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Public Financial Management and Reforms to the State Sector Act

Abstract

This article addresses changes to the Public Finance Act that have been proposed in the Public Finance (Wellbeing) Amendment Bill or are being considered for future legislative or administrative action. It discusses these changes in the context of the State Sector Act. The interrelationship between the two pieces of legislation is described, as are the implications of proposed changes to the Public Finance Act. These changes include requirements for the specification of objectives for wellbeing (outcomes) in the budget process and reporting of wellbeing by the Treasury at least every four years. Changes also include, potentially, greater flexibility in the nature of appropriations and the selection of the services that will be provided within an appropriation, as well as legislative support for the public service to operate in a more ‘joined-up’, innovative and collaborative way.

The article identifies as a strength of the proposed changes to the Public Finance Act and the State Sector Act that they maintain consistency between the two acts, but also identifies the risk of replacing one one-size-fits-all system with a different one-size-fits-all system, and considers a ‘two-track’ public management system as an alternative.

Keywords Public Finance Act, State Sector Act, wellbeing, outcomes, outputs, appropriations, budget
This issue of Policy Quarterly is focused on the reforms proposed by the current government to the State Sector Act. It is important also to address proposed and potential changes to the Public Finance Act, given the interrelationship between these two pieces of legislation.

There is a common theme to the statements of the minister of finance and the minister of state services on why reform to the two acts is needed. The theme is that while both have had positive benefits, in terms both of the government’s fiscal performance and of the performance of the government in meeting the needs of citizens, the acts are now over 30 years old, the world has changed and become ever more complex and interrelated, and both acts need to be changed to be fit for purpose. In the words of the minister of finance: “It is time, 30 years on, to bring the Public Finance Act into the 21st century and put wellbeing and collaborative government at the centre of our approach” (Robertson, 2019).

This article will introduce the role of the Public Finance Act and describe the manner in which the State Sector Act and the Public Finance Act were designed to operate as ‘twins’. It will address a major set of changes made to the Public Finance Act since it was passed and the rationale for those changes. It will describe and assess key changes currently being proposed for the public financial management system, considering also the relationship to the changes concurrently being proposed for the State Sector Act.

The article draws on some of the contributions to the ‘New Zealand’s Public Finance Act at 30: lessons, achievements and future directions’ (PFA30) conference held at the end of July 2019 at Victoria University of Wellington.

Role of the Public Finance Act
The Public Finance Act 1989 establishes the architecture for the public financial management system. This system serves a number of purposes. It establishes certain key components of the relationship between Parliament and the government, including the conditions under which the government can consume resources, when Parliament has authorised that action through an appropriation. The act also establishes the powers of the government in relation to borrowing, securities, derivatives, investment, banking and guarantees.

The Public Finance Act establishes the legislative arrangements for the government’s management of its overall fiscal position, including the specification of the principles of responsible fiscal management and requirements for documents that provide transparency for budget decisions. It establishes the ex post reporting and audit requirements for the government.

New Zealand’s public service performs well by international standards in responsiveness to government, effectiveness for New Zealanders, and integrity.

In establishing the nature and types of appropriation, the act determines key aspects of the functioning of the public financial management system at the departmental or Crown entity level, including the requirement to have an accrual-based accounting system that can record expenses or capital expenditure against an appropriation. The act also specifies the reporting requirements of departments (and departmental agencies) and Crown entities, which mirror and reinforce the nature of the appropriations.

One of the most significant features of the act, in relation to how it influenced the behaviour of both departments and ministers, is that it was outputs, rather than outcomes, which were specified as the basis for the appropriations. Outputs are the ‘goods or services that are supplied by a department or other organisation (s2). Outcomes were, until 2013, defined in the act as ‘a state or condition of society, the economy, or the environment and (b) includes a change in that state or condition’ (ibid.). The requirement to specify appropriations in output terms was a fundamental change mandated by the Public Finance Act, and one that has a number of challenges in its implementation.

The public financial management system can be seen as having two key roles in relation to the performance of the government: fiscal performance, relating to the government’s aggregate fiscal position; and outcome achievement, encompassing the effectiveness and efficiency of the government’s activities.

In relation to fiscal performance, there is little debate over the effectiveness of the Public Finance Act. The fiscal performance and position of the New Zealand government are very strong relative to the decades (of deficits) before the introduction of the legislation. They are also very strong relative to comparable countries such as Australia, Canada, the United Kingdom and the United States (Ball, 2019). And there is international recognition of the level of transparency associated with the fiscal management system in New Zealand. On this dimension of performance, the present government seems satisfied with the functioning of the act.

As was noted by the minister of finance and other speakers at the PFA30 conference, New Zealand also ranks very highly in international indices of standard of living and social progress, and also in the quality of the public service. Or, as the minister of state services noted in his overview of the proposals for reform of the State Sector Act:

New Zealand’s public service performs well by international standards in responsiveness to government, effectiveness for New Zealanders, and integrity. The proposals in these papers are not about fixing a system that is fundamentally broken. Rather, they are about improving from a high base; ensuring the public service is making the biggest possible difference to the
wellbeing of New Zealanders, delivering services that are easy to access and joined up around their needs, and serving an ever more diverse and changing community. (Hipkins, 2019c)

Notwithstanding the performance of the public management system in New Zealand, both this and previous governments have identified issues with outcome achievement and the efficiency of the system. Consequently, the Public Finance Act has been amended 58 times since 1989 (Brumby, 2019) and the State Sector Act 13 times since its enactment in 1988 (Hipkins, 2019c, para 13). A key issue of concern is the output focus of appropriations and accountabilities, and the conclusion that this focus encourages departments and Crown entities to operate in ‘silos’ and creates barriers to collaboration. These issues, apparently, have not been adequately addressed by successive amendments to the acts, and are a key basis for the major reforms now proposed.

The State Sector Act and the Public Finance Act

At the time the State Sector Act and the Public Finance Act were enacted it was intended that they would operate in tandem and be mutually reinforcing. This reflected the view that state sector employment and financial management arrangements were subsystems within a broader public management system; and that management systems work better when their various components operate in an integrated fashion, providing consistent signals, accountabilities and incentives to actors within the system. The Treasury’s briefing to the incoming government in 1987, which articulated the rationale for the proposed changes, stated:

When considering reform of the public sector it is essential to recognise the mutually reinforcing nature of these elements and to avoid piecemeal change that could weaken or distort the incentives of those given responsibility for management decisions to act in a way consistent with the objectives they have been given. (Treasury, 1987, vol.1, p.55)

In the financial management context, the implications of seeking an integrated system were most radically reflected in the following statement:

If we are to move to an accrual accounting system we would also need an accrual budgeting system so that actual results can be measured against plans and budget. The accounting system would need to be on the same basis as the budgeting system to avoid the possibility of conflicting objectives. An accrual budgeting system is one which is expressed in terms of costs to be incurred rather than in funds to be obligated or spent. (ibid., pp.83–4)

This recognition of the need to have coherence within the accounting, budgeting and appropriations systems was fully reflected in the Public Finance Act.6

The aim of having consistent and mutually reinforcing elements could also be seen in the way ‘performance’ was defined, specified and measured for purposes of both acts. Specifically, the concept of ‘performance’ envisaged clear distinctions between: ‘ownership performance’ and ‘purchase performance’;7 inputs, outputs and outcomes;8 and Crown and department.9 These distinctions were embedded in the nature of appropriations as well as in the performance management documentation under the State Sector Act. For example, ‘outputs’ were a key component in the specification of departmental and chief executive performance and accountability within State Sector Act performance management arrangements, as well as being a basis for budgeting, appropriation and reporting10 under the Public Finance Act.

A further illustration of the interrelationship between the two pieces of legislation can be seen in the process through which the Public Finance Act was implemented. The move to accrual budgeting and accounting necessitated a dramatic improvement in departmental accounting systems. The decision-making authority given to chief executives by the State Sector Act enabled them to establish accrual accounting systems within 18 months. Such a rapid transition would not have been possible prior to the act.11

Changes to the Public Finance Act since enactment

It was noted above that the Public Finance Act has been amended 58 times since enactment. While a number of these amendments are relatively trivial, others have greater significance. One significant set of changes relates to the manner in which performance intentions and
achievements are specified. Warren (2019) presents the changes in Figure 1.

This figure captures the continuing struggle to manage ‘performance’ in relation to outputs (services) and, more particularly, outcomes, or wellbeing. In the original act both concepts were seen as being important to making policy choices, with outputs being one form of intervention the government could take to achieve its desired outcomes. When ministers, through the planning and budgeting process, had determined the outputs they wished departments to deliver, those outputs became the basis for formal chief executive and departmental accountability; outcomes, while constituting the rationale for government action, were not the basis for such accountability.

In the period since the act was implemented, there has been a consistent ambition to emphasise the role of outcomes in representing the fundamental purpose of public services and to incorporate outcomes more directly into the formal management system. There has been a parallel pattern of diminishing the significance of outputs. This ambition has been articulated consistently in reviews of the public financial management system and given effect through successive changes to the system.

The legislative change in 2013, designed to give greater focus to outcome achievement, resulted in the introduction of a new type of appropriation, adding to those already existing. This ‘multi-category appropriation’ is specified as follows:

- 2 or more categories of 1 or more of the following:
  - output expenses:
  - other expenses:
  - non-departmental capital expenditure. (s7A(1)(g))

The intent of this somewhat inelegant specification of an appropriation type is clarified in the following section, where it is specified that the appropriation must be approved by the minister of finance and ‘must include only categories of expenses or non-departmental capital expenditure that contribute to a single overarching purpose’ (s7B(b)).

In effect, this amendment enables appropriations for expenses of different types, including different output categories and non-departmental capital expenditure, so long as those expenses ‘contribute to a single overarching purpose’. ‘Purpose’ is not defined in the act, though Treasury describes the intent of this set of amendments as being to ‘lift the strategic focus of statements of intent to drive a clearer focus on results and outcomes’ (Treasury, 2019).

Interestingly, the 2013 amendments removed the definition of ‘outcome’ (though not ‘output’) from the act. Irrespective of this, the concept is still in current usage, whether described as ‘outcome’ or ‘wellbeing’.

At the very least, the 2013 amendment enables appropriations, and the associated accountability, to be defined in terms of a set of expenses and capital expenditure designed to achieve a single purpose or outcome. This is a fundamental change to the act, arguably the most significant since it was enacted. In an important way, it reverts to the programme budgeting approach which New Zealand implemented in the Public Finance Act 1977, in that a programme comprised a set of activities designed to achieve a single outcome, and programmes were the basis for appropriation.

The fundamental problem with programme budgeting that the Public Finance Act sought to address was that it oversimplifies the nature of the relationship between outputs and outcomes. It does this by identifying a number of different activities (or outputs) that contribute to one outcome, and then formatting the budget, with its associated accountabilities, on that basis. However, the relationship between outputs and outcomes is not many outputs to one outcome, as the programme concept (and the definition of a multi-category appropriation) implies, but often many to many, and also complex and dynamic, and with interrelationships between different outcomes (health, education and income, for example). An activity or output that contributes to a health outcome may also contribute to educational and income outcomes. Therefore, relating an appropriation to a single outcome had the effect of ignoring the other outcomes to which the set of outputs contributed.

The rationale for the Public Finance Act focusing on outputs rather than outcomes within the accountability and appropriations structures was outlined by the author in a 1992 presentation, in which it was concluded:

There are some international precedents for giving outcomes a higher profile in the design of government management systems than has occurred in the New Zealand reforms. There are also some
good reasons for being sceptical about any attempt at comprehensive and detailed specification of outcomes, any attempt to construct a budget on an outcomes basis, or any attempt to hold managers explicitly accountable for outcomes. (Ball, 1992)

In the same paper it was noted that the Government Accounting Standards Board in the United States had addressed this issue in its 1990 research report Service Efforts and Accomplishments Reporting:

The extent to which public agencies can affect or control the outcomes and efficiency of the service being measured is of continuing concern to public officials. As with financial performance, SEA reporting does not indicate why the results are what they are, or what or who has caused or contributed to those results. These questions can be answered only, if at all, through in-depth evaluation and investigation. Fortunately, for public disclosure of SEA information, as with financial information, it is acceptable that the information presented should be appropriate and accurate in measuring results. This information is not expected to indicate clearly who or what caused the reported performance to be at the levels it is. (Government Accounting Standards Board, 1990, p.18)

This conclusion recognises the challenges and limitations in using outcome information for accountability purposes, and reflects the rationale for the manner in which outcomes were, earlier, addressed in the Public Finance Act. However, it nevertheless supported the reporting of outcomes provided the measurement is ‘appropriate and accurate’.

The Public Finance Act did not require such reporting of outcomes, either at the departmental or whole-of-government level. This is a key element of the changes the government is now proposing. This issue is discussed further in the following section.

It is very significant that the 2013 amendment changed the act in a manner which enabled outcome-based appropriations, albeit the specific wording requires such an appropriation to ‘contribute to a single overarching purpose’. Despite the changes, in the June 2019 speech announcing his intention to institute public service reforms, State Services Minister Chris Hipkins stated:

When I came into this job as Minister of State Services, I said the Public Service needs to be adaptive and responsive to the changing needs of citizens. I talked about what we needed to do to make this happen. These include moving from outputs to outcomes, even though outcomes are harder to measure and harder to control. (Hipkins, 2019a)

The minister’s statement reflects the continued ambition to find a way to place more focus on outcomes within the formal management system and less focus on outputs, notwithstanding the earlier efforts to achieve this ‘rebalancing’.

Proposed changes to the Public Finance Act

There are two key areas in which the government has indicated a desire to reform the public financial management system. The first is to establish an independent fiscal institution, and the second is to embed intergenerational wellbeing into that system. Both these topics have been the subject of discussion papers issued by Treasury (Treasury, 2018a, 2018b). However, the proposal for an independent fiscal institution will not be discussed further here. It is noteworthy that in his conference speech the minister of finance did not refer to the independent fiscal institution in relation to either the amendments to the Public Finance Act that he will ‘soon’ introduce18 or the ongoing work programme he described.19 Rather, he stated:

It is very significant that the 2013 amendment changed the act in a manner which enabled outcome-based appropriations, albeit the specific wording requires such an appropriation to ‘contribute to a single overarching purpose’.

Our modernisation of the public finance system, addressing its current limitations, is a key element of aligning the public sector to a wellbeing approach. The work programme includes three important themes – they are:

• Firstly, changing the overarching framework for measuring success and identifying the priorities, through amendments to embed wellbeing in the Public Finance Act, as well as the government’s broader commitment to sustainable development goals

• Secondly, changing the financial management framework, to increase flexibility, encourage collaboration and support and enable a more strategic focus. This includes changes to the appropriation system and a different approach to planning and reporting

• And thirdly, rethinking the approach to the Budget, so that we look at existing as well as new spending, and create more space to focus on the challenges and trade-offs needed to improve wellbeing for all New Zealanders. (Robertson, 2019)

All three themes envisage changes to the Public Finance Act. The first suggests that the act will be amended to establish a process for specifying wellbeing objectives alongside financial and economic objectives, and to specify the associated
reporting requirements. The second refers to ‘changes to the appropriation system’ which may, or may not, require changes to the act.20 The third theme seems less obviously to imply changes to the Public Finance Act, as the key focus of this theme is better examination of the ‘baseline’ level of expenditure. The fixed nominal baseline and allowances approach to the budget process is not specified in the act, and could be changed without amending it. However, the minister also noted that within this theme the appropriation system could be changed (Robertson, 2019).

There is a clear relationship between the three themes: all three seek to make the public financial management system perform better in achieving outcomes (wellbeing).

**Theme 1: Overarching framework for measuring success**
In relation to the first theme, the minister stated that he:

> will soon introduce legislation to amend the Public Finance Act so it includes two key changes:

- The Government will be required to set out how its wellbeing and fiscal objectives will guide its Budget
- The Treasury will be required to report on the state of current and future wellbeing in New Zealand, at least every four years

These changes recognise that we expect wellbeing monitoring to evolve over time as theory, evidence and data availability develop and improve.

Embedding wellbeing in the Public Finance Act may be contentious, depending on how it is done. Scott (2019) identified the risk of politicising the Treasury, if, as is proposed, Treasury is responsible for reporting on the achievement of wellbeing objectives. Scott (2019) stated that he:

> The Treasury will be required to report on the state of current and future wellbeing in New Zealand, at least every four years

He also identified that they considered would best achieve their desired outcomes. ‘Embedding wellbeing’ may also be seen as entirely consistent with the act, or as a logical development from the planning, budgeting and reporting framework established by it. Embedding wellbeing in the Public Finance Act is entirely consistent with the idea that outcomes are, and should be, the ultimate focus of public service activity. Outputs are one means by which outcomes are achieved, along with transfers, regulation, taxation and ownership. The act as originally enacted envisaged that ministers would choose the outputs (or other interventions) that they considered would best achieve their desired outcomes. ‘Embedding wellbeing’ can be seen as elaborating the specific aspects of wellbeing that will be considered in the budget planning and decision-making process and be the subject of formal ex post reporting requirements.

There is a significant respect in which embedding wellbeing into the Public Finance Act is a logical development of the framework underpinning the Public Finance Act. In the same way that departments are accountable for delivery of the agreed services and are required to report on this, the government as a whole is accountable for outcomes, and under the proposed reforms would be required to report on their achievement.

There have been initial moves in this direction, with an amendment to the Public Finance Act requiring reporting on child poverty, the proposals outlined in the Treasury’s discussion paper on wellbeing, and the proposed requirement that ‘The Treasury will be required to report on the state of current and future wellbeing in New Zealand, at least every four years’. The introduction of the Public Finance...
(Wellbeing) Amendment Bill confirms the intent expressed in the earlier discussion paper.

However, the way forward could be more coherent with the underlying structure of the act in at least two ways. First, part 3 of the Public Finance Act deals with 'Reporting by Government reporting entity', and states the reporting requirements for monthly and annual financial statements, and the associated audit requirements. Reporting ex post on outcome achievements would logically sit within or alongside part 3 of the act. As discussed above, attributing causation to changes in outcomes or wellbeing makes accountability more difficult than is the case with reporting on outputs (or operations and activity) by departments. Nevertheless, reporting on outcomes targeted by government provides useful information on the extent to which its priority outcome or wellbeing targets are being met.

The proposed requirement that Treasury report on the state of current and future wellbeing in New Zealand, at least every four years, has two aspects that warrant comment. First, if reporting were done only every four years, there would be a disjunction with both the annual budget cycle and the electoral term. From a management perspective, it would mean there was infrequent feedback on levels of achievement and therefore a lack of information as a basis for re-evaluating prior budget decisions and reprioritising if required. Arguably, one of the reasons the Public Finance Act has been successful in terms of fiscal management is that there is feedback on performance on a monthly basis, allowing (indeed encouraging) management to respond in a timely fashion to emerging circumstances and events. On this basis, reporting on at least an annual basis would seem desirable. While it may be that for some outcomes relatively little or no change could be observed within a year, in other cases more rapid change would be expected. Indeed, it may be that outcomes change as a result of factors other than government interventions, and this may also be relevant information.

Further, with a three-yearly electoral cycle, it could emerge that the government in office at the time the reporting on wellbeing takes place was not in government for the majority of the reporting period. Insofar as the text would necessarily describe and explain the wellbeing achievements (reflected in the data in Indicators Aotearoa New Zealand or the Living Standards Dashboard), this opens significant scope for alternative interpretations, which could make the reporting highly contentious and diminish both public confidence in the reporting and the longevity of the wellbeing focus.

Second, there is the question of which organisation(s) should have responsibility for reporting on wellbeing performance and in which document(s) should this reporting take place. As stated above, a distinction between ex ante and ex post reporting is a key element of the Public Finance Act framework. Hence, the budget documentation should articulate the wellbeing priorities and objectives the government is seeking to achieve through the budget, alongside the fiscal objectives. A step was taken in this direction in the 2019 Wellbeing Budget.

Given the concerns above, it is not clear which organisation or organisations should best be responsible for the ex post
The level of transaction costs and the nature and extent of scrutiny in the budget process are affected by the Public Finance Act primarily through its specification of the nature of the appropriation structure.

(Robertson, 2019).  

The minister elaborated by identifying three problems in the performance of the existing system:

- the difficulty and transaction costs associated with moving funding from one ‘pool’ to another, reallocating resources from less to more effective programmes;
- the difficulty of reporting in one place the result of collaborative efforts of multiple departments or agencies in achieving a single outcome, illustrated by the example of ‘a joint venture of eight government agencies who work on reducing and eliminating domestic violence’ (ibid.);
- the cost and ineffectiveness of agencies’ strategic planning processes, where strategic plans ‘end up sitting on the shelf gathering dust’. The minister indicated that the government was ‘testing a fundamentally different approach with one or two pilots where each pilot will put a spotlight on a specific long-term issue’.

The way the government seeks to address these three problems is underpinned by a common proposition: that government performance will be enhanced if there is flexibility to reallocate resources between activities that are carried out by different agencies acting collaboratively in pursuit of single outcome-based objectives, and that the formal aspects of the planning, budgeting, operations and reporting of the joint activities should be aggregated in line with the ‘specific long-term issue’.

While this proposition may be valid for a certain subset of the government’s activities, it may not be optimal for all. Below, consideration is given to the possibility that the management system needs to accommodate a two-track approach.

Theme 3: Rethinking the approach to the budget

In relation to the third theme, the minister noted:

My experience of the past two Budgets is that they involved quite high transaction costs focussed on a relatively small proportion of government spending. Ministers also had little visibility of what was being funded through baselines and where there were opportunities to stop some things to fund other new initiatives.

As a small first step, we will consider bringing in:

- Single departmental output appropriations for small departments and consolidating small appropriations to provide more flexibility to move funding between programmes and output classes (work that will be phased over two years)

Looking further ahead, we will consider:

- Aggregating non-departmental appropriations aligned to high-level outcome areas
- Introducing multi-department, multi-Minister appropriations, allowing multiple departments to be responsible – collaboratively – for what they achieve. (Robertson, 2019)

In the statements above, a number of issues are raised:

- a concern for the level of transaction costs in the budget process;

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Figure 3

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<thead>
<tr>
<th></th>
<th>Outcome-focused Collaboration</th>
<th>Output-focused Specialisation</th>
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</thead>
<tbody>
<tr>
<td>Expectations</td>
<td>Achievement of Shared Goals</td>
<td>Delivery of Services</td>
</tr>
<tr>
<td>Operating Model</td>
<td>Value-add through collaboration</td>
<td>Value-add through specialist skill</td>
</tr>
<tr>
<td>Information needs</td>
<td>Fast feedback loops from citizens</td>
<td>Fast feedback loops from system</td>
</tr>
<tr>
<td>Accountability for</td>
<td>Commitment to shared goals and mana to achieve them</td>
<td>The quality, quantity and cost of the provision of services</td>
</tr>
<tr>
<td>Accountable to</td>
<td>Citizens before hierarchy</td>
<td>Hierarchy before citizens</td>
</tr>
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<td>Accountability direction</td>
<td>Horizontal between collaborators</td>
<td>Up through the hierarchy</td>
</tr>
<tr>
<td>Trade-offs generally favour</td>
<td>Effectiveness</td>
<td>Efficiency</td>
</tr>
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<td>Funding</td>
<td>Collective / Relationships</td>
<td>Services</td>
</tr>
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- the relatively small proportion of the total budget that is scrutinised in the annual budget process;
- the degree of flexibility a department should have to adjust the set of outputs it produces within a single appropriation; and
- whether the appropriation system should have an even greater ‘outcome’ focus than that granted by multi-category appropriations, by allowing multi-department and multi-minister appropriations.

The level of transaction costs and the nature and extent of scrutiny in the budget process are affected by the Public Finance Act primarily through its specification of the nature of the appropriation structure. However, the manner in which the government chooses to administer its budget process, within the requirements of the act, is the major determinant of the costs. As in any budget system, there is a trade-off between the desire for scrutiny and contest, and the possibility of efficiencies and reallocations, on the one hand, and the desire to minimise the transaction costs on the other.

At one extreme, an organisation could adopt a variant of a ‘zero-based budgeting’ approach. This approach forces an annual reconsideration of all existing expenditure, and is seen as being of value in facilitating the reallocation of resources to more productive uses. In reality, the transaction costs of a zero-based budgeting process militate against its full implementation, though its methodology is consistent with the desire of the government to give greater consideration to baseline expenditure. An incremental approach to budgeting, essentially taking last year’s expenditure as given, will certainly be less costly to administer, but leaves on the table the value that could be extracted from increasing efficiency and reallocating expenses to interventions that make a greater contribution to outcomes.

The fixed nominal baseline system that has been used in New Zealand errs very much towards the incremental end of the spectrum, where, as the minister notes:

> About 98 per cent of government expenditure – or $89 billion – sits outside the annual Budget process, and yet – as I’ve already mentioned – we spend most of our time assessing how to allocate the next two per cent or so located at the margin through each Budget. (ibid.)

The system of fixed nominal baselines has at least two effects. First, it limits the amount of analysis and scrutiny that needs to be undertaken in relation to baseline expenses, reducing transaction costs. However, it also reduces the incentives on departments to re-examine the value generated by services within the baseline.

Certainty of forward funding reduces the incentive to seek greater efficiency or more innovative services.

The dilemma the minister faces is that he wishes to reduce the transaction costs associated with the budget process while increasing the scrutiny of baseline expenditure. In his speech he indicated that the intent is to look at ‘baselines and marginal expenditure together to better prioritise what will improve wellbeing for New Zealanders, and ensure sustainable resourcing to deliver it’. He indicated that the government was looking to achieve this through baseline reviews, where, ultimately, ‘80 per cent of baselines are covered by a review every few years’.

The following quotation suggests that the minister considers that a significant element of the transaction costs arises from the number of appropriations:

> More than half – 50 per cent – of the money is in just two per cent of the appropriations.

However, when assessing transaction costs, the size of the transaction is also significant. Using the minister’s numbers, the mean transaction size for the 2% of appropriations that constitute 50% of government expenditure is approximately $2.3 billion. These, obviously, are very significant amounts and the process of establishing the nature of what is to be delivered, issues of distribution, assignment of risks, etc. can be expected to generate substantial transaction costs. The mean transaction size for the other 98% of the appropriations is $46.5 million, and even this amount would seem to warrant serious analysis and scrutiny.

The need for examination of the base implies some increase in transaction costs, whether that examination is conducted annually or selectively over a number of years. Consistent with this, it is reasonable
to look to reduce transaction costs where it is efficient to do so. However, the transaction costs associated with the efficient allocation of approximately $90 billion should, if the allocation process is rigorous, be significant. The test is whether the transaction costs are warranted by the results of the allocation process, not by the ease with which departments can comply with the requirements of the process.

Same problem, alternative solution. Or is it? The ministers of state services and finance both acknowledge that the existing acts have been successful, but identify performance issues that remain. As described above, the minister of finance is proposing a work programme and legislative amendments that have the public financial management system focus more on outcomes, give ministers and departments greater flexibility in selecting outputs within appropriations, and support collaborative work between agencies.

While it might be argued that much of what the minister seeks could be achieved within the existing legislation, the changes are predicated on the view that legislative changes can better support the direction in which he aims to take the system.

Warren (2019) described two different approaches to managing activities within the public sector, which he describes as ‘outcome-focused collaboration’ and ‘output-focused specialisation’. The differences between the two approaches are summarised in Figure 3.

Warren also refers to organisations which operate a ‘two-track’ system in which they manage different types of service or activity in different ways, specifically by managing some functions through hierarchies and other functions through networks.

Warren’s contention is that the public management system currently operates in a hierarchical manner and that this is suitable for a subset of public services which are more routine in nature, and are produced more efficiently through output-focused specialisation. However, for other activities such a hierarchical approach leads to the issues that are problematic in the current system: the creation of siloes, lack of collaboration and the need for greater flexibility. For these other activities, which address complex problems that require learning, adaption and experimentation, outcome-focused collaboration, operating through networks rather than hierarchies, is more effective.

An important element of the rationale for the State Sector Act and the Public Finance Act was that the context and managerial issues confronting different departments are very different, and the pre-existing, highly centralised, approach did not allow for managers to be responsive to those differences. However, as has been observed, there are elements of the public financial management system that are themselves insufficiently responsive to the differences between those services that can most effectively be delivered through outcome-focused collaboration and those that can best be delivered through output-focused specialisation.

The changes being proposed for the State Sector Act seek to move the whole public service from output-focused specialisation to outcome-focused collaboration. The changes proposed by the minister of finance are also supportive of outcome-focused collaboration. However, the specific nature of some of the changes seems at least to open the possibility of tailored application, depending on the nature of the activity, even if the language used by the minister’s implies the universal application envisaged by the State Sector Act reforms.

As currently described, the changes are not explicitly confined to a subset of public services, which opens the possibility that, if applied too widely, outcome-focussed collaboration could be used where a more hierarchical approach would be superior. This is certainly the intent of the State Sector Act approach. However, if the Public Finance Act changes are enabling, rather than applying to all services, then the changes may be adopted only in those areas where outcome-focused collaboration is the superior approach. Were this to be the case, the solution proposed by Warren might still be achieved, albeit that there is not within the current proposals a clearly defined two-track system.

The description of the proposed changes to the Public Finance Act and the State Sector Act, taken together, suggests that they represent a move from one ‘one-size-fits-all’ model to a different ‘one-size fits-all’ model.

The place of outputs in the system

The minister noted in his speech to the conference that the Public Finance Act when it was first introduced ‘shone a light on what government was spending money on’ (Robertson, 2019). It did this by requiring departments to specify the outputs they were producing, enabling ministers to make strategic decisions about whether they considered those outputs were adding value.

In seeking to have the budget process examine the base as well as the margin, the same information set is required: that is, a clearly described set of outputs. The value of activities within the base is not a function of the level or type of expense, but of the services (or other interventions) that are produced. To examine the base, ministers need a clear picture of what services are produced. As the minister notes: ‘As a Government, we can’t ensure a joined-up, long-term approach to enhancing wellbeing, if we don’t actively look at what agencies are doing, and how it creates public value’ (ibid.).

Unfortunately, the clear ex ante specification of outputs, the subsequent management of their production and their
costing, and their ex post reporting involves significant transaction costs. This runs against the minister’s intention to make the process ‘easier for agencies’: ‘It’s important for us to make it easier for agencies to plan, deliver and account for their work programmes, and to do it collaboratively, and cost-efficiently, with a minimum of waste’ (ibid.).

However, in the period since the act was first implemented there has been a progressive degradation in the quality of output specification, meaning that it is now more difficult for ministers to see clearly what departments are delivering. The transaction costs associated with the specification and reporting, ex ante and ex post respectively, of outputs means that unless this information is used by management, especially in the budget process, the incentives to continue to produce it are significantly weakened. The use of a baseline in the budgeting process reduces the incentives on departments to produce high-quality output information, as their revenue stream is not dependent on the production of that information. Similarly, high-quality information on output costs also has significant transaction costs, and if output costs do not play a significant role in determining departmental budgets there will be a reduced incentive to produce this information, leading to a degradation in information quality. In order for ministers to examine the base, whether through periodic spending reviews or as part of the annual budget process, the decline in the quality of this information will need to be reversed.

**How do these proposed changes interrelate with the State Sector Act changes?**

The close relationship between the Public Finance Act and State Sector Act at the time they were passed was noted above. This important interrelationship is also recognised by the current government in advancing its reform programme. And it is also recognised that the ‘[c]hanges to the State Sector Act 1988 will build on the high performance base of the Public Service, with the overall aim of delivering better outcomes and services for New Zealanders’ (State Services Commission, 2019).

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**... ministers acknowledge that the New Zealand public management system has produced good results and is highly regarded internationally and by New Zealanders, but the ministers are nevertheless seeking further improvements.**

One of the issues raised by the minister of state services in explaining the need for the repeal of the State Sector Act and its replacement with a Public Service Act is that the departmental form of organisation alone is not flexible enough to help us meet all the needs of New Zealanders. Over and again we have found the basic departmental form inflexible for:

- 3.1 allowing different departments to work together to address complex problems which cross organisational boundaries;
- 3.2 creating autonomy, or independence, without the cost and complexity of a separate department;
- 3.3 creating greater visibility and strengthening accountability for important issues and priorities. (Hipkins, 2019b)

Building on the 2013 amendments to the State Sector Act, and the development of the System Design Toolkit, the changes proposed by the minister will give legislative backing to the following: an Interdepartmental Executive Board; public service joint ventures; a more flexible departmental agency model; and functional chief executives. In relation to these new organisational forms, the minister notes:

To give effect to these new organisational forms in legislation, some will require amendment to the Public Finance Act 1989. These consequential amendments would not alter the fundamental elements of the public finance framework – parliamentary authorisation of expenditure, transparency of objective setting and decision-making, and clear lines of accountability and reporting from officials to Ministers and Parliament. What would change is the range of administrative units able to become appropriation administrators, performance and strategic reporters and assume public finance responsibilities under the Act. (ibid., p.12)

This recognition of the need for appropriation system changes to reflect the new organisational forms reinforces the idea that the two pieces of legislation should be complementary and mutually reinforcing.

The discussion above concerning a ‘two-track’ system raises the possibility of having different operating modes within the public sector – outcome-focused collaboration and output-focused specialisation. The description of the proposed changes to the Public Finance Act and the State Sector Act, taken together, suggests that they represent a move from one ‘one-size-fits-all’ model to a different ‘one-size-fits-all’ model. While this may have the merit of being a coherent system, it does not reflect the experience of the past 30 years in two ways. First, for some activities an output-focused, hierarchical approach to management may be most efficient. Second, the range of activities in the public sector militates against a ‘one-size-fits-all’ approach. While the original legislation went a considerable distance in enabling decision making in different organisations to reflect their individuality, the experience since has been that the system as a whole does not sufficiently accommodate the variation within the organisations that make up the public service.
The changes being proposed for the State Sector Act and the Public Finance Act are significant. They envisage a public management system that operates in a way that is significantly different to that originally envisaged by the acts, but in a way that reflects and extends a number of changes that have been formalised through amendments to both acts since their original passage.

Key elements of these changes include an intent to focus more on outcomes than outputs, a desire to give ministers and departments greater flexibility in the nature of appropriations and the selection of the services that will be provided within an appropriation, and a desire for the public service to operate in a more ‘joined-up’, innovative and collaborative way. These changes reflect perceived issues in the operation of the system and the complexity of some of the problems New Zealand still faces. There is also an intent to change the budget process to make it both more efficient and more comprehensive, with reduced transaction costs and greater scrutiny of baseline expenditure.

A strength of the changes proposed by the ministers of state services and finance is that they maintain the complementarity of the two acts, emphasising the importance of a coherent public management system with consistent incentives on decision makers. The focus of both is firmly on clear accountabilities.

Consequently, these changes will have a material impact on the nature of financial management within departments, with a range of implications for financial managers, financial services and the public sector more broadly. To give some idea of the scale of these changes, it is intended to introduce 146 new sections to the State Sector Act and the Public Finance Act, 140 as part of the Public Finance Amendment Bill. This is significant, but the significant change is that these new sections are a very different way of thinking about financial and public sector management.

Overall, the trade-off to making the changes is that it will take time for the budget process to achieve its potential. In the meantime, the new arrangements of the State Sector Act and the Public Finance Act will provide a more flexible, co-ordinated and accountable system for the public sector in New Zealand. The next section of this Economist article, ‘[time will tell]’, will give a sense of that transition.

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1 The different types of appropriation include appropriation for output expenses, other expenses, borrowing expenses and capital function. It would, however, constitute a significant change to do appropriations for benefits or related expenses (transfers) and multi-category appropriations.

2 For departments, outputs remain the basis for most appropriations, though there has been a pattern over time of aggregating outputs into fewer appropriations. This gives greater flexibility to departments at some cost to parliamentary authority in relation to the purpose of the authorised expenses.

3 Key challenges are the effort required to specify ex ante the service(s) that will be delivered, the budget period, and the measurement (including costing) and monitoring of the services actually delivered. For reasons that will be explained later, departments have stronger incentives to ensure their outputs are delivered, and as a consequence, it is argued, departments are less willing to collaborate with other organisations in achieving outcomes.

4 As distinct from the assignment of decision rights between the Parliament, the ministers and departmental chief executives.

5 A number of speakers at the PF2030 conference, including the minister of finance and international speakers, referenced the high level of fiscal transparency.

6 While arguably part of the reason for the rapid introduction and successful implementation of an accrual-based financial reporting system has been little etumed internationally, although the adoption of accrual reporting has been (Bromby, 2019).

7 Ownership performance relates to the aspects of an organisation’s performance that would be of interest to its owner, such as maintenance of capital, financial performance, organisational strategy and risk management. Purchase performance relates to the interests that a customer might have – including the nature of the product or service, the quantity and quality of the service, location of delivery, and cost. These two interests – purchase and ownership – could conflict: for example, if a department were to run down capital to meet service demands. Accrual accounting was needed to measure performance on both dimensions – whether capital was being maintained (ownership) and the cost of services (purchase).

8 Both acts largely removed controls over inputs, other than the appropriation mechanism that specified total input costs. In exchange for freedom to manage inputs, departmental managers were accountable for the delivery of outputs. Through the requirements of State Sector Public Finance Act, ministers determined the nature and level of services (or other interventions) required, based on the outcomes they were seeking to achieve.

9 This distinction required clarity as to the accountability of ministers and chief executives and departments. So, for example, ministers would determine and be accountable for the level of income tax, while Inland Revenue would be accountable for the collection of the tax, and associated services. Similarly, the Department of Conservation (DOC) would be accountable for the management of Crown assets such as the national parks. In these examples, tax revenue would be revenue of the Crown, not Inland Revenue, and the national parks would be on the Crown balance sheet, not DOC’s.

10 Reporting of outputs was required in the Statement of Service Performance, and to emphasise the need for high-quality information on this statement, like the financial statements, required to be audited.

11 In the international setting, the speed with which the accrual accounting systems were put in place in New Zealand is notable. Most departmental directors of finance (as they were then described) had little or no experience of establishing or operating an accrual-based accounting system, as this was not required in the context of a cash-based and Treasury-operated accounting system. In many cases, chief executives recruited new chief financial officers who had the requisite skills and experience. This process would have been significantly more difficult and time-consuming if the necessary skills, at both CFO and subordinate levels, were not already developed and internally rather than imported.

12 Little (2018) suggests that the changes have led to a “patchwork system” and noted that: “The irony is that the overall effect of these changes can be to take us further away from a more meaningful performance framework.”

13 While outcomes were not formally the basis for chief executive accountability, in many cases where ministers were seeking to achieve their priority outcomes, chief executives had an incentive both to demonstrate how their department’s outputs contributed to the minister’s outcomes, and to seek improvements to the design or delivery of their outputs.

14 This pattern of diminishing the significance of outputs is illustrated by the use of two terms: ‘outputs’ to describe outputs. The progressive lessening of the specification and reporting requirements in relation to outputs in the formal system has the effect of reducing any visibility of the system, but runs counter to the point that it is only through the production of outputs (or other interventions) that outcomes can be achieved; outcomes cannot themselves be directly achieved without some form of intervention.

15 The introduction of strategic result areas (SRAs), the Better Public Services initiative, the social investment approach and the core Crown segment, state-owned enterprises, mixed-ownership model companies, Air New Zealand Limited, Kiwi Group Holdings Limited (the state-owned enterprises sector), the Crown entities sector, plus other entities not fully consolidated into the financial statements of the government, principally tertiary education institutions.

16 The government also produces unaudited monthly financial statements, except for the first two months of the year.

17 Information in the government’s financial statements is the basis for assessing compliance with performance objectives and financial performance of the areas of expenditure within the government.

18 It should be noted that recent amendments to the Public Finance Act have included initiatives to seek to align the output category definitions in the act. Specifically, sections 15A (End-of-year performance information requirements) and 15EA (Main Appropriation Bill: supporting information relating to child poverty) require information that relates to wellbeing status rather than to plans. Clearly distinguishing ex ante objectives and ex post achievements enables clearer communication about achievements relative to plans, and thus more effective accountability.

19 It may be that the four-year report is intended to be similar to the Investment Statement, a document that is required by section 264A of the act to be prepared by the Treasury at least every four years. However, this statement is largely based on information that has already been reported in the financial statements, except for information in post reporting documents. It is not clear whether the equivalent formal reporting of wellbeing achievements is intended to take place, if not in the proposed Treasury report.

20 In this article I will use the term ‘achievements’ in relation to wellbeing performance. However, it has been noted above that the attribution problem means it is difficult or impossible to demonstrate causality in the result of government action. Notwithstanding this, it is central to the reforms the government is considering that it wishes to formalise the place of wellbeing in the planning, budgeting and reporting processes, and by implication this is how it is choosing to be held accountable.

21 The issues addressed in themes 2 and 3 are not the subject of the changes in the Public Finance (Wellbeing) Amendment Bill.

22 This term appears equivalent to the term used to define a

Public Financial Management and Reforms to the State Sector Act

multi-category appropriation – a ‘single overarching purpose’.

29 A March 2015 article in the Wall Street Journal (Kesmodel, 2015) noted the recent revival of the zero-based budgeting approach.

30 While these transaction costs might be substantial, they would be very significantly less than the transaction costs associated with contract specification and performance monitoring in relation to an equivalently sized commercial contract.

31 Little (2018): ‘The current financial and vertical accountability structures incentivise silos – good for delivering discrete, tangible outputs that are delivered by a single agency, but creating a barrier to helping those with complex needs and tackling complex issues that fall across departmental boundaries.’

32 Little (2018) refers to ‘a hierarchical, top-down control model, and a one-size fits all approach’.

33 The focus on outputs for accountability purposes and the requirement for ex ante specification of services to be delivered are two examples.

34 In particular, changes to the appropriation system appear to recognise that some activities require greater flexibility as to the nature of services than do others.

References


