7. MANAGING THE PUBLIC SECTOR

A well-managed public sector can contribute to higher living standards throughout the community.

The State Sector Act and the Public Finance Act provide Ministers with powerful tools for accomplishing the Government's goals. They enable Ministers to clarify choices, make better decisions, and ensure that these decisions are implemented.

The tools do not in themselves guarantee better performance from the public sector. But if they are used effectively, they will increase both the accountability and performance of departments. They will allow Ministers more time to concentrate on key issues, set directions and clarify responsibilities.

Further reforms will also produce gains. There are many agencies that fall outside the normal departmental or state-owned enterprise structures. Applying the principles used elsewhere in the public sector will help clarify the relationships between these agencies and the Government. This will increase their incentives for efficiency.

INTRODUCTION

Public spending, including transfers, accounts for nearly 40% of GDP. This year the Budget outlined plans for departments to supply goods and services costing $5.7 billion, to make gross income transfers and payments for non-departmental services totalling $20.6 billion and to collect $27.2 billion cash in taxation. The Crown has approximately $12 billion invested in the assets of its departments.[1]

If well managed the public sector can increase the potential for higher living standards throughout the community. However, there is evidence, particularly from the state-owned enterprise experience, that many government activities are run less efficiently than they could be.

The Public Finance Act 1989 and the State Sector Act 1988 provide the means for Government to achieve its objectives by helping Ministers to:

- clarify the choices they face
- implement the policies resulting from their choices
- track progress towards their objectives.

Each of these is dealt with below in the section on the core state sector. In addition, the form into which activities are organised is also important in determining results. This is examined in the section on commercial activities.

THE CORE STATE SECTOR

Choices Facing the Government

Ministers face a vast range of decisions yet their time is limited, particularly in Cabinet and its subcommittees. They may also have responsibility for oversight of the management of very large departments and some may have no experience in management. At the same time the quality of decisions made by Ministers is probably the most important determinant of the success of a government. Together, these factors put pressure on the decision-making process. Conscious attention by the Government to this process can ensure that the areas which are key to success are brought into focus and given appropriate attention.

1 Excluding the New Zealand Defence Forces and the Iwi Transition Agency, and including the Housing Corporation.

Recent changes to the management of the public sector, contained in the Public Finance and State Sector Acts, are designed to help Ministerial decision-making in several ways:

- They allow Ministers to be more explicit about what results, or "outcomes", they are looking for on behalf of the electorate. It is desirable for this to occur within an overall strategy that brings consistency among decisions. Choosing services ("outputs" such as surgical treatments) that contribute effectively to the desired effects on the community ("outcomes" such as a reduction in pain and discomfort) may be difficult and the relationships complex. This will normally require detailed policy analysis. A clear distinction between outputs and outcomes also makes it easier for Ministers to focus both on the relative priority of the desired outcomes and the selection of services which best achieve those ends.

- They encourage Ministers to make separate decisions over what services to buy and where those services should be purchased. In particular, the reforms distinguish between the Government's role as "purchaser" of the services its departments produce and its role as the "owner" of those departments. As purchaser, the Government wants to get the best quantity and quality of service possible for the money paid. As owner, the Government wants to be sure that the resources tied up in the department are achieving as much as they could if invested elsewhere in the economy.

- Better information now enables Ministers to judge better whether a particular service should be bought from a government agency or from the private sector. Ministers now can compare the costs in each case. Previously, the differences in the accounting, regulatory and tax regimes have precluded meaningful cost comparisons.

- Finally, Ministers are assisted to identify and evaluate investment choices. Ministers now have information on the level of assets in departments and in some cases on how well that capital is being used. This will aid in decisions on the level of capital for different departments and whether or not to invest more or less in departmental operations.

Taking Advantage of the New Management Process

The maximum benefit is likely to be obtained from the Public Finance and State Sector Acts if Ministers:

- Recognise that their former role can change to put greater emphasis on setting directions and clarifying what they want done. Less time and effort would then be spent on day-to-day matters without political or strategic significance.

- Concentrate attention on the key issues. In the past there was a tendency for new ministerial initiatives to be added on to what departmental managers claimed was the cost of past activities. No information or procedures existed for establishing priorities on the total use of resources.

- Put considerable effort into clarifying policy goals or outcomes and the relationship between these outcomes and the outputs or services purchased. Under the reforms to date, the outcomes contained in the Estimates have generally been poorly specified. This was to be expected during the transition to the new system. Furthermore, the policy analysis necessary to make sure departmental outputs contribute effectively to the Government's desired outcomes is often non-existent and there are few staff qualified to do it. It is likely to be some years before there are clear and sensible definitions of the outcomes to which goods or services contribute. In developing these definitions and establishing the links between outputs and their effects, Ministers need to be wary of elaborate specifications and detailed policy analysis in areas of low return, even if the quality of that analysis is good. Analysis should focus on outputs or transfers that have a material impact on the Government's financial position.

- Give continued attention to the way outputs are specified when departments seek budget approvals. Output specification can be a surprisingly subtle process, and is likely to take some time before the definitions have been adequately examined and tested. In the process, departments are likely to seek to lump together different types of output in a small number of output classes. This gives departments greater flexibility at the expense of Ministerial control and should be firmly resisted. Further, Ministers should keep in mind that the more closely output definitions resemble goods or services which could be purchased in the private sector, the greater will be the ability of Ministers to make ready comparisons of alternative sources of supply. Difficulties in arriving at clear specification of outputs can be a sign of low-value activities, or lack of clarity about the purposes of a department.

Implementation of Government Decisions

Converting the Government's decisions into action is also critical if its objectives are to be attained. Ministers have several mechanisms available to ensure that the agreed services are delivered in an efficient manner. These include:

- specification of job descriptions for Chief Executives
- appointments of Chief Executives
- Chief Executive performance agreements
- departmental corporate plans
- departmental budgets
- Chief Executive rewards and sanctions for performance
- "Machinery of Government" changes to best match functions with organisations.

The relationship between the Minister and Chief Executive is of prime importance. Good public administration requires an arms-length but well functioning relationship between Ministers and Chief Executives, including clear mutual expectations. Ministers need to ensure that their choices are clearly set out in the annual performance agreements with the Chief Executive, the departmental corporate plans and the Estimates of Expenditure. The Estimates show the budgets approved for particular classes of outputs, while the performance agreements and corporate plans spell this out in more detail. It is important that these documents are consistent with one another so that the Chief Executive's responsibilities are clear, the department has explicit plans for producing the agreed outputs, and adequate resources are available. Similar consistency between the three documents should also be found in their references to expected financial performance.

There is value in stating fully the performance expected of a department in the documents made public near the beginning of each financial year. Public scrutiny adds to the incentives on a Chief Executive to deliver as agreed with the Minister. These public documents currently include the Estimates and the departmental corporate plans. The less specific these are, the less the Minister can determine whether his or her objectives were met.

Specifying what performance Ministers expect of their departments is time-consuming and requires expertise to be available to Ministers. Further, Ministers need to be able to discharge this role with considerable independence from departments, in order to make sure the specified outcomes and outputs reflect the Government's priorities, not the department's. This may be possible only if Ministers have additional support in their own offices to counterbalance the superior information and resources at the disposal of the Chief Executive.

Because the new approach to public sector management gives Chief Executives greater flexibility over the use of inputs (staff, materials, plant and equipment), it also demands greater management skills. For many existing Chief Executives these are new skills which some have had difficulty in mastering.

The answer to improving the competence of the group of Chief Executives is complex. It will require such things as:

- encouraging Chief Executives to develop their skills through a range of incentives and sanctions

- reviewing the appointment process to ensure the State Services Commission's responsibilities and accountabilities are clear

- addressing the serious shortage of people in the public sector with the potential for good performance in top management jobs

- avoiding highly specific job descriptions which result in no real choice among qualified candidates for appointment. There are a number of reasons for considering restructuring departments so that those with a large operational role do not also have the responsibility for major areas of policy advice. This would also have the advantage of increasing the number of positions for which managers with only private sector managerial experience would not be disadvantaged

- devising an adequate set of incentives to reward good performance and sanction poor performance is one of the most important steps towards better management. Further work is required on the design of rewards for good performance. The power to dismiss Chief Executives is a crucial discipline in the system and needs to be exercised when it is warranted by poor performance. This should only occur when performance standards have been clearly specified in advance and specific feedback on poor performance given over time. The State Services Commission has a vital responsibility to ensure high standards of personnel management in those regards. The risk of arbitrary dismissal would adversely affect the incentives for people to seek these positions.

Monitoring the Results

The final stage is the monitoring of performance. Under the new system Ministers can obtain timely and reliable information on the actual performance of departments. This enables them to assess the performance of Chief Executives, but implies a willingness by Ministers to take effective action where performance is not up to standard. The reporting mechanisms presently in place include monthly financial reports (including reporting on compliance with appropriations), quarterly reports on output production, and full financial statements every six months.

Private sector organisations do not normally have elaborate systems for monitoring the production of their output. The most effective monitoring is done by customers who have the most immediate interest in the product. If a product does not meet price or quality standards, the firm will quickly receive clear signals to this effect because sales will fall. Where this form of monitoring can be used in the public sector it will be far more effective than any set of administrative procedures. However, for public goods, like defence, such direct consumer monitoring is not possible. It is therefore necessary to ensure that there is high quality and incisive monitoring of outputs which cannot be made subject to consumer preferences. The corollary is that where it is possible to use consumer monitoring in the production of public services there are likely to be significant efficiencies resulting.

Further Developments

For the reformed system of public sector management to be fully effective, a number of further refinements are required:

- The pilot system to improve the incentives on departments to manage more efficiently their fixed assets and working capital has been introduced this year for three departments. It should be fully implemented.

- The specification of outputs, and the development of mechanisms for pricing those outputs, both need to be improved. This will give Ministers clearer choice, as well as ensuring better implementation of these choices.

- Further development is required to ensure that departments properly manage the assets, liabilities, revenue and expenditure which they administer on behalf of the Crown. These include such expenditures as benefit payments, tax receipts and payments to other agencies, such as area health boards, for the supply of outputs. The magnitude of some of these items is so great that they warrant close attention by Ministers. For instance, a variation of only 1% in expenditure on social welfare benefit payments amounts to savings or waste of over $90 million.

Some change in Parliamentary procedures would help to reinforce the new system. Information is now available for more effective scrutiny by Parliament of governmental requests for appropriations, and for subsequent assessment of performance. A significant step would be to implement the changes to parliamentary processes recommended in May 1989 by the Government Administration Committee and agreed to by the Government. Parliament may also need some additional resources to analyse and make best use of the information now available.

CROWN AGENCIES

"Crown agency" is a generic term used to describe a whole range of public sector organisations, such as the Accident Compensation Corporation, Transit New Zealand and tertiary education institutions, which are neither departments, SOEs nor local authorities. The set of changes to the system of public-sector management outlined above have yet to be applied to the majority of Crown agencies. Through the progressive application of the same set of principles to this sector, there is potential for significant further efficiencies, and improved services, from the wider public sector.

COMMERCIAL ACTIVITIES

Recent experience with state-owned enterprises (SOEs) demonstrates the importance of the way activities are organised. Judged in commercial terms, SOEs have significantly out-performed their predecessors.

The financial performance of SOEs has improved significantly following corporatisation. Estimates of earnings before interest, depreciation and tax are shown in Table 7A.

TABLE 7A - ESTIMATED EARNINGS BEFORE INTEREST, DEPRECIATION AND TAX[1]

	$(million) 1986/87	1987/88	1988/89	1989/90
Postal and Agency Activities of Post Office/NZ Post	2.1	124.9	32.2	53.0
NZED/ECNZ	779.9	802.6	941.4	1031.7
State Coal/CoalCorp	(9.2)	14.4	12.6	22.7
POSB/PostBank[2]	(39.3)	78.6	120.9	134.3

Notes

1 This measure is a better indicator of performance than profit after tax as it removes most of the effects of balance-sheet restructuring at the time of corporatisation.
2 Earnings after interest and before tax. The 1988/89 figure is for an 11-month, and the 1989/90 figure is for a 13-month period.

At the aggregate level, some indication of the improved performance is given by the increase in the book value of the shareholders' investment in SOEs. Considering the original SOEs established in 1987[1], this has increased by around $1.7 billion - or over $1,500 per New Zealand household - between 1987 and 1990.

The evidence indicates that improved financial performance has been aided by major productivity improvements in a number of SOEs.

In addition, giving consumers the potential to choose an alternative supplier appears to have spurred SOE performance, and delivered customer benefits, even in areas where SOEs are regarded as having a dominant position. For example:

- Telecom cut the real price of a basket of telephone services by over 20% in the year to September 1989.
- Electricorp reduced the real average wholesale price of electricity by 8% over the three years to 1989/90.
- NZ Post improved on-time delivery of high-priority mail from around 80% to over 95% in the period 1987-90.
- NZ Post's retail network (retail outlets and delivery centres) has grown by more than 20% since 1 April 1987.
- CoalCorp's nominal prices in 1990 were around 20% lower than those charged by its predecessor, State Coal Mines, in 1987.

1 Excluding PostBank which was sold during the period, and Forestry Corporation which operates under a licence agreement.

Shortcomings of SOEs

Although SOEs represent a major improvement over their predecessor organisations, the universal problem of ensuring that directors act in the owner's best interest remains. Owners of private firms are better able to deal with this as they benefit from some mechanisms, such as directors' equity stakes and take-overs, which are absent with SOEs. The lack of such tools makes it difficult for the Government to ensure that SOE directors act in the Crown's interest.

The risks of owning SOEs should not be underestimated. Many operate in relatively risky sectors such as property, banking and energy. If such an enterprise got into financial difficulty, strong pressure from creditors could be expected, notwithstanding the explicit absence of any Crown guarantee. The Crown's exposure with state-owned trading enterprises therefore potentially extends even beyond the loss of its equity. If an SOE becomes unable to pay its debts then normal commercial processes effectively hand control of the assets from the shareholders to the creditors. This amounts to a privatisation de facto and if the Government has non-commercial reasons to retain ownership of the company then it will have to pay off the creditors. It follows that where the Government has explicitly signalled a commitment to long-term ownership of a business there is implicit government backing for that entity's liabilities which weakens the monitoring of the company by creditors.

Finally, while SOEs remain in public ownership the pressures for Ministers to become involved in operational decisions will persist. Even the best-intentioned government will find it hard to resist such forces over time. Thus, there is a risk that eventually the benefits flowing from corporatisation will be eroded.

Sale of State-Owned Businesses

The monitoring difficulties described above stem, directly or indirectly, from the absence of tradable equity. It is hard to see how the problems can be resolved without addressing this basic difference between SOEs and other businesses.

Accordingly, the merits of government ownership of SOEs should be carefully weighed against the costs. Where continued regulatory, social or other issues are of concern, it is likely that these could be better met by other means. For example, market-dominance considerations are often better addressed by changes to the market structure or through regulation. Social concerns could be met by direct social-policy intervention or by mechanisms such a "Kiwi share". In such cases, the benefits of sale could be reaped while still furthering the Government's other policy objectives.

Lessons from Previous Asset Sales

Over a dozen significant sales of state assets have recently been completed. A number of important lessons emerge from the experience:

- Make the objectives of sale clear, and stick to them. Announcing a policy, and then reversing it (or merely appearing to) creates confusion among the parties involved, and harms the Government's credibility. For example, the sale of Air New Zealand was launched before decisions on the sale structure were clearly established.

- Prepare thoroughly, and then proceed swiftly. A sale which founders or is frustrated by an unforeseen impediment harms credibility and can reduce value. Detailed preparation minimises such risks. In contrast with the difficulties accompanying some early sales, recent sales, such as the State Insurance Office, underwent intensive preparation and have proceeded smoothly.

- Make the roles of participants clear and distinct. In general Ministers direct policy, officials implement it, and SOE boards and managers assist by providing information about the business. Boards and managers lack the neutrality to ensure that all prospective purchasers are treated equally. For example, Air New Zealand's board and management made no secret of their preference for British Airways (BA) over Qantas. Had they controlled the sale process, BA might have felt secure as the front-runner, with a weaker incentive to bid a fair market price.

Future Directions

A key lesson from the experience with SOEs is that the choice of organisational form matters. Three major alternative frameworks are now well established. They are government department, SOE and privately-owned company. To date less attention has been paid to the Crown agency form, or other organisational forms such as joint ventures. There are potentially significant gains from clarifying accountabilities in the Crown agency sector.

Departments are legally part of the Crown, and liabilities incurred are fully backed by the Crown. Departments are accountable to Ministers and are subject to the relatively tight external financial controls (compared with SOEs and privately-owned companies) set by the Public Finance Act 1989. In most cases they supply the bulk of their output to the Crown, or on behalf of the Crown to third parties.

SOE Boards of Directors have operational autonomy in terms of the Companies and SOE Acts. The Crown's strict liability for SOE obligations is limited to its equity holding. Boards are accountable to, and are monitored by, shareholding Ministers on their commercial performance. Their outputs are traded in markets.

Privately-owned companies are like SOEs, except they have tradable equity, and the Crown carries no legal liability for their obligations. Compared with an SOE's shareholding Ministers, a private company's owners have a wider range of mechanisms available to ensure that directors act in their best interests. From the owner's perspective, private companies are thus likely to perform better on average than SOEs.

Rather than transforming these basic models, or creating new ones, major gains are likely to flow from critically examining existing activities to determine whether they are in the best form to meet Government objectives.
In particular, the SOE form appears better suited for some activities currently performed by government departments. SOEs are likely to be superior where the interests of customer and owner can be readily identified and separated. There is no simple way of determining whether this holds for a particular activity. A number of factors must be considered. The SOE form is more likely to be appropriate than a departmental structure where either of the following apply:

- the primary interest the Government has in the activity is as owner
- the bulk of the agency's output is sold direct to third parties, or is contestable in its supply.

CONCLUSION

The essential point of this chapter is that the structures and processes through which decisions are made affect the quality of those decisions within the public sector. The effects of outmoded systems have been demonstrated through the SOE reforms. Efficiency gains were very large, and there is no reason to suppose that similar inefficiencies do not exist in government departments and other public sector organisations. The State Sector Act and the Public Finance Act provide the means by which Ministers can attack this problem. However the tools are new, and acquiring skill in their use presents a challenge for Ministers and public sector managers alike.