Better Public Services

ISSUES PAPER:

The core elements of New Zealand's public sector management model as originally formulated

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(with a 2011 introduction)

This paper offers a guide to the core ideas or propositions underpinning the New Zealand public sector management model as it was articulated by Treasury officials in the late 1980s.

CENTRAL AGENCY PARTNERS IN THE STATE SECTOR REFORM PROGRAMME

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Introduction

This paper offers a guide to the core ideas or propositions underlying the New Zealand public sector management model as this model was articulated by Treasury officials in the late 1980s.

It is intended to help explain what the model, implemented progressively from the late 1980s, intended to deliver. And it is also intended to assist New Zealanders in 2011 to better assess whether or not the model is delivering on its promise and – if not – where our focus might best be directed to drive better results.

The paper includes:

- an outline of the country's public sector environment prior to the reforms of the 1980s;
- a list of shortcomings or problems that it was hoped reform would help resolve, as viewed by Treasury officials at that time; and
- a structured list of the key components of the model around which the public sector management system was built in the late 1980s and 1990s.

The approach adopted

In this paper the public sector model is described as a set of general propositions or guiding principles. Thus a distinction is drawn between the model on the one hand, and the actual public management system on the other, where the system is a specific but evolving set of rules, processes, rights and obligations that may or may not have been inspired by those propositions or principles.

It is important to note that the propositions outlined here are derived from the public writings of senior Treasury officials that were involved in implementing the public sector reforms of Ministers in the 1980s. Extensive reference is made to Government Management, the Treasury's briefing to the incoming government in 1987, and various papers authored or co-authored by Graham Scott who was Secretary to the Treasury from 1986 to 1993. References to these are given at the end of this paper.

Some Caveats and Cautions

In a short paper like this, the scope for presenting all the subtleties, complexities and adaptations of the issues and ideas is very limited. Because of that, it is important to honestly acknowledge some important points upfront.

The first point is that this is just a set of propositions as articulated by the Treasury. They are not the reasons for the reforms of the late 1980s and 1990s. Public sector reform of some kind was probably inevitable after 1984. Treasury recommendations for reform may have been influenced by particular ideas and theories, but most could have been derived just as readily from other viewpoints or practical experiences. Ultimately the reforms were owned and driven by Ministers on the basis of the problems, opportunities and political pressures as they perceived them at the time.

The second point is to note that the terms and analogies sometimes used to describe aspects of the model in the late 1980s were influenced by the desire to encourage a major change of mindset within the public sector. If we think about it, it should be obvious that terms like "purchase" and "contract" applied to the core public sector could not have been meant in any literal sense – they were rhetorical devices. In trying to set out the core propositions of the model, this paper has generally tried to avoid using these terms.

The third point is not to make the mistake of thinking that any public sector management system can be adequately described or understood by reference to its formal decision rights, obligations and processes alone. It is also heavily influenced by informal rules and expectations, and it is further affected by elements of environment, culture and history. A reliance on descriptions of the explicit elements of our system, for example, is likely to give outsiders an impression of very formal, legalistic interactions between Ministers and public servants, whereas in reality in New Zealand their interactions have generally been easy, informal and frequent.

The final point is that we should expect any public sector management system to come in for increasing criticism as time elapses since reform occurred. It does not necessarily mean that the underlying model is broken, though of course that possibility needs to be seriously considered. But it can also be because:

- fewer people remember or appreciate what preceded it and what problems drove the push for change; and

- more people see the gap between the rhetoric and the reality, or confuse the model with its implementation (including a realistic acknowledgement that reform is a process which is, by definition, never fully complete).

Another view is that public sector reform is invariably a cyclical process due to the absence of any universally agreed founding principles or values. It has been suggested that, over time, government attention continually shifts between various objectives that can pose irresolvable dilemmas. As one problem is alleviated, others are exacerbated and new challenges are identified. Consequently the pendulum swings between different principles, and no system endures for long. In such circumstances, change is inevitable but we should take care to recognise the costs of change.

Public sector management prior to the reforms

The public sector environment prior to the reforms was characterised by:

- accountability viewed mainly in terms of compliance with written rules, the absence of corruption, and the avoidance of mistakes;

- significant Cabinet influence on matters of departmental operational management through specific directions that were codified into manuals of instructions;

- responsibility for the efficiency of departmental administration divided between Ministers, department Heads and the State Services Commission, with the departmental Head's legal responsibility to their Minister not matched by an ability to hold the Head to account for his/her performance;

- departments headed by public servants with permanent tenure (removable only for gross breaches), and remuneration set by an independent body, the Higher Salaries Commission;

- departmental staff employed by one central employing body (the SSC), who set the grading for each job within service-wide occupational classes and negotiated with state sector unions for any changes to pay and conditions – a process that was subject to compulsory arbitration and complicated pay-fixing criteria that put more emphasis on wage relativities than on recruitment and retention factors;

- annual salary increments for departmental staff up to specified maximum levels; and a maximum term of employment for public servants of 40 years;

- departments with delegated rights to make appointments but no ability to appoint a candidate from outside the public service unless they had "clearly more merit" than any internal applicant;

- unsuccessful internal candidates having the right to appeal external appointments to an Appeal Board – a process that emphasised experience and competence in previous duties and that could create lengthy delays;

- budget allocations that were not finalised until some months into the financial year, and approved only for the current year;

- appropriations of predominantly one year duration based on control over the gross cash cost of inputs acquired, and which made no distinction between current and capital expenditure;

- the normal practice of increasing appropriations for the additional costs arising from pay settlements;

- wide use of cash accounting in the decades immediately prior to the 1980s reforms (but note that accrual accounting had been standard up until World War II, when there developed a shortage of accountants);

- centralised cash management, payment and provision of financial data, with complex rules (in the form of Treasury Instructions) issued to departments governing the approval, accounting and use of public money;

- the Treasury making at least 95% of Crown disbursements, which required detailed process instructions and inhibited the development of financial management information systems in departments;

- departmental reporting to Parliament (through the Estimates and departmental annual report) being largely limited to cash-based financial information and narrative descriptions of proposed or actual activities;

- the centralised, non-contestable supply to departments of such goods and services as printing and stationery, office accommodation, cleaning services, car rental and IT purchasing;

- the existence of a number of large state trading operations, accounting for about 12% of gross domestic product and 20% of gross capital formation, in a variety of structures, including government corporations with commercial privileges, and departments of state with additional policy and regulatory functions;

- trading operations that were obligated to pursue a number of non-commercial objectives that involved trade-offs with commercial objectives, while subject to a mix of commercial advantages and constraints, and with limited performance reporting and monitoring arrangements; and
- departments structured predominantly along sectoral lines, with responsibility for a wide range of different functions within their particular sector.

The problems needing to be resolved

This system did not appear to assist in resolving a number of problems, including:

- a large and growing annual fiscal deficit, with growing levels of Crown debt;
- a large and growing public sector, with poorly performing trading activities;
- general public and Ministerial perceptions of an inflexible and unresponsive public bureaucracy;
- difficulties establishing and getting people to take responsibility in cases of clearly identified serious management failures;
- big problems in finding/keeping good quality staff in key or emerging professional areas, and in redeploying staff;
- information systems that were unfit for making effective decisions;
- an unstable budget process that encouraged grossly inflated agency bids, and provided no satisfactory way of dealing with agency over-expenditure;
- Ministers and control departments acting with very limited information; and
- input controls that led managers to take decisions that did not make the most effective use of resources and that limited their ability to respond to any changes in circumstances.

The public sector management model that was outlined

The focus on public sector management that led to the reforms of the late 1980s arose out of a concern with the relatively poor performance of the NZ economy over a long period of time. As such, it was just a logical extension of the wider economic reform programme embarked upon by governments after 1984, which extended to most sectors and included a major reappraisal of the role of the state in those sectors.

There were two broad reasons cited by the Treasury for thinking that management of the public sector had significant and enduring implications for national economic performance:

- With public sector activity representing a large part of the economy, any general inefficiency in the sector must necessarily impose a very substantial cost burden on the rest of the economy (in addition to which the large tax burden could adversely affect private incentives to produce and work).

- With better economic performance dependent on the quality of government intervention decisions, the Crown needed a public sector that was capable of providing consistently relevant and high quality policy advice.

Theoretical influences

The advice tendered to Ministers on reform, particularly from the Treasury, was influenced by a range of insights and ideas from:

- various strands of the economics of institutions (including transactions cost theory, agency theory, and public choice theory);

- finance and accounting theory and practice; and

- an eclectic literature on public and private sector management.

Academic evaluation and criticism of the system has tended to centre on some of these theoretical frameworks, often implying that the Treasury utilised these ideas uncritically and without recognising that practical realities in New Zealand were more complex. An alternative view held by many insiders is that the Treasury sought to apply the most promising ideas in a pragmatic but consistent way, knowing that some adaptation was required, but then used the language of these ideas to help explain and embed a significantly new system. The truth may include elements of both. Discussion of some of these theoretical influences can be found among the references provided at the end of this paper.

Fundamentally, however, the Treasury's approach to public sector reform was a comparative institutional one. The starting point was that there are no perfect, costless solutions to economic and social problems due to the presence of:

- scarcity of resources, which results in competing demands;

- interdependencies – what one person does has direct and indirect effects on others;

- uncertainty or bounded rationality, which limits knowledge of future impacts or consequences;

- the costs of obtaining information needed to make decisions; and

- opportunism or incentive problems – people's motivations are not always in alignment.

The task of finding solutions to economic and social challenges therefore becomes one of assessing and comparing alternative feasible arrangements (both private and public) against some generally agreed criteria for making social choices in the wider public interest. The choice of solution is then ultimately an empirical matter that depends on the circumstances of each case.

What this also implies is that managers in both the public and private sector confront similar challenges, even if they manifest themselves in different ways. Thus it is not surprising that Treasury officials thought that the public sector could learn useful lessons from some of the management techniques then being applied in the private sector.

The core propositions of the model

At the core of the New Zealand public sector management model were some propositions about performance management and accountability. In addition there were supplementary sets of propositions about financial control and reporting, state sector employment matters, and the structure of the public sector.

A Performance management and accountability

Performance management is about supporting better decision-making

- Moving the public sector away from a simple focus on compliance with rules set from above on the use of resources and powers (public administration) toward a focus on results with significant discretion to manage (public management) is likely to enhance public sector performance and the achievement of democratically-elected governments' objectives by generating more and better quality information about performance.

- Performance information is needed to allow and encourage better decisions to be made, and is not an end in itself.

- Better decisions are expected for a number of reasons:
  - giving managers discretion means decisions are taken by those most likely to have the best information about what can be done;
  - those to whom performance information is provided can use it to change what is sought, how much and from whom, for the future;
  - those whose performance is being monitored will use knowledge of this as an incentive and guide to their current performance effort.

The performance management model rests on accountability for results

- An effective performance management model is likely to rest on the idea of accountability for results.

  If there are not to be detailed controls or rules on resource use, then the focus of accountability must be on results. This requires knowing what results are sought by democratically-elected governments, and what results are being achieved, and the ability to take action based on this knowledge. If the manager is to be accountable for results, however, (s)he must have a high degree of freedom to manage, and a motivation to perform.

- An effective performance or accountability relationship has four essential and mutually reinforcing elements. These are:
  - clear specification of objectives (desired performance);
  - authority to act ("freedom" to manage);
  - incentives to perform; and
  - provision of reliable information on results (actual performance).

- In respect of performance management, there is a need for an unbroken chain of accountability from managers to departmental chief executives to Ministers to Parliament to avoid accountability gaps.

Different elements of performance need to be distinguished

- The elements of performance in which a government is interested as owner of an organisation are not the same as the elements of performance in which it is interested as "purchaser" of an organisation's outputs.

  The different decision rights and responsibilities exercised in those distinct roles create a demand for different kinds of performance information. When the government is both owner and purchaser, the tension between the two interests makes it important that the organisation report on both kinds of performance.

- Because people cannot be held accountable for things they cannot control we also need to distinguish between performance in output delivery and performance in outcome achievement.

  In most circumstances, it is not practical to try to hold managers accountable for achieving outcomes due to the limited control that managers have over all relevant contributing factors, the difficulty in attributing causality to those factors that can be controlled, and the potentially long lag between intervention and outcome. Managers, however, have much greater ability to control the day-to-day delivery of outputs. Thus, the formal reporting and accountability arrangements for public sector entities are focussed on outputs rather than outcomes. The function of policy advice is to identify the appropriate connections and feedback loops between outputs and outcomes.

B Financial reporting, budgeting and control

Financial reporting and controls should support accountability for results

- The ability to assess performance requires that decisions on resource allocation reflect the full resource cost of those decisions, including the opportunity costs of capital employed.

- Accrual accounting should replace cash accounting because it provides a far more robust measure of resource use and, in particular, recognises the existing stock of assets, liabilities and future commitments.

  So that performance can be assessed against intentions, this requires the adoption of both accrual-based reporting and accrual budgeting.

- By reporting information in accordance with independently established rules for financial measurement and disclosure, the users of the reports can have a high level of confidence that the information is relevant and reliable.

  All financial statements within the public sector should comply with Generally Accepted Accounting Practice (GAAP) and New Zealand accounting standards should be expanded to cover the public as well as the private sector.

- Appropriations should be linked to the nature of the performance system so that Parliament and its committees can oversee the level and purpose of resource use by Executive government.

  Hence appropriations should reflect accrual costs, and there should be different appropriations for outputs, capital investment in government agencies, and income transfers. In addition, appropriations should be able to be set on a time span that is appropriate to the nature of the output.

Emphasise budget management rather than budget maximisation

- The Budget should be introduced before the start of the financial year so that departments can plan knowing what resources will be available to them.

  With the Budget traditionally presented around June/July, this could be addressed by moving the government on to a June 30 financial year.

- The budget process should change to limit opportunities for gaming by departments, and reduce the bias against expenditure restraint.

  This was eventually done by adopting three-year rolling baselines, controlled by Cabinet, and costed on the basis of current policy with no allowance for price increases. This became the starting point for any budget bids.

Replacing financial controls with financial incentives

- Greater accountability for performance allows the relaxation of centralised controls over cash.

  Departments should have responsibility for establishing payment systems, making and accounting for payments, and managing their own bank accounts and day-to-day cash flows. However, to enable overnight bank balances to be managed efficiently, bank accounts should be "swept" overnight, and managed centrally.

- Departments should have incentives for efficient financial management.

  This could be achieved by imposing a capital charge to recognise the opportunity cost of capital employed, paying interest on overnight cash balances and term deposits, paying departments the full price of outputs at the time of delivery, and allowing departments to retain any net surpluses generated from their operations subject to their Minister's approval.

C State sector employment matters

A neutral public service still needs to be responsive to Ministers

- There should be a clearly defined accountability relationship between a Minister and departmental Head, but in a way that minimises risks to the impartiality and the professionalism of the public service.

- Ministers should be able to play a role in the appointment and performance assessment of departmental Heads.

  This could be achieved by constituting an agency with responsibility for advising Ministers on suitable appointees, who could seek information on Ministerial expectations of the position and the attributes required. Parliamentary notification could be required where Ministers do not accept the agency's recommendation.

  Further, this agency could act as employer, set remuneration and other conditions of employment, and periodically assess the departmental Head's performance, with views sought from the relevant Minister or ministers.

- Unlimited tenure can reduce incentives on a departmental Head to innovate and perform.

  Departmental Heads could be employed on five-year potentially renewable contracts (with the added benefit that contract expiries would not normally coincide with elections, which limits the scope for significant disruption coinciding with election periods).

A decentralised public service labour market is needed to support accountability for performance

- The government should make a clear distinction between its separate and distinct roles as labour market regulator, on the one hand, and as an employer, on the other.

  In order that managers are given room to do their job, and can be effectively held to account for their organisation's performance, a useful starting presumption is that public sector labour market regulation be no more prescriptive than private sector labour market regulation.

- The ability of managers to recruit, retain, train and motivate suitable staff is a key element in being able to achieve their organisation's objectives.

  Hence a decentralised system that gives managers authority over employment and personnel matters (including pay) is important if they are to be held to account for their organisation's performance.

D The structure of the public sector

Separate out commercial activities and have them operate on a similar footing to private sector businesses

- Commercial trading activities should be separated from non-commercial activities in order to reduce the dilemmas faced by managers in deciding how to make trade-offs between different objectives and interests.

- Commercial and non-commercial objectives should be clearly delineated, with the managers of trading enterprises having commercial success as their primary objective, and the cost of meeting any non-commercial objectives explicitly recognised and met by the Crown out of general taxation.

- Competitive advantages and disadvantages, including unnecessary barriers to competition, should be minimised so that commercial criteria provide a fair measure of performance.

- Managers should have greater authority over investment, personnel and other input procurement decisions, as well as output characteristics, pricing and marketing, so that they can be held accountable for their performance.

- Trading enterprises should have a form that is appropriate to their commercial purposes and operate in pursuit of performance targets agreed with ministers, under the guidance of boards whose members have an appropriate mix of commercial expertise and industry knowledge.

- Private ownership and tradeable equity can provide even greater discipline on the management of trading enterprises than is possible under government ownership due to greater external monitoring and takeover opportunities, assuming regulatory issues can be adequately addressed.

Structure non-commercial public organisations to create focus, ensure conflicts are exposed, and facilitate contestable advice and service provision

- Consideration should be given to separating policy advice and regulatory activities from operational activities.

  The potential benefits of this are that it should help to:

  - reduce the dilemmas faced by managers in deciding how to appropriately make trade-offs between different objectives and interests, which are decisions more appropriately taken by Ministers;
  - reduce the potential for advice or regulation to be captured by the interests of the public service-provider (a bias toward continuing existing forms of public provision), or the interests of existing service recipients with whom the provider has established close relationships;
  - allow more scope for contestable policy advice in order to expose Ministers to the different interests and perspectives involved; and
  - make it easier to introduce competition between service providers.

- Activities should not be split or reallocated unless they provide likely benefits in terms of focus, transparency or synergy.

- The Crown's purchase and ownership interests in the provision of services need to be distinguished, in order to allow the benefits of public provision to be compared with the options for contracting out.

- Where feasible, service provision should be contestable in order to take advantage of the incentives for performance provided by competition.

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