costing of public services is a tougher issue because it requires fresh breakthroughs in public management, especially as regards cost accounting and analysis, and true contestability in public services. In this area, additional work has to be done in costing outputs, testing the practicality of Mode C appropriations, and relating the volume of outputs to the volume of resources. Unlike other

elements of reform which have been introduced across the board, pilot testing may be appropriate in this area.

Taking accountability seriously is a genuine triumph of New Zealand public management. Other countries give lip service to holding managers accountable; New Zealand has robust mechanisms in place to enforce accountability. Paradoxically, however, basing accountability on the ex ante specification of performance can have unanticipated consequences, as when unspecified matters escape accountability. My sense is that this problem will not be remedied by even more detailed specification of performance. Rather the solution will have to come from embracing a "responsibility" model of accountability.

This model would not distinguish so sharply between producers and purchasers, between outputs and outcomes, and between the responsibilities of Ministers and chief executives. It would not split Government into seemingly airtight compartments and assign formally differentiated roles to each. In practice the boundaries between Ministerial and chief executive accountabilities are somewhat fuzzy. I do not believe that all of the intellectual argument of principal-agent theory, as powerful and enlightening as it is, is necessary to advance managerial reform in New Zealand, nor do I believe it advantageous to have a Government with a split personality. Pretending that the Minister is a fully independent purchaser doesn't make it so, though it may add to transaction costs.

A less prescriptive approach to reform would not mean reversing course. A managerial revolution built on ideas must ultimately be tested by experience. New Zealand has passed the test with flying colours. Public services are more accessible and responsive, more sensitive than in the past to the needs of citizens and clients, and much more efficient. A culture of performance has penetrated New Zealand public management. Chief executives and managers know and accept that they are judged on the performance of their organisations. They know that producing agreed outputs at budgeted cost is a critical and legitimate measure of how well they are performing. They accept that improving performance must be an ongoing objective, and that it is necessary that productivity gains in the state sector keep pace with developments in the market economy.

Many of these improvements are a matter of technical or operating efficiency - more outputs produced with fewer inputs. This alone would not be a minor achievement, for it is in the delivery of services that citizens interact with Government and form judgments on its performance. But as important as it is, efficiency in producing outputs is not the whole of public management. It also is essential that Government has the capacity to achieve its larger political and strategic objectives. More than twenty years ago, the Nobel Prize economist Kenneth Arrow wrote in *The Limits of Organisation* (1974) "the prime need in organisational design is increasing capacity to handle a large agenda.... Shortrun efficiency and even flexibility within a narrow framework of alternatives may be less important in the long run than a wide compass of potential activities."

The next steps in New Zealand State sector reform will have to address this larger agenda. They will have to move from management issues to policy objectives, to fostering outcomes, such as social cohesion, that have been enunciated by the Government and are embraced by New Zealanders. They will have to do for outcomes what has been accomplished for outputs. The task ahead is much more difficult than what has been accomplished thus far, but the rewards of success will be even greater.

## TERMS OF REFERENCE

### Study of the New Zealand State Sector Management Framework

This is an external study of the New Zealand State sector management framework, jointly commissioned by the State Services Commission and The Treasury, and carried out by Professor Allen Schick of the University of Maryland, Washington D.C., USA.

#### *Key Task*

To produce an authoritative, independent report which identifies and substantiates the extent to which public and political confidence in the reforms is justified, which points to improvements that can be made, and which stands as a benchmark against which future progress can be measured.

#### *Key Principles*

The key principles to guide the study shall be those of the State Sector Act 1988 and the Public Finance Act 1989, and the recommendations should be directed towards improving State sector management within the framework of those principles, drawing on experience with the reforms to date.

#### *Key Issues*

The review is to focus particularly on the roles of Parliament, Ministers and Chief Executives (CEs) in the new regime, on the clarity of each of those roles, and on the adequacy of the information available to support their decision making. The following list of issues to be addressed is indicative rather than exhaustive:

- ! the form and content of the Estimates, departmental plans and reports;
- ! the modes and structure of appropriations, especially as regards appropriation by output class;
- ! the specification of outputs and progress towards measuring outcomes;
- ! full cost attribution, including accrual accounts, the capital charge, and audited financial statements;
- ! the distinction between government as owner and government as purchaser;
- ! the practice and potential of strategic management;
- ! performance agreements and purchase agreements as `contracts' between Ministers and Chief Executives;
- ! the scope of the flexibility (especially as regards finance) available to Chief Executives;
- ! the provision and contestability of policy advice;
- ! the new roles of the central agencies (Treasury, State Services Commission and Department of the Prime Minister and Cabinet);
- ! the evidence, including quantitative evidence, for the success or otherwise of the reforms.

**PROFESSOR ALLEN SCHICK: BIOGRAPHICAL NOTE**

Allen Schick is a Professor of Public Policy in the School of Public Affairs at the University of Maryland and a Visiting Fellow at the Brookings Institution. He previously taught at Tuft's University and served in the Congressional Research Service. Schick received a B.A. from Brooklyn College and M.A. and Ph.D. degrees from Yale University.

Schick is a specialist in political institutions and government finance. His books include *Congress and Money* (1980), *Crisis in the Budget Process* (1984), *The Capacity to Budget* (1990), and *The Federal Budget: Politics, Policy, Process* (1995). He is also the author of more than 200 articles and reports.

Schick has received the Brownlow Award from the National Academy of Public Administration for the best book on political institutions, the Hardeman Prize from the University of Texas for the best book on the U.S. Congress, and he has been recognised five times by the American Society for Public Administration for the best article in *Public Administration Review*. He has also received a Guggenheim Fellowship and the Waldo Prize for lifetime contributions to the literature of public administration.

Schick's current interests pertain to reform of government management. He has conducted studies for OECD on management reform in Australia, France, New Zealand, Sweden and the United Kingdom, and he has assisted management improvement in the newly-democratic countries of East and Central Europe. He has served as a project director for a study in contemporary budget practices published by the Organisation for Economic Co-operation and Development.

## Output Classes and Appropriation Items: 1995/96 Estimates

Vote	Number of Output Classes		Other Appropriation Items	Biggest Output Class (\$000)	Smallest Output Class (\$000)
	Departmental	Nondepartmental			
Accident Rehabilitation & Compensation Insurance	1	4	2	98,429	45
Agriculture	10	1	6	65,832	343
Attorney General	4	0	0	16,048	726
Audit	4	0	0	18,602	142
Business Development	1	1	1	4,997	2,114
Civil Defence	2	0	2	4,619	715
Commerce	6	6	7	8,764	134
Communications	2	5	2	12,556	599
Communication Security and Intelligence	Not Available			Not Available	
Conservation	9	2	11	41,685	1,129
Consumer Affairs	3	0	0	2,007	1,140
Corrections	6	0	1	166,001	891
Courts	6	1	4	88,794	2,250
CHEs	1	0	1	Not Applicable	
CRIs	2	0	1	1,466	238
Cultural Affairs	1	5	2	11,244	86
Customs	5	0	4	21,182	2,171
Defence	3	0	4	3,459	2,723
Defence Force	24	0	2	346,746	8,126
Dept. of Justice	14	5	3	58,905	38
Education	8	19	29	1,208,798	299
Education Review Office	4	0	0	9,321	422
Employment	5	4	6	78,350	582
Energy	6	1	6	8,241	1,572
Environment	2	4	5	13,182	386
Finance	9	0	16	19,949	1,115

Vote	Number of Output Classes		Other Appropriation Items	Biggest Output Class (\$000)	Smallest Output Class (\$000)
	Departmental	Nondepartmental			
Fisheries	7	1	2	19,477	860
Foreign Affairs & Trade	10	5	7	164,670	374
Forestry	6	1	5	25,009	1,323
Govt. Superannuation Fund	3	0	4	4,265	147
Health	7	13	6	1,128,760	1,063
Housing	3	0	1	9,348	2,304
Immigration	4	0	0	33,363	730
Internal Affairs	15	3	18	26,036	21
Justice	4	5	3	48,218	126
Labour	8	3	5	20,804	271
Local Government	2	0	3	1,918	1,425
Maori Affairs	10	1	11	6,932	296
National Library	6	1	1	14,259	47
Office of the Clerk	4	0	3	5,578	592
Ombudsmen	1	0	0	Not Applicable	
Pacific Island Affairs	3	1	5	2,738	235
Parliamentary Environment	1	0	0	Not Applicable	
Parliamentary Counsel	3	0	0	2,693	284
Parliamentary Service	6	0	7	16,704	192
Police	12	0	2	203,011	587
Prime Minister and Cabinet	7	1	1	4,069	300
Racing	1	0	0	Not Applicable	
Research, Science, Technology	4	13	4	257,792	2
Revenue	15	0	14	100,199	540
Security Intelligence	Not Available			Not Available	
Senior Citizens	1	1		850	492
Serious Fraud	2	0	0	2,778	1,864
Social Welfare	13	19	36	122,559	70
Sport, Fitness, Leisure	1	2	1	506	280
State-Owned Enterprises	1	0	0	Not Applicable	

Vote	Number of Output Classes		Other Appropriation Items	Biggest Output Class (\$000)	Smallest Output Class (\$000)
	Departmental	Nondepartmental			
State Services	5	2	3	7,226	50
Statistics	3	0	2	50,758	587
Survey and land Information	6	3	10	28,736	691
Tourism	2	3	1	34,174	514
Transport	5	12	8	47,121	907
Treaty Negotiations	2	0	3	9,211	4,545
Valuation	5	0	0	11,833	295
War Pensions	1	0	6	Not Applicable	
Women's Affairs	3	0	0	2,673	333
Youth Affairs	3	2	1	9,337	416
<b>TOTAL</b>	333	150	288		

**SOURCES OF INFORMATION**

Four main sources of information were used as an input to this study:

- C an extensive review of documentation on aspects of the State sector management framework;
- C interviews with departmental chief executives, senior managers and staff;
- C two surveys: one of departmental chief executives, and one of managers; and
- C group discussions.

**Documentation**

Over 500 documents - some department-specific and some relating to the wider Public Service and State sector - were reviewed as part of the production of this report. The documents covered the fields of strategic management, performance management (including specification, monitoring and reporting), accountability frameworks, human resource management, ethics and professionalism, budget systems, and organisational design.

**Interviews**

Interviews were conducted with chief executives, senior managers and, in some cases, staff in the following departments: Inland Revenue Department, (the then) Ministry of Agriculture and Fisheries, Te Puni Kokiri, Customs Department, Education Review Office, Department of Social Welfare, Department of Labour, Ministry of Health, Ministry of Commerce, Audit Office, Ministry of Transport, Department for Courts, Ministry of Foreign Affairs and Trade, Ministry of Defence, State Services Commission, The Treasury and the Department of the Prime Minister and Cabinet.

Visits were made to regional offices of the Inland Revenue Department, Ministry of Education, Department of Labour, Education Review Office and Department of Social Welfare.

Discussions were also held with: managers in the Land Transport Safety Authority, Northern Regional Health Authority, and the ACC; academics at Victoria and Auckland universities; the Public Service Association; politicians (including Ministers and government and opposition MPs); and informed outside commentators.

**Surveys**

Qualitative and quantitative surveys were conducted of departmental chief executives and a sample of managers.

**Group Discussions**

A number of discussions were held with departmental chief executives and staff from the State Services Commission and The Treasury. A consultative panel, made up of chief executives and representatives from the State Services Commission, The Treasury and the Department of the Prime Minister and Cabinet, was established to advise and assist the author of this report.