THE TREASURY
Kaitohutohu Kaupapa Rawa

Improving Public Policy: Delivering Value through Good Financial Management

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Good afternoon everyone and thanks for inviting me.

Today I want to talk about a core part of public policy development, that of making sure it is financially durable, efficient and effective. Frankly, public policy ideas that don't take account of their financial impact are just plain poor policy.

This isn't about a narrow focus on numbers. For me, the fundamental platform for an effective state sector – a sector that, we shouldn't forget, is funded by the taxpayer – is the delivery of value. We have to make sure we are delivering policy advice, services and outcomes that make a real difference to improving the living standards of New Zealanders for the best possible value for the taxes they contribute. And good financial management is an absolutely crucial element of this.

It's coincidental but appropriate that I'm talking about this subject at the same time as the funeral of Tony Dale, one of the key architects of the financial management reforms in the state sector in the 80s and 90s. Those of us working in public finance today stand on the shoulders of giants such as Tony and others who put in place frameworks that have served New Zealand extremely well over the years. What I want to talk about today is to how to enhance those frameworks further.

I'll be covering four main areas of financial management with important impacts on state sector performance: managing capital, managing operating expenses, managing debt and net worth and financial management capability across the public service.

Size of the state sector

But first off, let me give you a sense of the scale of the state sector. The Crown manages over $263 billion in assets and almost $184 billion in liabilities.

In any given year, we spend around $73 billion and bring in revenue of a similar amount.

The government's share of New Zealand's GDP – the purchase of real goods and services excluding transfer payments – is 25 percent. Core Crown revenue and expenses amount to around 30 percent of GDP each. By the time you add Crown entities and State-owned enterprises, expenses are around 40 percent.

No matter how you measure it, the business of government is the biggest business there is in this country. That's why managing it well is so important. Even small improvements to financial management in the state sector could contribute to large improvements in outcomes for the people we serve.

Things are really moving on this front. The public service is increasingly focused on outcomes that make a real and measurable difference to New Zealanders' living standards. Ideas on how to do things better are being transformed into action.

Managing capital

Let me start with how we're managing capital, and in particular how we're underscoring the importance of having a medium-term framework for making decisions about capital.

One year ago the Treasury published an Investment Statement on the shape and health of the Crown's portfolio of assets and liabilities – what taxpayers collectively own and owe.

I stressed at the time that owning the right assets, managing them well, funding their maintenance sustainably, and managing risks to the Crown's balance sheet are all critical to the ongoing provision of high-quality, cost-effective public services.

That's a strong lesson that came through in the wake of the global financial crisis which hit some governments' balance sheets hard, with sometimes dramatic flow-on effects for their ability to fund ongoing social programmes.

As you'll appreciate, this means high quality management of the Crown's balance sheet is vital to progressively enhancing New Zealanders' living standards.

And that's not just about the management of new capital allocations through the Government's annual Budget or from within agencies' own resources. It's also about the need for stronger incentives and data analysis for managing existing capital, as well as the need to realise the value from investments already made.

The process of producing the Investment Statement gave us a much better evidence base to confirm what we knew anecdotally – namely, that:

- we need better information to assess whether Crown assets are fit for purpose, and are being cost-effectively managed

- achieving better outcomes at a lower cost will require change to the rules, policies, practices and frameworks around decision-making

- the system doesn't provide incentives for good performance, only compliance.

It's recognised across the public service that existing guidelines are unduly prescriptive, don't provide information about capability in a timely manner, and don't focus enough on quantifying the expected value or benefits – not just the costs or risks – involved in managing assets and before making new investments.

This is no doubt because existing guidelines were devised at a time when departments' and entities' advice to Ministers usually didn't consider system-wide and portfolio-wide management impacts of any individual investment decision.

Those days are now over.

Since the Investment Statement was published there has been a lot of consultation between the Treasury and public sector agencies about how to address these shortcomings. In the first instance, we're updating and strengthening the guidelines departments and Crown entities follow as they manage assets under their control and as they think about whether to make new investments. New guidelines will come into effect on 1 July.

Among the changes, a new Investor Confidence Rating will be developed, using performance and capability assessments. Investment-intensive agencies will also be required to produce long-term investment plans, and there will be stronger assurance arrangements.

Another change is stronger recognition of the role performed by functional lead agencies. These are the different departments that act as centres of expertise across the public sector in the areas of ICT, procurement and property, and which contribute to investment management decisions in these areas.

In tandem with the Government's 10 Better Public Services Results, this reinforces the expectation of cross agency collaboration: it's no longer OK to keep working and making decisions in silos.

The Treasury's objectives from these changes to the investment system include enabling better targeting and recycling of scarce resources, and to generally raise the likelihood of investments realising their full potential benefits to the country.

We expect to see greater management of investments *as a portfolio*, and, individually, *over their lifecycle*, in order to better optimise performance and to see improvements in the capability of agencies – including the Treasury – to be fully across the whole cycle. This will make the Crown's use of capital more effective.

It's fair to say these changes aren't news headline material. But together they will transform the way we do our business in the state sector, to the benefit of the wider society, the sustainability of the Crown accounts and to the performance of the economy.

A similar focus has emerged from the development of the New Zealand Infrastructure Plan, due in August. Through the Plan, we want to get more out of existing assets and the better allocation of new investment. One of the long-term and systemic challenges to achieving these outcomes is the overall asset management system and practices. We need to step-up to a more sophisticated approach. In developing the Plan, the Treasury is working not only through the new guidelines I mentioned but also with professionals in local government and the wider asset management community.

This will result in a coherent programme of work, captured in the Infrastructure Plan, across not just central government but also local government and all infrastructure providers.

If we get this right we will potentially save New Zealand millions of dollars every year by reducing avoidable costs on projects and programmes, and maximising the value from the investments we have already made.

Infrastructure, including transport, education, water and telecommunications, involves high capital costs in any economy. In water and transport alone, local authorities own over $75 billion of assets and, in some cases, up to 70 cents in every dollar of all rates paid by homeowners is spent maintaining and renewing these assets.

Part of the work into strengthening the investment approach to infrastructure spending involves more detailed analysis of trends in future demand. Considering that many of these assets will last for 100 years or more, understanding this future demand is vitally important.

In transport, for example, around $65 billion of capital investment is planned in Auckland alone over the next 30 years. In total over the next ten years, local authorities across the country have over 1,100 major transport projects planned that are cumulatively worth over $20 billion.

And I want to emphasise that one of the questions that it's important we explore is whether we're doing enough to manage transport demand effectively. For example, what are we learning about transport demand trends? What role do we think that road pricing could play to manage that trend and enable the delivery of greater value for the public's investment? Are we thinking creatively enough about the ways that demand could be managed? For example, we all notice the reduction in traffic congestion during the school holidays. Have we considered what the benefits may be of varying school or university starting times? Would that free-up capital investment so that it could be used elsewhere?

Looking after our capital investment matters. And that applies to all of our balance sheet, whether we're talking about investments in transport infrastructure or in new school buildings or in hospitals or whether we're talking about the Crown's commercial investments. The Treasury monitors the Crown's interests in around 50 enterprises with commercial objectives, which represent $56 billion of company equity and funds under management. That's a lot of public money. I hope it's pretty obvious why the Treasury wants to ensure that the Boards of these entities deliver the best possible performance and at the same time that the Crown retains the ability to take action when those investments are not delivering value or may, in fact, be at risk of losing their value.

For those of you with a real interest in capital management, we intend to publish the government's forward intentions on capital investment in the next few months. It will cover baseline capital and new capital spending intentions out to 2018/19, so you'll get a sense of the pipeline of investments coming up and where the spending pressure points may be.

Managing operating expenses

Let me turn now to the management of operating expenses, where there are also some great innovations happening. Perhaps the foremost of these is the work we've been doing to enable more effective social spending.

At the Treasury we are referring to this shift as social investment. Essentially it's about shifting the focus to citizens and users of services and their outcomes, rather than the traditional focus on agencies, outputs and programmes. It aims to deliver the gold nuggets of insight from the raw ore of data to enable better decisions about where to invest operating spending on individuals and their families. Very simply, it's about delivering better value.

Sometimes called population-based data analysis, it's about better use of the information we already have and mining a richer understanding of the drivers of outcomes – positive or negative – and ultimately the drivers of future fiscal costs and social and economic benefits. It represents a significant evolution in the quality of evidence-based policy-making.

It builds on the liability approach that helped the Ministry of Social Development to better understand its clients and better target effort towards the groups most at risk of long-term benefit dependence and as a result costly for the public purse. Knowing who to target, the focus can shift to how best to assist them to sustainable employment and intervene earlier where needed.

The idea is now to apply this approach to understanding clients across the social sector. We want to be able to measure the effectiveness of our investment and know what types of interventions – whether in, say, education or youth justice – are most cost effective to achieve the impact we want.

As it matures, we expect that the new processes will permit an ever-more precise measuring of results for individuals and their families arising out of the social investment in them. And as a result we will deliver better value.

We are developing tools to support comparisons of return on investment across different initiatives and programmes – including building up a database of common or benchmark costs and outcomes over time that can be used to compare the cost benefit of programmes.

We want to enable the government to spend money to secure specific outcomes, for example to invest directly in reducing child assaults and be able to measure the effectiveness of its investment.

That is a different world to the current system where the focus is securing spending on favoured programmes or, as the public service would put it, specific outputs.

I am sure you can immediately appreciate the transformative potential of this work. We are moving to a whole-of-life investment approach to social spending which will be transformative over time. It undoubtedly represents a step-up for the New Zealand public financial management system.

It will give greater assurance to citizens that their governments are meeting their expectations to deliver essential services while also always taking care to make the best use of scarce financial resources. In other words, delivering value.

That is why in recent months the Treasury and MSD have worked together to see what data can tell us about who ends up in prison; who are persistently reliant on welfare; and who are being held back with poor educational attainment.

If things don't change for these groups of people, it's a high personal cost to them and a high long-term cost to the country. Our analysis will let us identify who are best to target and what interventions work for them. Doing this successfully means we can improve people's lives and improve the Crown's books at the same time.

Managing debt and net worth

I've talked about managing operating expenses and won't talk about the management of revenue. I do, however, want to say something about the management of net worth and of debt.

The principles of responsible fiscal management, as laid out in the Public Finance Act, call for the Government to reduce total debt to prudent levels and maintain levels of net worth to provide a buffer against shocks in future. This is about reducing our vulnerabilities and strengthening the resilience of our economy.

The current fiscal strategy aims to reduce core Crown net debt to 20 per cent by 2020, then keep it between 10-20 per cent of GDP. This will allow for the operation of automatic stabilisers over the course of the economic cycle, so that the Government can borrow more in times when extra stimulus might be needed. Creating a target for net debt at a lower level than currently has been instrumental in driving expenditure restraint and returning the operating balance towards surplus. The focus on debt is in line with most international practice for fiscal policy, and our debt levels are very low compared with most advanced economies.

However, net debt still has a relatively narrow focus, looking only at the core Crown, a subset of financial assets and liabilities within that. It ignores a wide range of social assets and liabilities held to provide public services, such as schools and hospitals, commercial assets and liabilities held with commercial objectives, and some financial assets and liabilities, held to pre-fund expenditure such as EQC.

Net worth, as a measure of total assets and liabilities, includes all these elements. It represents the full balance sheet for the Crown, providing a comprehensive fiscal indicator, and one which is monitored extensively to understand the fiscal position more widely than can be through debt.

There are difficulties with such measures – for example, by increasing the breadth of the measure, it also becomes increasingly subject to asset price volatility. Nevertheless, good analysis of these elements of net worth, as we have in our Investment Statement, is part of the process for better fiscal management.

When people think of the Treasury's involvement in debt and net worth, it's likely to be about the role of our Debt Management Office. It has the important responsibility of managing the government's debt, overall net cash flows, and some of its interest-bearing assets within an appropriate risk management framework. But our interest and impact are broader than that. As an example, I'd like to share with you some of the Treasury's efforts to strengthen the robustness of the fiscal models we use when preparing our projections for the Crown's finances over the medium and longer term.

The law requires governments, at each Budget, to report on their fiscal objectives over the following decade and, at least once every four years, the Treasury to produce a Long-term Fiscal Statement looking ahead at least 40 years.

The Treasury produces these medium and long term projections through two models that share similar structures, logic and input data called the Fiscal Strategy Model and the Long-term Fiscal Model.

Both models have been rebuilt and several improvements made. In particular:

- every asset and liability category is individually modelled
- a full range of cash variables is now projected, along with accrual ones
- the growth of physical capital is more intricately and transparently modelled, including the role of depreciation
- there is better ability to model the impacts of plans for both capital and operating spending
- Crown entities, like ACC, are subject to more detailed modelling
- there is now greater transparency in the relationships between variables, for example how capital contributions to the NZ Superannuation Fund impact residual cash.

The first of these revamped Fiscal Strategy Models will be published on the Treasury's website on Budget Day, 21 May. The Long-term Fiscal Model will be used in our next set of very long-term projections which must, at the latest, be presented to Parliament before July 2017.

I am pleased with this substantial improvement in the models. In the first instance it strengthens the underlying quality of the Treasury's fiscal policy advice. And more broadly it helps all departments and agencies of the Crown better understand potential cost pressures in their areas of specialty – not just over the next four years, but over the medium and long term.

Financial management capability across the public service

What I have emphasised today, I hope, is the importance of maximising public value and value for money to ensure that we are delivering public goods and publicly-funded services efficiently and effectively to New Zealanders. The final aspect of this that I'd like to cover is the work being done to strengthen strategic financial management capability across the public service.

Last year the Treasury established a new role to lead these efforts. Paul Helm has joined us as Head of the Government Finance Profession. The aim of the work he is doing with others in the public service is to achieve transformational change in finance teams, or as Paul puts it, to make the shift "from bean counters to trusted business advisors". They're doing this through raising awareness, professionalism and skills development in financial management within government agencies.

Strategic financial management is, as you know, about allocating resources to where they are most effective and managing the efficiency of those resources once they are allocated. It contributes to this through bringing timely and robust financial information to inform decision-making at an agency – and increasingly a cross-agency – level. Skilled practitioners can link the financial and non-financial aspects of performance, and they use this insight to inform, influence and be a catalyst for change not just within their agency but across their sector.

Strategic financial management capability isn't a "nice to have" but a "need to have". That's why it's an expectation that all Chief Executives are held to account for, why it's a focus of the Public Finance Act, and also why it's a focus of Performance Improvement Framework reviews. To state the obvious, it's important that chief executives and chief financial officers talk to each other and work together to ensure those expectations are met.

For example, I expect CEs and CFOs to give a lot of attention to the latest administrative and support services benchmarking report, which should be coming out in the next month or so. This looks at the cost, efficiency and effectiveness of back-office functions and gives an indication of how they stack up against international benchmarks. The Treasury's aim for the public sector is to see it reach the upper quartile of performance against comparators by 2022. CEs will no doubt be seeking advice from their CFOs on programmes that will make progress towards this goal.

There's huge potential for government agencies to further develop how they anticipate and respond to financial challenges and opportunities. Ultimately that will deliver better value for New Zealanders.

Conclusion

To conclude, the aspects of financial management that I've discussed today – lifting capability and managing capital, operating expenses, and debt and net worth – are important ingredients of good public policy. And good public policy is a reflection of the public service's duty to demonstrate stewardship.

Public servants in whatever role they're in have a responsibility to look after the Crown's medium and long-term interests. As the effective owners of our own state sector system, the onus is on us all to make sure the system is permanently focused on improving performance, making best use of the resources entrusted to us, and remaining sustainable well into the future. We have to put our efforts into driving the capabilities, processes and actions that will maximise our collective impact.

Good financial management encourages us to do that. It prompts us to understand the impact that policy is having over the medium and long term, and test spending in existing areas to see if it's delivering the results we need. It reminds us that we have to step back and ask ourselves some big questions:

- Are we focusing on the right things?
- Are we clear about the outcomes that the tens of billions of dollars spent every year by the public sector are trying to achieve?
- Are we getting the best value for our citizens from every dollar of that money?
- Do we understand the link between costs, inputs, outputs and outcomes?
- Are there alternative approaches that might provide better value?
- Are we doing enough to shift the focus towards the outcomes that will deliver better public services and make a difference to New Zealanders' living standards?
- And if our departments or the wider system aren't doing enough, what needs to change?

On that note, I'm happy to take a few questions of your own.