THE TREASURY
Kaitohutohu Kaupapa Rawa

Public Sector Financial Management – stepping up to the challenge

John Whitehead speech to the Public Sector Financial Management Conference 10 December 2009

4500 words

Hello and thank you for the opportunity to address you today.

I'm very pleased to be here with a group of people who play such an essential role in the management of public finances.

We've certainly heard a lot in recent times about the big financial challenges that we face.

And of course there has been any number of people ready to grab a headline by telling us how to tackle them.

Meanwhile chief financial officers and others with responsibilities in this important area of management have been getting on with what they do best. So at the outset I want to acknowledge the work that you are doing in these testing times. How we do things like manage our budgets, lead cost reduction initiatives and do the cost-benefit work on projects and funding bids, has assumed a greater importance.

And the people here today are critical players in those areas of endeavour.

In his opening keynote address this morning, the Minister of Finance laid down some challenges for us as financial managers, in particular about the management of the Crown's balance sheet.

My role as Secretary to the Treasury is to step up to these challenges and to encourage others to step up – not only here today but also beyond this gathering.

In July this year I gave a speech about the need for the public sector to change the way it operates in response to the Government's call for us to deliver "smarter, better public services for less."

Five months on, the points I made in that speech are still relevant – the imperative for change remains strong.

I want to cover three main areas today:

Firstly, I will touch on the current economic and fiscal outlook and New Zealand's long term fiscal position. As the Minister of Finance has noted, domestic economic recovery is expected to be stronger than we forecast in May. But that doesn't mean the pressure is off – it is important that we keep our eye on the long-term.

Secondly, I'll talk briefly about why in this environment, improving state sector performance is more important than ever.

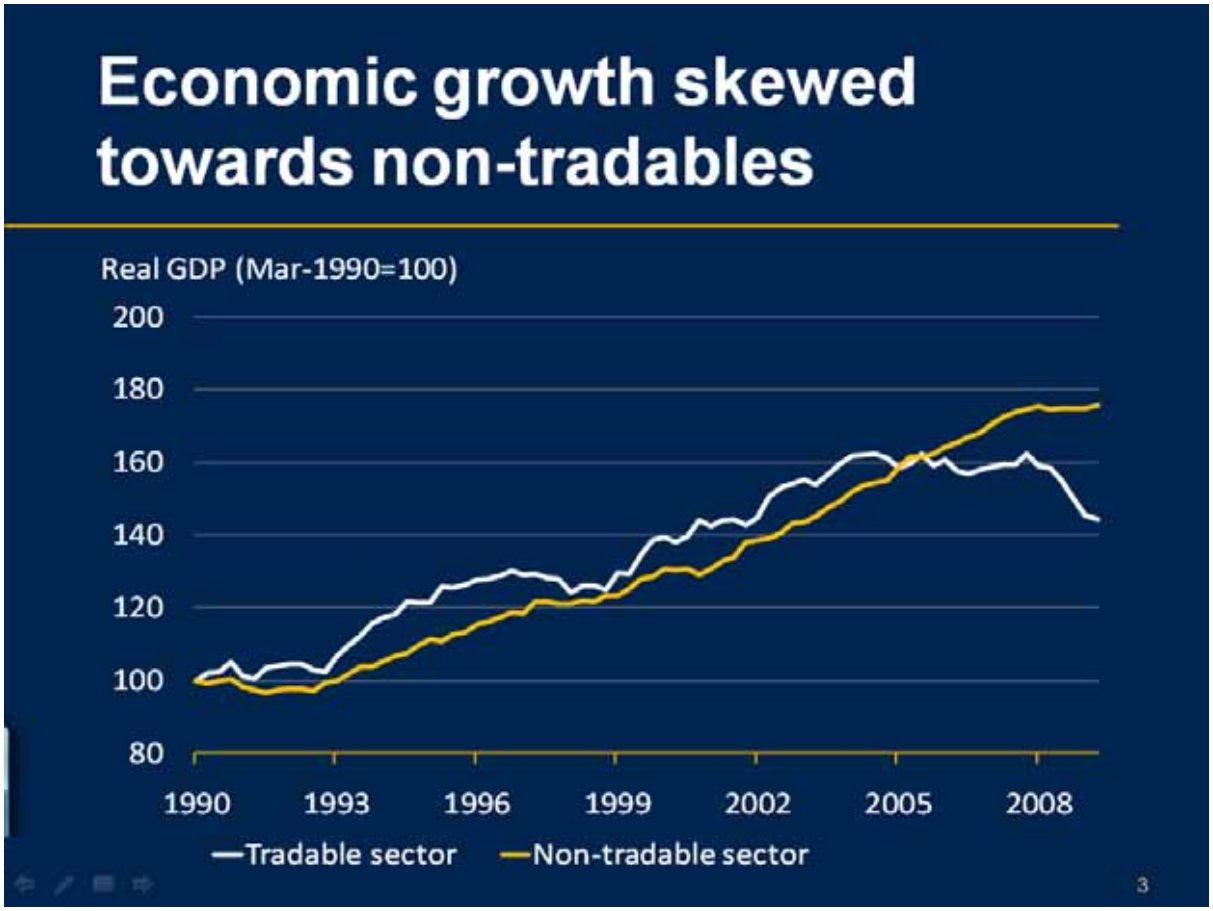
And finally, I'll talk about some of the initiatives already underway to lift performance – there has been a lot of activity since July. I'll be focussing on the types of things that CFOs and financial managers need to be engaging in, and some of the actions that agencies, including my own, are already taking.

The Short Term Outlook Has Improved, But Pressure Remains

I'll begin by making a few comments about the short term economic and fiscal outlook.

The Minister of Finance has already noted that the forecasts in next week's *Half Year Economic and Fiscal Update* are likely to show that the domestic economy is recovering more strongly and earlier than we forecast back in May.But the Minister has also reminded us that this by no means implies that we can relax our efforts.

I would like to reinforce that message with some further comments on the imbalances in our economy:



New Zealand's economic growth in recent years has been badly skewed towards the non-tradeable sectors – that is, towards growth in household and government spending. This graph shows how there has been no growth in output at all from the tradeable sector over the past five years.

This happened when domestic demand was strong, partially because of large increases in government spending, so there were few spare resources - such as labour - to produce exports. So it is vital that we boost our exports if we are to ease the burden of debt, and lessen the chances of a painful period of adjustment.

While it is good that growth is returning, the sobering reality is that there remains a degree of uncertainty about whether it's sustainable. Both here and abroad the recovery is fragile. No one knows for sure how the global economy will respond when monetary authorities and central governments start to reduce their stimulus packages. And, changes to fiscal policy typically take longer to implement than changes to monetary policy.

In these circumstances, there is a *permanent* requirement for us in the public sector to meet taxpayers' demands for higher quality essential services from within our operating baselines and to progressively raise our productivity rates.

To put it very directly, we now face a structural deficit as substantial and as entrenched as we faced a quarter of a century ago. It's going to take a sustained effort over a significant period of strong financial management, as well as some tough policy decisions to sort this out.

It's also important to realise that new fiscal disciplines aren't just a consequence of the global financial crisis. A more focused, efficient and productive public service was also one of the government's election commitments, and it is fundamental to improving growth.

New Zealand's Long Term Fiscal Outlook

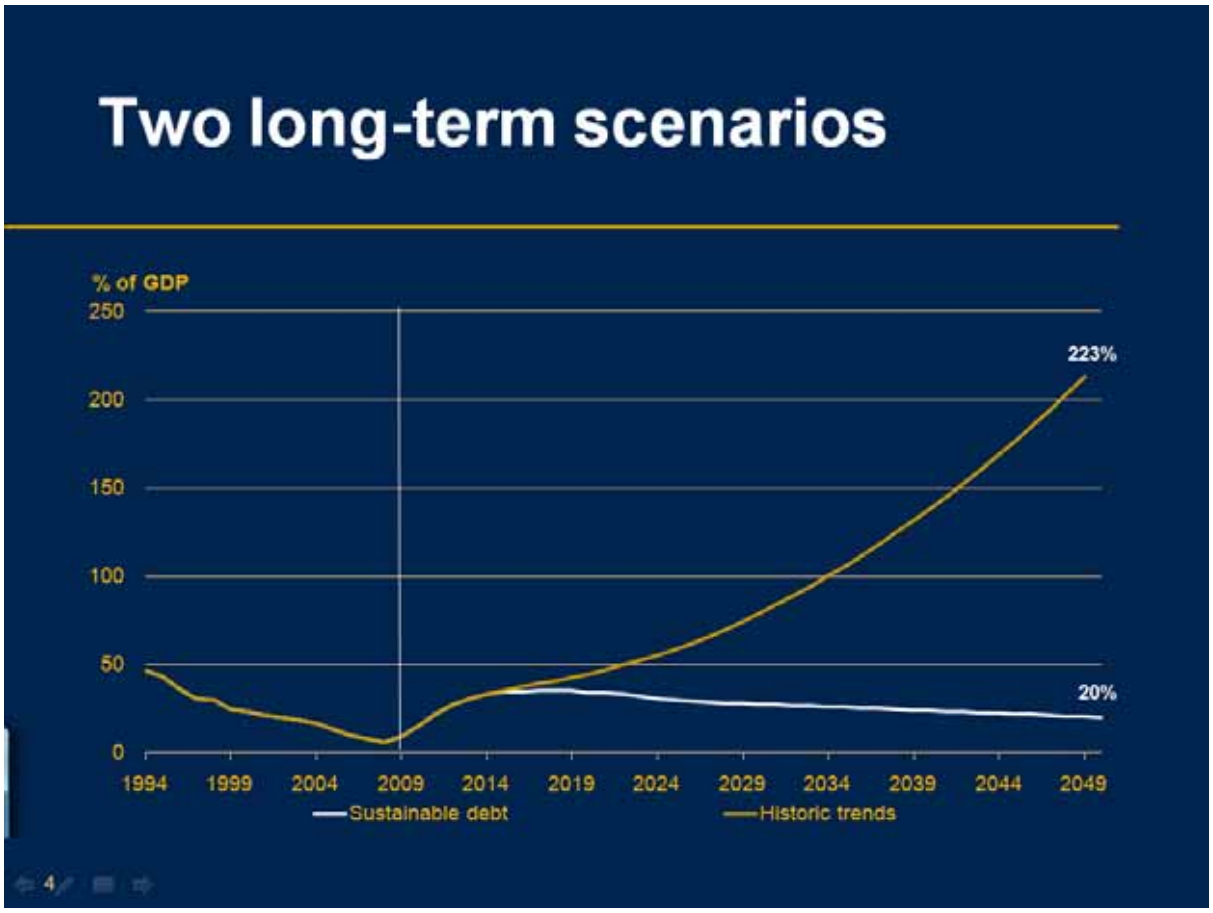
Secondly, I want to emphasise the need to keep our focus on the long-term, which also underpins the need for change.

Recently Treasury released the 2009 Long-term Fiscal Statement.

It looks at what we have to do to achieve a sustainable fiscal position over the next 40 years. Of course, projecting anything over this length of time involves significant uncertainty. Projections are generally based on long-run trends and are very dependent on the assumptions made.

To illustrate, think about the recent Atea 1 rocket launch from Great Mercury Island. The rocket was aimed as precisely as it could be while it was still on launch pad. When it was launched, the rocket went up in the general direction it was expected to go but there was no way that the Rocket Lab company could foresee every variable of its flight path. They had a general idea where their rocket would land, but there was a significant degree of uncertainty involved.

The recent Long-term Fiscal Statement uses two main scenarios to examine the fiscal outlook: what we called the 'historic trends' scenario and the 'sustainable debt' scenario.



The historic trends scenario paints a very challenging picture. As shown in the gold line on this graph, if we continue to do what we've been doing, then net public debt could reach more than 220% of GDP by 2050. Borrowing transfers the costs of today onto future taxpayers, adds interest costs and means the country is less well placed to deal with future shocks. While taxes could be raised to help to mitigate these fiscal pressures, higher taxes can limit growth, resulting in a smaller economy and lower revenue.

What the Statement shows is that this fiscal problem requires a fiscal solution.

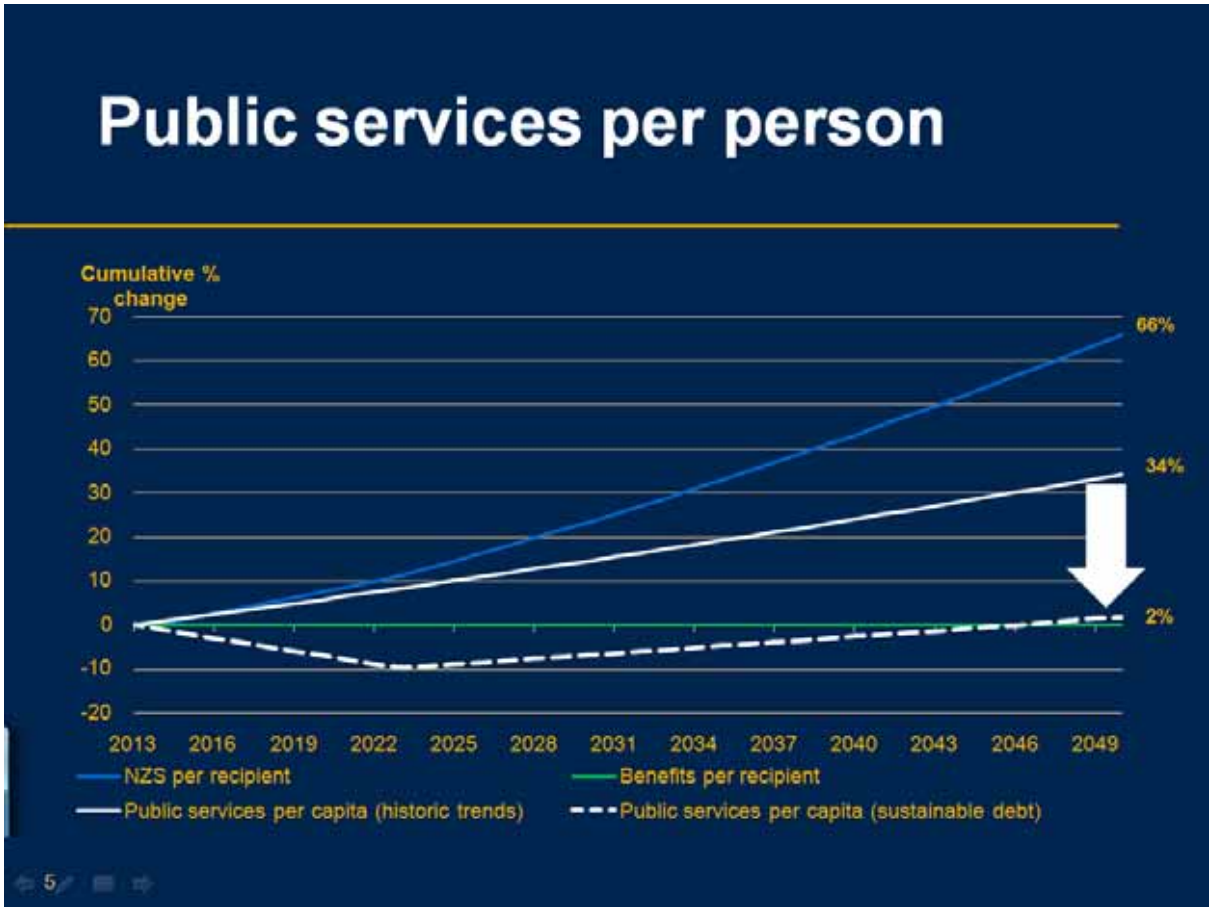
While economic growth helps, it won't be enough, because much of government spending is driven by wages, which tend to increase as the economy grows.

The statement also highlights the tough challenges and choices around revenue and spending over the next 40 years. Population ageing will make these choices even more pressing.

Early, gradual changes can help. Planned and incremental change is far more likely to be positive and successful than drastic, last-minute reactions.

The 'sustainable debt' scenario addresses this issue. It recognises that governments will want to manage debt – and it takes the Government's goal of net public debt at 20% of GDP as the desired level. This is the white line on the graph.

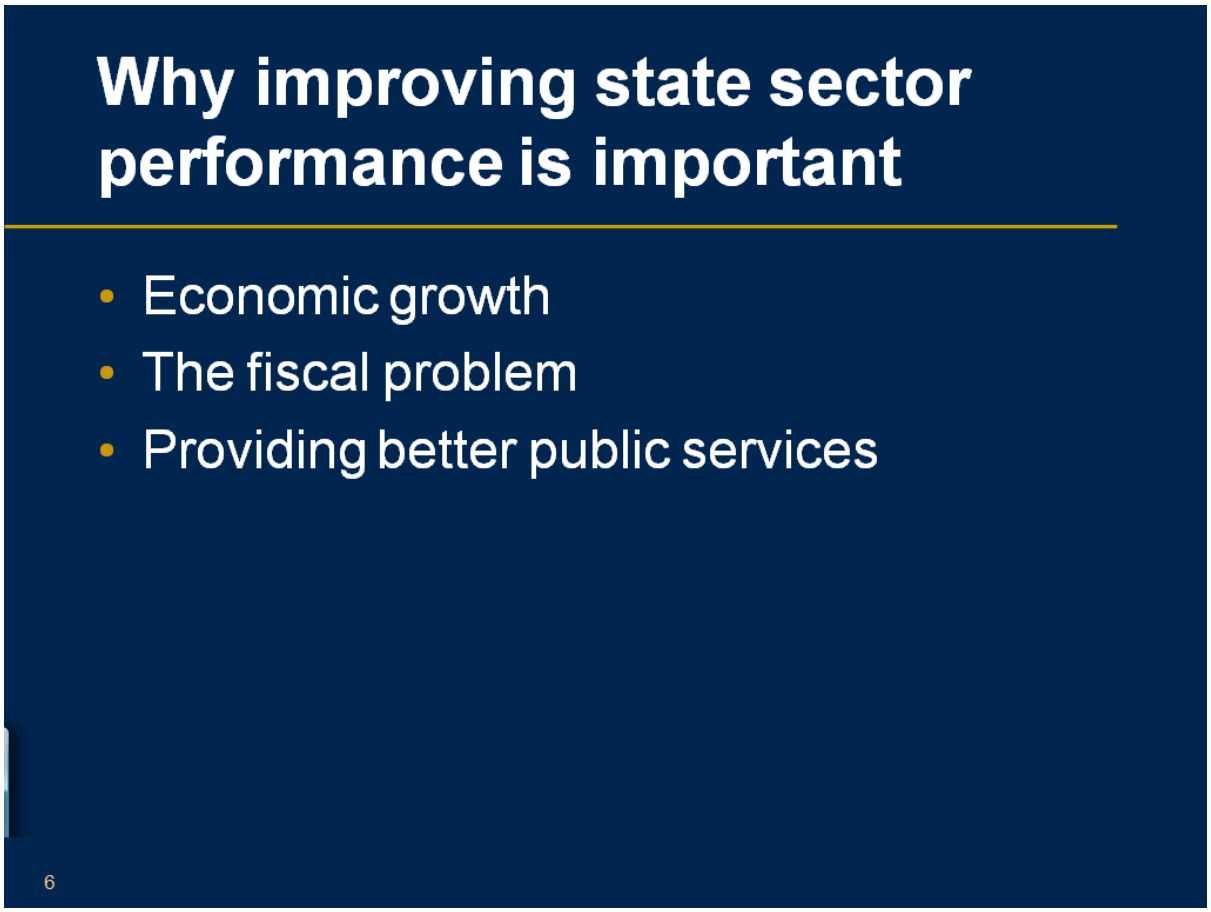
But achieving this sustainable debt scenario will be very challenging. It will require difficult decisions to be made about government spending and taxation.



This graph illustrates the scale of the adjustment that would be required. After an initial 10% decline in the level of Government services provided to the public, by 2050 services are only 2% higher per person than in 2013. This contrasts with growth in services of just under 1% *per year* over the past 20 years, and therefore a change of this size would be inconsistent with current public expectations of ever-increasing numbers of services offered by government.

This scenario underlines the need for the public sector to improve productivity so that a greater number of services can be delivered for a given level of spending. You each have a role to play in achieving this.

Improving the Performance of the State Sector is Important



As I said earlier, when facing these long term challenges, it is more important than ever that we get as much value as we can from the state sector. I'd like to reiterate some of the points I made in my July speech about why the public sector needs to improve its performance.

Firstly, the public sector is a major part of the economy, with core Crown expenses at 35% of GDP. Therefore it's hugely important that it works as efficiently as possible in delivering the right services in the right way. If we want to close the gap with Australia, the public sector has a significant role to play.

The deficit track and mounting debt are a second and obvious reason why we need a real focus on the level and quality of government spending. Put simply that means providing quality services in a way that does not undermine the economy. And it means providing them in a way that minimises the negative impacts of fiscal deficits, higher interest rates, and higher taxes.

The public sector simply cannot continue to grow at the rate it has in recent years. In dollar terms, core Crown spending increased by nearly $25 billion since 2002. There was a corresponding growth in personnel, with the number of core public sector employees going up 44% between 1999/00 and 2006/07. As the projections in the long term fiscal statement show, that rate of growth is simply unsustainable.

Three Areas of Focus

So what should we be doing to improve state sector performance? I'd like to focus on three broad areas today:

The first is *financial leadership*, which includes building the right capability and skills.

The second is *using existing resources better* – making the best use of what we have rather than seeking more.

The third area is *improving the quality of our proposals*. Where we need to seek new funding or regulatory change, we must ensure that we focus on providing high quality advice for decision makers.

Financial Leadership

The Minister of Finance has been very clear that he expects Chief Executives to know their business. CFOs and finance teams need to be able to support Chief Executives in achieving this.

Earlier this year, the CFOs network produced a report called *Public Sector Preparedness: A Financial Perspective,* in response to the Minister of Finance's invitation to consider how the public sector can be better prepared and equipped to deliver on the Government's aim of "better, smarter public services for less."

Many of the ideas contained in that report are consistent with Treasury's own views.

Public sector CFOs, and some of you are here today, have expressed frustration that finance teams are often not involved in key decisions until late in the process. Sometimes finance teams are used only to provide quality assurance, rather than playing a part in analysing options and business planning.

There are a number of reasons for this. In many public sector organisations the CFOs don't sit at the top table so they are not involved in key strategic decisions.

Given the fiscal constraints the public sector faces now and for the next several years, a much greater emphasis needs to be placed on the finance function within public sector organisations.

The CFO is a key leadership position and the person in the role needs to focus not just on compliance, but also on strategy and really adding value to organisational performance.

At Treasury we have redefined the CFO role and finance function to give it much greater weight than it previously had.

The CFO at the Treasury now sits at the Deputy Secretary level, reporting to one of two Deputy Chief Executives. This will give the CFO more influence over resource allocation, financial management and strategic planning within the organisation.

The Treasury CFO now also has the title of "Chief Accountant" and is tasked with providing professional leadership for other public sector CFOs, and supporting the development and implementation of strategies for improving management of financial resources across the public sector.

I see this as being an important shift in response to the sort of concerns that have been raised by CFOs.

However, we also need to keep improving on the basics of financial management.

Over the past year, my staff have been engaging with other public sector CFOs about the accuracy of their agencies' forecasts. I'm really pleased to see that we have recently seen an improved level of accuracy, but the pressure is still on to do more.

Forecasts by public sector agencies have an impact on fiscal decision making and play a significant part in determining the Government's borrowing requirements. In tight fiscal times, enhancing the accuracy of these forecasts is more important than ever.

As central agencies, we want to support you in identifying strengths and weaknesses in your organisations, and help identify the steps you can take to address any weaknesses.

To this end, central agencies are about to implement the Performance Improvement Framework – a tool that agencies can use to drive performance improvement in their organisations. My colleague from the State Services Commission, Tony Hartevelt, will be talking about this in more detail later today.

Using Existing Resources Better

When I think about improving state sector performance, I constantly come back to the need to use existing resources better. This is not just a one-off change that will last for the next few budgets – it's the way we'll need to work for many years to come.

Improve our asset management: As the Minister of Finance has already highlighted, lifting economic growth and improving our fiscal situation means that we need better management of the Crown's portfolio of assets. This is one way in which we can use existing resources more efficiently.

Treasury's National Infrastructure Unit is leading a programme of work which is intended to improve capital asset management practices across the public sector. This is a long term change management exercise. It will have a number of benefits, including better visibility of long term capital intentions of agencies with big asset portfolios and high quality analysis of government investments.

To give you an example of what is already being done, Housing New Zealand Corporation has started taking steps to improve its capital asset management to ensure it is providing the best return to the Crown on its $15 billion investment in the state housing asset. The Corporation is improving its portfolio and tenancy management systems, reviewing its capital structure to ensure that its use of debt and equity is optimal, and improving its day-to-day operational systems to ensure maintenance and upgrade activities are efficient. It is engaging with Ministers to ensure policy settings are aligned with the government's priorities.

This is an example of how we can make changes at an agency level, which in aggregate can help address the challenges that the Minister of Finance has given us. As the Minister has noted, the Government has $217 billion worth of assets on its balance sheet. Managing assets of that magnitude sounds daunting, but part of the challenge is to break it down into smaller parts, with each of us doing our bit.

At the aggregate level, we can expect more scrutiny on all parts of the balance sheet. For example, the Government has moved to using net debt rather than gross debt as its fiscal anchor. This is another signal that the Government's scrutiny is not a short-term change, but a long-term focus that isn't going to go away.

The Minister of Finance has talked about why better risk management is an essential part of improving management of the Crown's balance sheet.

It is one of the reasons we moved CCMAU into Treasury, to create a centre of excellence. However, as well as ensuring individual entities have appropriate risk management practices, Treasury is also focussing on the aggregate risk position.

We are setting up processes to identify and manage those risks that cut across many areas of the Crown's balance sheet. This ranges from the effects of a large earthquake through to the potential economic fallout that could result from a sudden and disorderly adjustment to New Zealand's large external liabilities. We intend to provide the Minister of Finance with a

comprehensive risk report – perhaps every six months – which will help the Government manage them.

Shift focus from new funding to existing funding: On the operating side of the budget, we need to shift our focus away from the small increment of new funding available each year and on to the huge base of existing funding.

The process that we are running for Budget 2010 puts a much stronger focus on the $62 billion that is already in agencies' baselines. In order to live within the reduced operating allocations signalled at the time of this year's Budget, we need to build the skills within state sector organisations which allow us to make well-informed decisions about how to use baseline funding more efficiently and effectively – not just in Budget 2010, but also in future budgets.

The Treasury is currently looking across the public sector at ways to use baselines more effectively.

You have no doubt heard about a programme of work that we and a range of other agencies are starting that looks at ways to reduce the cost and improve the quality of administrative and support services across the public sector. These services include finance, HR, IT, procurement and various corporate and executive services such as travel and facilities management.

We're at the very early stages of this programme. Before we know how we can save money across these services, we need to establish a baseline. That means determining what we're spending on such services and how effective they are. We will then be able to compare with organisations here in New Zealand and overseas to get a sense of where we sit in relation to leading practice, and to agree some cost and quality targets.

We will be undertaking the baseline and benchmarking exercise with a representative sample of agencies over the first months of 2010, and once that is completed we'll be able to share findings about our opportunities to optimize performance. Similar public sector programmes overseas have reported savings of up to 25% of the cost of these services as well as service quality improvements. The success of this work, along with the Ministry of Economic Development's work on procurement, is dependent upon a high level of collaboration across agencies by people such as yourselves, and I look forward to updating you all with our findings as this promising work progresses.

Improving performance information: In order to use our existing resources better we also need to improve the quality of our performance information so that we are better informed about the price, quantity and standards of our outputs, and how these link to the outcomes the Government and the public expect us to achieve.

Treasury is presently working with the Department of Corrections and the Tertiary Education Commission on a project that will tell us what good performance information looks like, and we will share the findings with other agencies.

Improving the Quality of Proposals of Funding and Regulatory Proposals

I want to come now to my third area of focus. It is around improving the quality of our proposals for *new* funding and for regulatory change.

I said earlier that we need to shift our focus from the increment of new funding available each year to the huge base of existing funding. However, in cases where we do need new funding we need to ensure that Ministers get the right information, so that they make well-informed decisions. You all know that stopping existing spending programmes in the public sector is much harder than starting them, so making the right decisions about where to put new resources is critical.

Robust business cases: We know there is a significant gap in Treasury's guidance to state sector agencies on business cases. There is also a sector-wide capability gap in the use of economic analysis to inform decision-making. We are currently working to fill this gap by leveraging off good practice in other countries. For example we are looking closely at the UK Treasury's training materials and the Victorian Government's work in the area of investment logic mapping as possible models for New Zealand.

Providing procurement options: Treasury's National Infrastructure Unit recently published Cabinet-approved guidelines on Public Private Partnerships, or PPPs. These guidelines are important not just because they provide government agencies with a consistent process for the consideration and execution of a PPP, but because they also highlight the importance of establishing both service needs and procurement options at a much earlier stage in the development of the business case than has been the norm amongst government agencies.

This sort of disciplined approach will yield better value and better services, whether or not government decides to formally go down the PPP path.

The National Infrastructure Unit is also formally involved in five catalyst projects that could lead to a change in the way Government procures certain services. The Unit is working to ensure that the agencies involved in these projects give full consideration to the broad range of procurement options before settling on a solution, provide appropriate guidance and ensure that the analysis is rigorous.

The initial projects – for a prison and school – are being explored because they offer good prospects to demonstrate new ways for public sector agencies to procure the services and/or infrastructure that they require. There are also a number of other possibilities in the social infrastructure that are being looked at.

Regulation: In the same way that we are putting greater emphasis on the quality of spending proposals, we are also seeking to improve the quality of new regulations. The government believes that high quality regulatory environment is essential to help raise New Zealand's productivity growth, international competitiveness and living standards. Given our small size and distance from major world markets, the quality of our regulation needs to be

better than the rest in order to attract and retain increasingly mobile talent, skills, capital, technology and entrepreneurship.

A year ago the Treasury took on responsibility for the regulatory management system and I believe that it complements our other roles as the government's primary economic and fiscal adviser. History has shown that when fiscal pressures are tight, it becomes more tempting for governments to use regulation to solve problems, because in many cases the costs of regulation are borne by others.

In August this year, the Government released a statement titled "*Better Regulation, Less Regulation*" which sets out its commitments to improve the quality of new regulatory proposals, as well as the existing stock of regulation. The statement aims to change the culture of the public service with respect to regulation, in particular so that regulation is not seen as a first resort to solving problems.

Over the past year, the Treasury has been reviewing the regulatory management system and recommended to Cabinet options to strengthen arrangements. This led to a suite of measures that came into effect last month.

These measures help to give effect to the commitments in the Statement on Regulation and I hope that they will have many benefits, including greater departmental accountability for the quality of policy advice, greater ability to give free and frank advice, greater transparency of political decision-making, and more incentives to build regulatory impact analysis into policy development early on in the policy process.

These are significant changes that present a real opportunity for us all to do better.

Conclusions

I've covered a lot of ground today. That is because, as I said at the start, improving public sector performance is a challenge we have to face head on, and across a number of fronts, if we are to make a difference to New Zealand's future.

As we come out of the recession we no longer have the luxury of a strong world economy and government financial surpluses. While economic growth is returning, the impact of the recession will continue to be felt in the Government's accounts for many years ahead.

There has been a once in a generation economic shock. which has had powerful implications for the affordability and nature of public services.

I want to stress that the fiscal constraints that we are now operating under are not temporary. In the public sector we have no real choice other than to think very differently about what we do and how we deliver services.

How we respond will determine what sort of services future governments are able to deliver to future generations.

Experience from both the private and public sectors, both here and overseas, shows that the necessary trade-off between the quality of public services and the cost of providing them can be achieved if we have good information in the hands of talented people who take a strategic approach to their work.

Today, I've reviewed what Treasury and other agencies are doing in response to the changed environment. But of course the reality is that we all need to play our part if we're going to deal with the fiscal challenges that lie ahead. You can expect to hear from me again in the middle of next year. I expect that we'll have managed through a tough budget in 2010, and that we will be well positioned looking to the next few budgets. I expect the quality of performance information on a number of fronts to be noticeably better, with agencies responding and changing the way they work. I want to be able to look the Minister in the eye and say that we are seeing real progress in managing the Crown's assets better.

CFOs and finance managers have a key role in all of this, and you will be hearing from a really interesting group of people over the next two days to help inspire you. I hope you enjoy the conference, and I look forward to working alongside you to help meet the challenges ahead.

Thank you.