FOREWORD

It is now ten years since the enactment of the Public Finance Act 1989. It introduced a new regime of financial management and Parliamentary accountability that was, at the time, without precedent anywhere in the world. The tenth anniversary seems a good time to pause, take stock and perhaps map a way forward. This report has been prepared with that objective in mind.

I am extremely grateful to the many people who gave freely of their time and contributed so constructively to the development of this report. By acknowledging their contribution, I do not mean to imply that they necessarily agree with all the views advanced. The report seeks to raise a number of important and complex issues and to stimulate debate. It would have been remarkable indeed if every person we consulted agreed with everything the report contains. Some have expressed reservations. A few have expressed opposing views on some matters. Nonetheless, I have been encouraged by the number of endorsements – first that these issues are topical and important, and secondly that many of the proposals we make are, at the very at least, worth exploring further.

My particular thanks go to Dr Judith Aitken, the Hon Justice Baragwanath, Dr Roger Blakeley, Dr Alan Bollard, Mr Len Cook, Sir Brian Elwood, Mr Howard Fancy, Mr Derek Gill, Dr Bob Gregory, Dr Arthur Grimes, Ms Susan Hitchiner, Professor Philip Joseph, the Hon Sir Kenneth Keith, Mr Colin Keating, Mr John Lepper, Professor John Martin, Mr David McGee, Mr Peter McKinlay, Professor June Pallot, Dr Mark Prebble, Sir John Robertson, Mr Gerald Scanlan, Ms Suzanne Snively and Dr Alex Sundakov. Their insightful and often detailed comments make it clear that the widespread and forward-looking debate we are seeking to promote has already begun.

D J D Macdonald

What Is This Report About and Why Have We Written It?

1.001 The purpose of this report is twofold:

- to promote Parliament's awareness of a number of issues relating to the way in which it currently scrutinises and controls executive government (the Executive), and holds it to account; and
- to point to opportunities for improvement and to stimulate debate about them.

1.002 We have not set out to advance detailed solutions. Instead, we have tried to set out clearly our perception of these issues and difficulties and to suggest, in general terms, some ways in which we think improvements might be pursued.

1.003 In doing so, we have also sought to bring together and summarise a number of observations we have made to Parliament since the introduction of the financial management reforms at the end of the last decade.

1.004 These issues relate to:

- the nature and purpose of the Executive's spending;
- the impact and outcomes of the Executive's spending;
- the structure and capability of the Executive's agencies (departments, Crown entities and State-owned enterprises);
- governance and accountability[1] ;
- appropriation and supply; and
- the assessment and management of risk.

1.005 In summary, we are seeking to highlight opportunities for Parliament to develop its own systems. We believe such developments will enable Parliament to exercise a more effective oversight of the Executive, and for the Executive itself to achieve better results.

1 The term "accountability" is often used with somewhat different meanings. In the context of this report, "accountability" for actions taken implies an obligation *both* to report on those actions (and usually their consequences) *and* to accept responsibility for those actions and their consequences.

1.006 We are acutely conscious of the need to avoid requiring Government agencies to produce costly information solely for the purposes of discharging external accountability requirements. This problem, quite properly, has been the subject of concern in the past.[2] Nonetheless, we see no need for Parliament to resile from requiring the Executive to supply appropriate information. We are convinced that the information which is most relevant for accountability purposes is also information that the Executive and its agencies require anyway for their own good governance and effective management.

What Are Our Main Concerns?

1.007 Although we consider that Parliament currently receives reasonably good financial information – especially about the outputs purchased by the Executive and the financial performance of its agencies – we have nonetheless identified scope for improvement.

1.008 We believe that non-financial performance information can be significantly improved. In addition, we believe that Parliament can and should receive much better information about the Government's desired outcomes and the extent to which those outcomes are being achieved.

1.009 We also believe that there are some extremely important information gaps. Parliament currently receives little or no information on:

- organisational capability;
- the way in which the Executive's agencies assess and manage risk; or
- the way in which the Executive proposes to make use of imprest supply.

1.010 If these gaps can be filled, we believe that it will improve Parliament's ability to scrutinise effectively the activities of the Executive, and to exercise its constitutional function of holding the Executive to account.

2 For example:
- *Report of the Inter-departmental Working Party on Accountability Documents*, State Services Commission, June 1994; and
- *Inquiry into Departmental Reporting to Parliament: Report of the Finance and Expenditure Committee*, November 1997.

What Are Parliament's Constitutional Accountability Functions?

2.001 The constitutional structure in New Zealand has been summarised, with elegant simplicity, as follows: *The Queen reigns, but the Government rules, so long as it has the support of the House of Representatives.*[3] It is not superfluous to add that members of Parliament achieve their office only through the support of the voting public and can continue as members for further terms of office only if their public support continues.

2.002 In formal terms, "Parliament" consists of the Sovereign and the House of Representatives acting together. Its only function is to make laws. However, it has been observed[4] that Parliament is inevitably identified with the House of Representatives, and in this report we will continue the common usage. We do so because the processes of Executive accountability are regulated both by laws enacted by Parliament and by the Standing Orders adopted by the House of Representatives.

2.003 Since the Government ceases to be able to rule when Parliament's support is withdrawn, Parliament is able to exercise considerable control over the activities of the Executive. As a result, there is an ongoing accountability dialogue between the Executive and Parliament. In effect, the Executive must continuously satisfy Parliament that it should continue to enjoy Parliament's support.

2.004 The constitutional structure and accountability dialogue create a number of sources of influence and control[5] , which include:

3 *On the Constitution of New Zealand: An Introduction to the Foundations of the Current Form of Government*, Hon Sir Kenneth Keith, *Cabinet Office Manual*, 1996, pages 4-5.

4 *Parliamentary Practice in New Zealand* (2nd Ed), David McGee, GP Publications, 1994, page 1.

5 In the context of the United Kingdom Parliament, the British constitutional commentator Bernard Crick described parliamentary control as *influence, not direct power, advice, not command, criticism, not obstruction, scrutiny, not initiation, publicity, not secrecy.* This definition is also a fair reflection of the position in New Zealand when the governing political party holds an absolute majority in the House. However, in the MMP environment, it is more likely that no one political party will have the ability to ensure that all its proposed legislation will be passed. In these circumstances, and particularly when the governing political party holds only a minority of seats, the enactment of bills, the provision of supply and the confidence of the House cannot be assumed. Parliamentary "control" then ceases to be merely influential and becomes more direct.

- The maintenance of an ongoing scrutiny of the activities of the Executive through information provided to Parliament or obtained by members of Parliament.
- A direct influence on the deliberations and decisions of the Executive through parliamentary debate and select committee activities.
- The enactment of laws that directly constrain the activities of the Executive itself.
- The enactment of laws (especially legislation that provides supply) that enable the Executive to give effect to its policies.
- An indirect (but important) influence on the deliberations and decisions of the Executive, inasmuch as those decisions are made in the knowledge that they must generally be disclosed to Parliament and will be subject to parliamentary and public scrutiny.

2.005 Parliament therefore occupies a critical intermediate position between the Government and the public. The accountability dialogue between the Government and the public is mediated and invigilated by Parliament.

Why Is It Timely To Reconsider the Current Accountability Arrangements?

2.006 In our view, there are now opportunities to improve the information that Parliament receives and enhance its systems in ways that previously were either not possible or not practicable. In some cases, they arise from new and developing technologies. In others, they represent new information structures that can now be built on the consolidated base of previous initiatives.

2.007 We also believe that a number of these influences – especially new technologies and increasing internationalisation – are causing major changes to the structure and processes of government. These in turn are directly affecting the nature of the accountability dialogue between the Executive and Parliament, and the way in which it can usefully be conducted.

2.008 It may be useful to elaborate on these views by placing them in an historical context. Over the last century, and particularly in the last 60 years, the range and scope of Executive activity has increased enormously. The resources now available to modern governments form a significant proportion of the total product of their national economies.

2.009 In New Zealand, Parliament's formal control over the activities of the Executive has been exercised through a suite of measures, many of which centred on the control of supply. However, as the scope and complexity of government activity has increased, control of supply by itself has ceased to be a sufficient instrument. Other controls have become necessary and have been introduced.

2.010 Among the most effective instruments of control that Parliament uses are those that require the disclosure of specific information. Parliament needs this information:

- before the event, when scrutinising the legislative and expenditure proposals of the Government;
- concurrently, when scrutinising the governance and activities of its agencies; and
- after the event, when scrutinising their performance.

2.011 In recent times, there have been important changes in the way information is generated and used in both the government and private sectors. These include:

- a general acceptance (reflected, for example, in the Public Finance Act 1989) that financial information alone is insufficient for effective management, and that non-financial information can be just as important, or more important;
- an improved understanding of the inter-relationship between information, capability, control and risk, and the need to reflect this inter-relationship in governance and management practice;
- significant advances in the capabilities of information systems;
- significant decreases in the cost of processing and sharing information; and

- an emerging acceptance of the need to focus governance and management effort on the achievement of results rather than simply on the delivery of outputs.

2.012 These changes can be seen as practical manifestations of profound and rapid theoretical developments over the last 40 or 50 years, which have greatly increased our understanding of:

- measurement and information;
- the development, emergence,[6] analysis, simulation, forecasting and control of complex systems (such as national economies, social structures and the processes of government); and
- the existence of fundamental and inescapable limits to our ability to forecast and control complex systems, and the consequences of these limits for the development of strategy, organisational capability, accountability and the management of risk.

2.013 Now that powerful and low-cost computers are generally available, these theoretical developments create practical possibilities. Taken together, they can make available to Parliament, the Executive, its agencies and the general public, tools with remarkable potentialities.

2.014 To take a simple example, most government departments and agencies now have a presence on the World Wide Web. The information that can be obtained in that way by any enquirer is limited only by what the agency chooses or is obliged to make available. If reliable financial and performance information was to be published through the Web site and updated at regular intervals, members of Parliament and other interested stakeholders could monitor agency activity in greater depth and in a more ongoing way.[7]

6 When used in relation to systems, the term "emergence" refers to the way in which, as they become more complex, they begin to manifest new phenomena that could not easily be predicted from the workings of their component parts.

7 A remarkable example of this approach has been developed in the US State of Florida. The site, known as "Florida Monitor" is a service of the Florida Legislature's Office of Program Policy Analysis and Government Accountability. The Web address is – http://www.oppaga.state.fl.us/.

2.015 However, the nature and implications of these developments is much wider. The new information technologies are establishing new information relationships that affect the way in which:

- government policies are developed and implemented;
- public goods and services are produced by government organisations;
- information is exchanged with stakeholders, including the general public;
- public services are provided to the public; and
- government organisations interact with each other, both locally and internationally.

2.016 It is important not to underestimate either the pace or scale of these developments. The extent of progress can usefully be illustrated with an example from computer modelling. Arguably the first major attempt to use a computer to model aspects of a national economy (that of the USA) was under taken in 1949 by Nobel laureate economist Wassily Leontief. His model involved 42 linear equations with 42 unknowns. To solve these equations, Leontief needed to make use of Harvard University's Mark II computer, one of the largest then in existence. The task took the computer 56 hours to complete. Today, that problem would be regarded as trivial and could be solved on a hand-held computer in less than a second.

2.017 In New Zealand, the nature and legal structures of Crown-owned organisations has also been evolving. They are generally classified into three broad types: departments, State-owned enterprises and Crown entities. The third of these classifications is a generic term for a wide range of different organisations[8] that include:

- ***Administrative tribunals*** which in general have powers to decide disputes between the State and individuals, or between individuals;

8 This typology has been suggested by the Legislation Advisory Committee. C.f. *Legislative Change: Guidelines on Process and Content,* Legislation Advisory Committee, 1991, pages 31-32.

- ***Funding bodies*** supporting public and charitable purposes;
- ***Advisory bodies*** with powers to give advice to the government and often more widely in areas of public policy and public interest;
- ***Service providers*** that furnish services in the public interest in a wide range of areas;
- ***Trading corporations*** that are usually companies but are not State-owned enterprises under the State-Owned Enterprises Act 1986; and
- ***Control and supervisory bodies*** other than those which are Offices of Parliament or tribunals.

2.018 The wide differences in the structures, functions, operations and governance of government organisations is mirrored by very significant differences in the nature of the information needed by Parliament and the public in order to maintain an effective accountability dialogue with the Executive.[9] However, the information issues become even more complex when the interactions and information flows between these diverse organisations are taken into account. For example, government organisations frequently establish both formal and informal working groups[10] to deal with specific issues or to pursue collective objectives. It may be that no one agency is primarily accountable and that no external reports acknowledge the existence of the objectives, the resources applied collectively to pursuing them or the group's performance in doing so.

2.019 In summary, the structures of government organisations are becoming more diverse and complex. The information exchanges between these organisations and with their stakeholders are increasing in frequency, scope and complexity. However, potentially there are large compensating benefits – in the efficiency and effectiveness of governmental operations; in the ability to customise and target services and resources; and in the extraction of information relevant to the development and evaluation of policy.

9 For example, "control and supervisory bodies", especially those that exercise coercive powers, need to account for the use of their powers. Having no such powers, "trading corporations" do not need to account for their use. However, they do need to account for their commercial activities. Different accountability requirements are imposed variously by the Public Finance Act 1989 and by other specific legislation, especially that which establishes and regulates particular bodies.

10 Such groups are sometimes described as "virtual departments".

2.020 Unless these trends can be controlled, there is a risk that Parliament's accountability dialogue with the Executive will be adversely affected by the sheer volume of the information flows. However, if Parliament is able to identify its core information needs and can devise and implement appropriate arrangements, there should be significant benefits. The beneficiaries will be both Parliament itself and the public it serves.

2.021 For these reasons, we believe it may be timely for Parliament to take stock of its information requirements and accountability arrangements. In doing so, it may wish to consider how it can make best use of what is already available, and position itself to adapt to, and profit from, future developments.

2.022 Ideally, the financial and non-financial information that Parliament receives should be integrated into a coherent whole. It should be structured so that a broad overview can easily be achieved, and the nature and relative significance of particular issues is made clear. In these respects, we consider the current arrangements to be less useful than they could be. We explore these problems and opportunities in more detail in the remaining chapters of this report.

2.023 Although we are advancing arguments for the provision of additional information, and occasionally for the strengthening of controls, we are not suggesting that Parliament should engage in "managing" the Executive. We do not envisage that the process of parliamentary scrutiny and control would be in any way different from what occurs now. As we stated in paragraph 2.001, the Government rules provided it has the support of the House. Parliament's role is:

- to scrutinise the Government's actions;
- to highlight potential and actual problems; and
- to review continuously whether or not the Government should have its support.

2.024 The suggestions made here are intended to facilitate that scrutiny.

3.001 In this chapter, we discuss what information Parliament needs about the activities of the Executive. This includes information to help resolve fundamental questions such as:

- why the Executive proposes to spend money, and on what;
- why the Crown needs to own particular things (especially the agencies of the Executive and State-owned enterprises);
- what the Executive expects its agencies to do (and whether or not they do it);
- what the Executive expects to happen as a result of its agencies' actions (and what actually happens); and
- what risks the Executive and its agencies are incurring in undertaking those actions, and how those risks are being managed.

What Currently Regulates the Information Parliament Receives About the Executive's Expenditure?

3.002 Most of the information that Parliament currently receives about the spending plans of the Executive is supplied pursuant to the requirements of the Public Finance Act 1989 and the Fiscal Responsibility Act 1994. Among other things, these Acts prescribe:

- the information to be submitted to Parliament in support of requests for appropriations; and
- the information to be reported to Parliament on the Government's overall fiscal objectives, on the use actually made of supply, and on the performance of agencies providing services to the Government.

3.003 The reforms brought about by the State-Owned Enterprises Act 1986, the State Sector Act 1988, the Public Finance Act 1989 and the Fiscal Responsibility Act 1994 have received international praise for being innovative and far-reaching. There can be no doubt that they have resulted in significant improvements in the quality and extent of the financial information available to Parliament.

3.004 However, Governments and other stakeholders have now had 10 years experience of the operation of the Public Finance Act 1989. In that time, a number of practical lessons have been learnt and the learning process has not stopped. Although that Act has already been subject to substantial amendment, we see scope for further refinement.

How Does Parliament Currently Control the Expenditure of the Executive?

3.005 Parliament currently regulates the fiscal activities of the Executive by employing a regime which enables it to:

- Examine (and approve by enactment of statute) the revenue, supply and expenditure proposals of the Government.
- Throughout the period to which its statutory approvals relate, maintain continuous direct oversight of the fiscal activities of the Government through statutory reports, Parliamentary questions, Parliamentary debates and select committee operations (including specific inquiries). It also maintains indirect oversight through the exercise of the Controller function by the Controller and Auditor-General.
- Review actual events against original intentions, and hold the Government and its agents to account for their performance.

3.006 Parliament can exercise its functions effectively only if approvals intended to be before the event are indeed given in advance,[11] and subsequent reviews are not postponed to a point where they become practically irrelevant. For example, Parliament often approves Imprest Supply Acts that provide the Executive with funding several months before it is invited to approve the purposes for which those funds have been spent.

3.007 If approvals are to be given and reviews conducted in an informed manner, Parliament must also be provided with sufficient reliable and timely information.

11 We address this issue further in Chapter 7.

How Is Government Expenditure Categorised At Present?

3.008 The Public Finance Act 1989 currently refers to seven different categories of expenditure. They are:

- outputs;
- benefits or other unrequited expenses;
- borrowing expenses;
- other expenses;
- capital contributions;
- purchase or development of capital assets; and
- repayment of debt.

3.009 To some extent, these classifications reflect the conventional view (expressed in much commentary on our system of public administration) that the Executive has two dimensions of interest in government agencies:

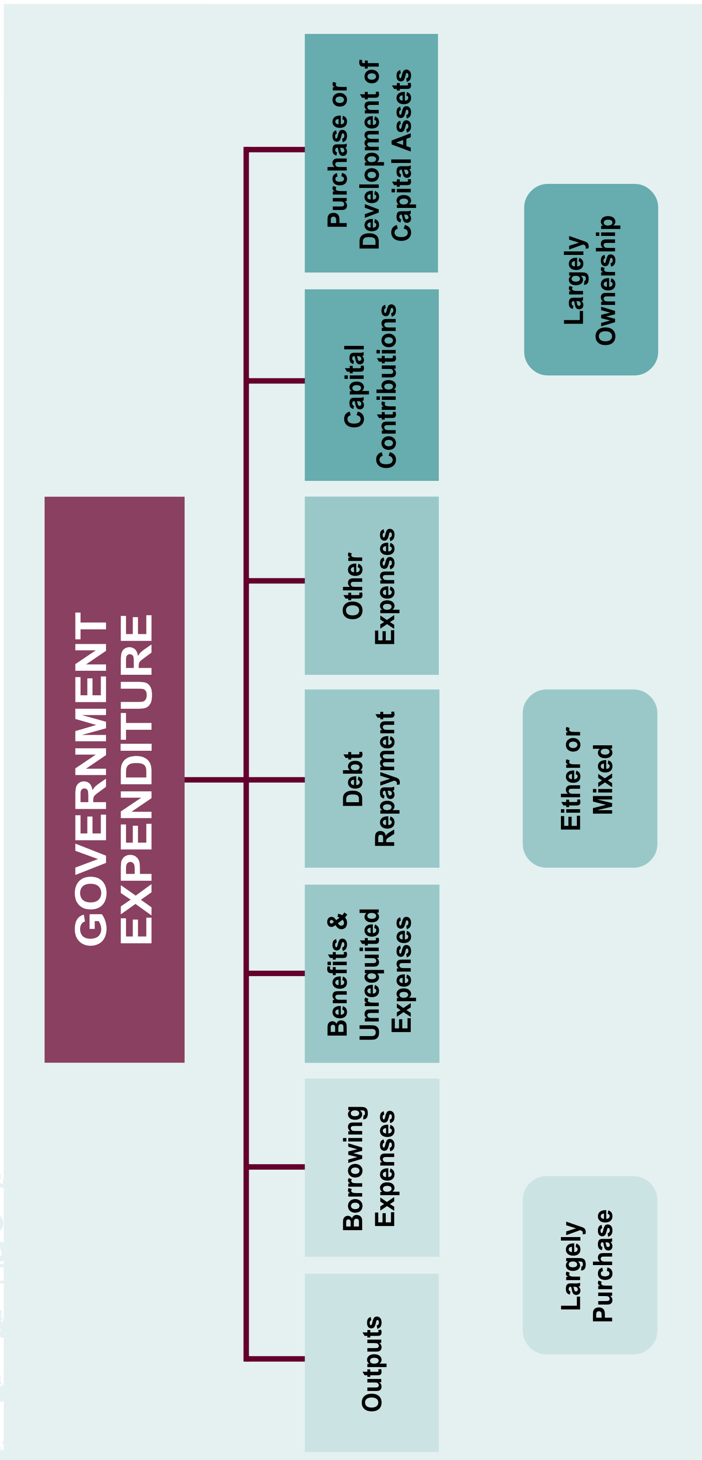
- a ***purchase*** interest, which is concerned with obtaining desired outputs at the best possible price; and
- an ***ownership*** interest, which is concerned with the efficient use of assets and with maintaining its agencies' capabilities in line with Government objectives.

3.010 The current categories of expenditure do reflect these two dimensions of interest, but only imperfectly.

3.011 These two dimensions of interest are also reflected in the categorisation of ministerial responsibilities. Ministers who undertake the purchase of outputs pursuant to appropriations voted by Parliament are referred to as "Vote Ministers". Ministers who exercise general control and oversight of government agencies as corporate entities are referred to as "Responsible Ministers".

3.012 The loose purchase/ownership relationships in the current classification are illustrated in Figure 3.1 on the next page.

Figure 3.1
Purchase/Ownership Relationships With Expenditure Categories



3.013 We do not believe it is particularly useful to view the Executive's expenditure from the perspective of its purchase or ownership interest. There are three main reasons:

- First, its interest in the public funds that it spends goes beyond simply purchasing for itself either consumable goods and services or fixed assets.
- Secondly, its interest in Crown-owned organisations goes beyond their ability to supply those goods and services efficiently.
- Thirdly, the terminology risks creating distortions. An assumption might easily be made (mistakenly in our view) that there is a simple relationship between the purchase interest and output prices, and between the ownership interest and the value of balance sheet assets. In fact, there is no simple relationship between output prices, output costs and purchase interest; nor between capital injections, balance sheet assets and ownership interest. The current categorisation of government expenditure risks confusing the reasons for incurring that expenditure. It also risks failing to make clear the likely impact of that expenditure on aspects of the ownership interest (such as organisational capability) that cannot easily be measured in monetary terms.

What Considerations Affect Government Spending and Ownership?

3.014 Whenever the Executive decides that the purchase of certain outputs is necessary to achieve its objectives, it must also decide if those outputs are best produced by its own agencies or purchased from non-government suppliers (the "make or buy" decision).

3.015 Such decisions are usually more complex for governments than for other purchasers. The scope of a government's interest is much wider than that of a private sector owner. Indeed, there are some quite fundamental differences and these need to be clearly understood.

3.016 For private sector owners of corporate entities (such as limited liability companies) the ownership interest will generally centre on a desire to maximise, or at least preserve, the value of the entities' assets and income. In addition, private sector owners may legitimately treat such entities as investments and sell them when the investments are judged to be mature or they no longer form part of the "core" business. As well, they rarely purchase much or all of the outputs of entities they own. Finally, an entity's earnings will generally be a good reflection of its performance.

3.017 The Executive, on the other hand, is rarely in a position to regard Crown-owned organisations merely as investments, in the sense that the term is used in the private sector. Indeed, few would regard it as a proper activity of government to create or purchase corporate entities as assets for the sole purpose of trading or speculating against the private wealth of the nation's citizens. Instead, the Executive will usually create and own Crown organisations in the manner of a trustee, for the benefit of the nation as a whole.

3.018 Because the State defines, defends and polices individual property rights, the Executive's interest in owning particular assets (including government organisations) is not always obvious. For example, if the Executive is concerned to optimise the supply and price of some good widely used by the public (such as electricity), it could choose either to own the means of the production of that good or to regulate the price charged by a private provider. If it chooses the latter option, it curtails some of the property rights of the private provider.

3.019 When governments make ownership decisions, a variety of considerations can be relevant. The Government is more likely to choose Crown ownership of organisations whose outputs are:

- very important for securing or defending the existence of the State (for example, defence, foreign policy or national security) or the establishment and enforcement of individual rights and liberties;
- capable of conferring benefits on more people without incurring significant additional production costs (for example, free-to-air broadcasting);

- capable of conferring benefits on a much wider group than those who can easily be made to pay for them directly (for example, medical treatment of contagious diseases);
- intrinsically important to the general welfare but unlikely to be freely produced or freely purchased in the quantities needed to maximise the general welfare (for example, clean water supply);
- subject to significant economies of scale and therefore likely to be produced by a natural monopoly (especially if effective regulation of the prices charged by a non-government monopoly would be difficult or impossible in practice); or
- essential to the Executive or to the working of the economy as a whole, so that the consequences of a supply failure are serious (especially if the Executive is unable in practice to avoid the risks resulting from a supply failure simply by quitting ownership).

3.020 Although many of the considerations listed above might persuade a Government to own an organisation, they are not necessarily conclusive reasons for doing so. In practice, the issues are complex. There is likely to be more than one reason why the Government wishes to own a particular agency. In addition, the outputs of many organisations that the Crown might own are "mixed goods" – that is, they have some characteristics that confer benefits on the wider public and some that confer only private benefits. So too do the outputs of many private producers.

Why Does Parliament Need Information About the Reasons for Ownership?

3.021 In constitutional terms, organisations are owned not by the Government but by the Crown. Parliament has an important role in establishing Crown ownership. Many Crown-owned organisations are created under the authority of a specific statute. In addition, Parliament must always appropriate the capital funds needed to establish or purchase a Crown-owned organisation.

3.022 There are important relationships between a Government's underlying reasons for Crown ownership of an organisation, the corporate form which best reflects those underlying reasons, and the information which Parliament needs to maintain effective oversight of the organisation's performance.

3.023 In our view, an organisation's accountability documents should include an explicit statement – determined by the Executive – of the reasons for Crown ownership of the organisation. We believe that Parliament is entitled to know exactly what those reasons are so that it can judge whether or not:

- the reasons are appropriate; and
- they are being fulfilled; and
- they remain unchanged; or
- they have changed in a way that –
  - suggests consequential changes in the organisation's objectives or corporate form; or
  - removes the reason for continuing Crown ownership, or even the organisation's continuing existence.

3.024 In making this observation, we do not wish to imply that there are absolute criteria which can be applied to determine whether or not an organisation currently owned by the Crown should remain in Crown ownership or should be sold. Such decisions are matters of policy. However, if a fundamental reason for owning an agency is to provide services that deliver significant benefits to the public, Parliament needs information to establish whether or not those benefits are actually being delivered.

3.025 In addition, the organisation's corporate form should be appropriate for producing outputs that can confer such benefits. For example, organisations producing outputs that are essentially public goods should probably not be structured as companies charged with making a profit, since that structure would create a high risk of under-supply.

3.026 There are other considerations as well. Different corporate forms imply different governance arrangements that may or may not be appropriate. There are circumstances where the primary governance of an organisation is clearly best undertaken by a Minister (for example, the Minister's own department). There are other circumstances (for example, the conduct of commercial business by a State-owned enterprise or the work of statutory officers like the Privacy Commissioner) where governance is best handled by a board or by statutory delegation. This is generally true when the overarching objective is to lessen the opportunity for, or appearance of, inappropriate political intervention. However, because devolved and remote governance arrangements, by definition, weaken the Executive's direct control, it is important to ensure that the risks incurred by using them do not exceed the likely benefits.

3.027 These tensions and uncertainties exist for a range of Crown-owned organisations and are also manifested clearly in the State-Owned Enterprises Act 1986. Such enterprises – in addition to operating as efficient and profitable businesses – are also charged to exhibit *a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so*. This general obligation has proved difficult for the Courts to interpret in practice[12] and also for the boards of SOEs themselves.

3.028 The Courts' problems of interpretation, and the boards' problems of governance, are compounded by being faced with two conflicting statutory objectives. In cases of conflict, should the commercial objective or the social responsibility objective prevail? Where such conflicts have been brought to judicial resolution, the Courts appear to have accorded priority to the commercial objective. There may be a case for amending the legislation to make clear:

- what is meant by "social responsibility"; and
- whether the obligation to pursue commercial objectives or the obligation to exhibit social responsibility should take precedence.

12 See, for example, *Auckland Electric Power Board v Electricity Corporation of New Zealand Ltd* [1993] 3 NZLR 53. Justice Barker observed, among other things, that there were obvious difficulties in a Court making a necessarily subjective assessment of whether or not a State-owned enterprise had exhibited social responsibility.

3.029 It is also worth observing that one of the fundamental reasons for enacting the State-Owned Enterprises Act 1986 was to remove conflicts in organisational objectives by separating out commercial and public good activities. The SOE would be free to pursue commercial objectives in the expectation that, where it was required to produce public goods, it would be directly and explicitly compensated for that activity.

3.030 We believe that the information provided to Parliament should address such tensions and all other aspects of the Executive's ownership interest. However, it seems to us that the current mechanisms are less complete and less useful than they could be. As a consequence, Parliament's ability to hold the Executive and its agencies to account is at risk of being at least compromised, and at worst rendered almost wholly ineffective.

3.031 For example, we doubt that the "statement of (corporate) intent" required of certain Crown entities has always proved an effective tool in facilitating Parliament's prior approval or subsequent scrutiny of their activities.

3.032 Section 41D of the Public Finance Act 1989 requires, among other things, that the statement of intent contain *the performance targets and other measures by which the performance of a Crown entity or group may be judged in relation to its objectives*. However, section 41I requires the entity to report only *such information, including a comparison against the relevant statement of intent, as is necessary to enable an informed assessment to be made of the* ***financial*** *performance* [of the Crown entity or group].

3.033 Hence, the annual reports of such entities often do not provide good measures of their ***non-financial*** performance; or their organisational capability; or the extent to which they have created benefits for New Zealanders, especially in relation to the Crown's fundamental reasons for owning them.[13]

13 Other aspects of this issue are addressed in "Appropriations for Non-departmental Outputs", *Report of the Controller and Auditor-General: Third Report for 1998*, parliamentary paper B.29[98c].

Why Does the Present Categorisation of Government Expenditure Create Difficulties?

3.034 As indicated in paragraph 3.018, one important consideration for the Government in a "make or buy" decision can be the need for assurance of the continuity of supply. If the Government determines that it must continue to purchase certain quantities of certain outputs over the medium or long term, and if it regards assurance of supply as sufficiently important, it may choose to acquire (or continue to own) the means of their production.

3.035 When the Government owns the supplying organisation, its purchase and ownership interests are sometimes regarded as competing. Its purchase decisions can be viewed in the context of a notional "price of continuous supply" – that is, an output price at which an efficient organisation can cover its direct production costs while maintaining its productive capability.[14] However, the Government may choose to purchase those outputs from that organisation at lower prices if it is prepared to compromise its interest as owner.

3.036 In this context, distinctions between purchase and ownership interest can be artificial and potentially misleading. If the Government chooses to own an organisation and to purchase its outputs, there is generally no economic conflict between purchase and ownership interest, since the overarching objective is to minimise the long-term cost of supply.

3.037 There are situations where it may be both desirable and economically rational for the Government to purchase outputs at prices below those of continuous supply. For example:

- the Government may have decided to reduce or discontinue the purchase of those outputs in the foreseeable future, making it sensible to allow an organisation's capability to run down; or
- there may be a more desirable alternative use for the funds represented by the shortfall between price and direct cost (so that maintaining capability incurs an opportunity cost).

14 When continuity of supply is important, governments must consider the price of continuous supply even when purchasing from private sector providers – else eventually there will be no supply.

3.038 There are also situations where it is not desirable or economically rational for the Government to purchase outputs at prices below those of continuous supply. In general, they occur when the cost of restoring a depleted capability exceeds the cost (including the opportunity cost) of maintaining it.

3.039 Although it is possible that the Government's demand for certain outputs remains relatively constant from one year to the next, the more common position is that its demand will be changing. For example, the demand for the outputs needed to discharge some statutory requirement, such as the payment of social security benefits, may be driven by influences outside the Government's direct control. In such circumstances, decisions about both output price and capital requirements must be made in the context of expected demand and the capability needed to meet it.

3.040 Experience with the Crown Health Enterprises[15] (CHEs) provides a useful example of the difficulties that can arise when the purpose and categorisation of expenditure is unclear.[16] During the 1994-95 and 1995-96 years, the CHEs collectively showed net operating deficits of 7.6% and 6% respectively of the revenue received. These deficits were compensated in part by capital contributions from the Crown. Had there been no capital contributions, the value of share holders' funds would have fallen to only 64% of the opening balances at 1 July 1994, seriously compromising the ability of a number of CHEs to continue providing services.

3.041 The CHEs were producing outputs by consuming capital. In other words, output prices were insufficient to enable them to maintain capability. Further, since the CHEs were not obliged to provide Parliament with statements of service performance, it was difficult for Parliament to know whether or not the services actually being provided were of good quality, or sufficient in quantity, or delivered in appropriate locations.

15 Now known as Hospital and Health Services.

16 For a more complete treatment, see "The Financial Condition of Crown Health Enterprises", *Report of the Controller and Auditor-General: First Report for 1997*, parliamentary paper B.29[97a], and "The Financial Performance of Crown Health Enterprises", *Report of the Controller and Auditor-General: Second Report for 1998*, parliamentary paper B.29[98b].

Is There a More Useful Way to Categorise Government Expenditure?

3.042 We think so. Given the above considerations, there appear to be real advantages in categorising the information Parliament needs about Government spending under the headings of ***current*** and ***capability*** expenditure – rather than expenditure that reflects purchase and ownership interest. These terms are defined as follows:

- ***Current expenditure*** is expenditure that the Government must incur to discharge its day-to-day business. It includes expenditure on outputs, transfer payments and debt servicing.
- ***Capability expenditure*** is that which the Government must incur to establish or extend an agency's ability to produce outputs.

3.043 Under these definitions, the expenditure needed to maintain the capability to produce particular outputs should properly be attributed to the cost of those outputs (and therefore be accounted for as current expenditure).

3.044 The definitions can usefully be illustrated by some examples:

- A Minister purchases from a department the same outputs as were purchased in the preceding year. The outputs are produced to the same general standard. Some staff resign during the year and the chief executive funds the training of their replacements to the same level of competence as those who resigned. Only *current* expenditure is involved.
- A Minister wants to purchase the same volume of outputs in the current year as was purchased in the previous year, but also wants all the work done to a higher standard from now on. The output factor costs (labour, stationery, corporate overheads, etc) are the same, but the chief executive also funds the training of key staff to a higher level of competence. The cost of producing the outputs is *current* expenditure and the cost of the additional (i.e. non-replacement) training is *capability* expenditure.

- A department is reorganised so that it can produce its outputs more efficiently and economically. The cost of undertaking the reorganisation is *capability* expenditure. The reduced ongoing cost of the outputs reflects reduced *current* expenditure.

- A department receives a capital injection to enable it to purchase a new computer system so that it can produce its outputs more efficiently and economically. The difference between the cost of the new computer system and the (lower) cost of the old computer system is *capability* expenditure; as is the cost of training staff to use the new system, and the cost incurred in any consequential reorganisation of the department and any other consequential retraining. The reduced ongoing cost of the outputs reflects reduced *current* expenditure.

- A department forecasts that it will need to meet a higher level of demand in future, which it can do only by producing a higher volume of outputs. Quality and unit costs remain the same. The chief executive must incur new costs in recruiting, training and equipping additional staff. The expenditure on that recruitment, training and equipment is *capability* expenditure. The higher factor costs incurred in producing a higher volume of outputs (albeit at the same unit costs) reflect greater *current* expenditure.

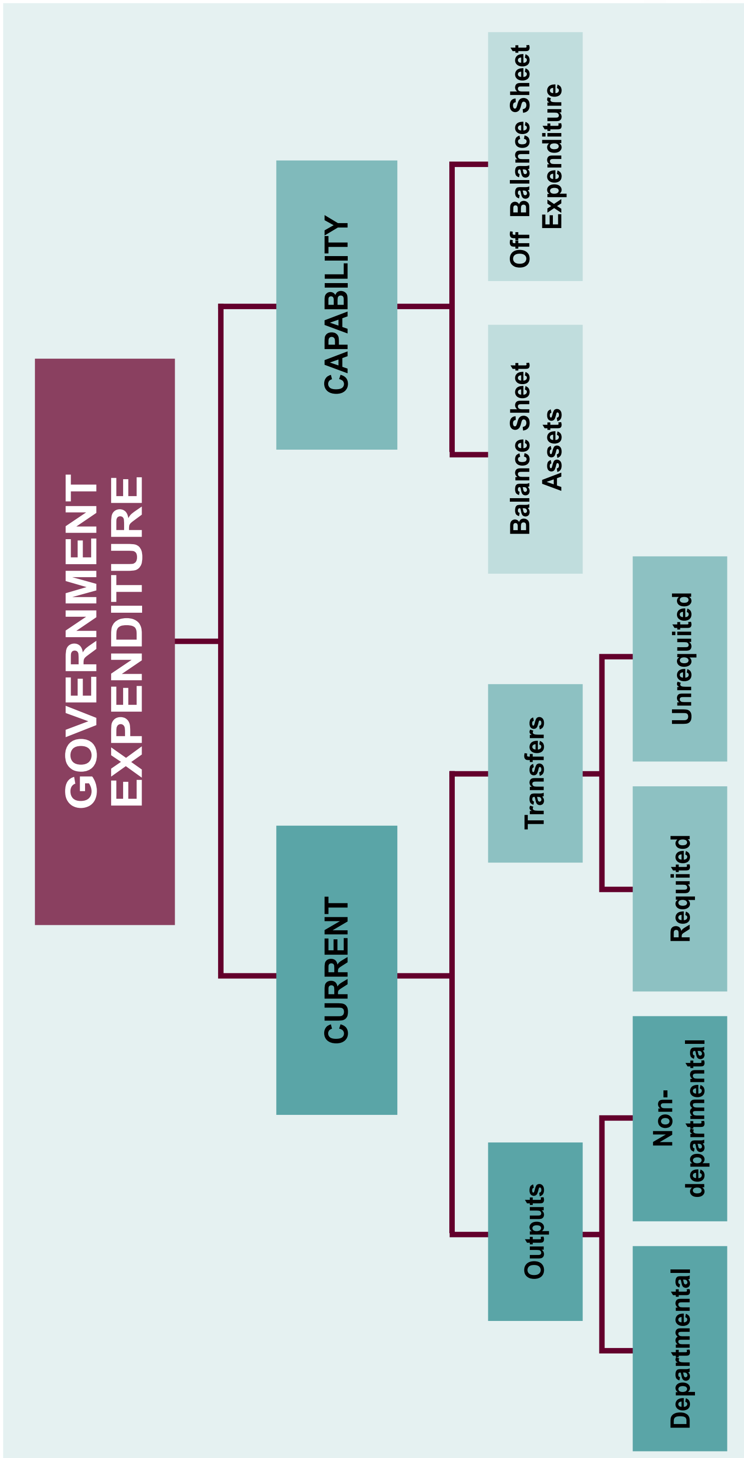
3.045 The core features of this categorisation are illustrated in Figure 3.2 opposite.

3.046 We believe that this categorisation has a number of advantages:

- First, it provides a comprehensive classification, since all expenditure can be placed in one of these categories. Under current expenditure categories not all of the Executive's expenditure is related directly to either purchases or ownership, as defined in paragraph 3.009. A significant proportion is neither ownership-related nor purchase-related.

- Secondly, it avoids any implication that ownership interest can be fully reflected in balance sheet assets. Much of the information needed about key dimensions of ownership interest is not simply information about expenditure. This is particularly true in relation to –
  - the extent of an organisation's capability;

Figure 3.2
Categorisation of Current and Capability Expenditure



THREE

  - the determination of necessary changes to an organisation's capability; and
  - the particular contribution that owning the organisation is expected to make to the public good.

- Thirdly, it should improve the quality of expenditure-related information. It would foster realistic expectations about the amount of expenditure that would have to be incurred to cause significant changes in the characteristics or quantity of outputs. It would avoid "concealing" or absorbing such expenditure within output prices or by consuming capital or otherwise depleting capability. For example, if a department is not explicitly and fully funded for the costs of a restructuring, there is a risk that output quality will be compromised in ways that are real but unmeasured, or that organisational capability will be adversely and permanently affected.

Summary of Conclusions

3.047 The Government's interest in a Crown-owned organisation is commonly classified into two dimensions – purchase interest and ownership interest. However, at present the expenditure categories in the Public Finance Act 1989 do not fit well with this classification. Even if they did, Parliament's interests are not the same as the Government's interests.

3.048 In our view, Parliament's information requirements are not particularly well reflected in the purchase/ownership classification and are not well served by the information structure that supports it. This is true because:

- The impact of expenditure on the Government's purchase and ownership interests is often inter-related and confused. This confusion can affect organisations (particularly their organisational capability) in ways that are not transparent.
- Parliament needs more ownership-related information about Crown-owned organisations than is provided in current financial statements. Its wider information requirements arise from (among other things) –
  - the fundamental reasons why the Crown should own a particular organisation (as opposed to purchasing from or regulating an organisation it does not own);

- the appropriateness of the organisation's corporate form (e.g. department, company, statutory corporation); and
- the organisation's capability.

3.049 Instead, we suggest that expenditure should be classified into two broad categories, current expenditure and capability expenditure, with subordinate categories that fall uniquely into one or other of these two broad categories. We believe this classification will enable the full span of Parliament's information requirements to be met with greater precision.

3.050 In the following chapters, we discuss what information would be relevant to Parliament's prior approval and subsequent review of the Executive's current and capability expenditure. We identify information not provided to Parliament at present that we believe would enhance its scrutiny and control.

3.051 We also advance certain considerations that may be relevant in determining who should be responsible for providing this information. First, however, we make some observations on the specification of the Government's desired outcomes – since the ultimate rationale for all Government expenditure is the realisation of those outcomes.

4.001 In this chapter, we review what Parliament needs to know about the objectives and consequences of expenditure by the Executive. We draw attention to a range of difficulties and make observations on the way in which some of them have been addressed by successive governments. We then suggest possible improvements.

What Are "Outcomes" and How Are They Described?

4.002 The Public Finance Act 1989 defines "outcomes" as the impacts on, or consequences for, the community of the outputs or activities of the Government. When determining whether or not to approve the Government's expenditure proposals, Parliament is presented with two critical questions:

- What outcomes are the expenditure proposals intended to achieve (and should Parliament agree with them)?
- Is it likely that the proposed expenditure will achieve these outcomes?

4.003 Recognising this, the Public Finance Act 1989 provides that the *Estimates of Appropriations*[17] (the *Estimates*) must contain information on *the link between the classes of outputs*[18] *to be purchased by the Crown and the Government's desired outcomes.*

4.004 We believe that the information currently supplied to Parliament concerning Government outcomes can be improved significantly. We have identified difficulties under seven general headings:

- Outcome descriptions have often been vague. There is no statutory requirement that such descriptions should be specific about what measures or criteria will be used to establish whether or not they have in fact occurred. We accept that the Government needs to express its desired

17 Parliamentary paper B.5.

18 It has been suggested to us that the words of the Act should be interpreted as relating only to non-departmental output classes. That does indeed appear to be a tenable interpretation. However, in practice the linkage has always been identified for all outputs, both departmental and non-departmental. We strongly support this practice.

outcomes in a way that is readily accessible to the general public. However, we believe that such statements need to be supported by further statements or specifications that indicate exactly how achievement of the outcome – or progress towards it – will be determined or measured.

- The Public Finance Act 1989 implies that intended outcomes be specified in advance, but does not require that actual outcomes be measured and reported. Given the foregoing comments, most outcome statements currently in use could not be measured and reported against.

- In the context of relating classes of outputs to outcomes, the term "link" (as used in the Public Finance Act 1989) has been interpreted narrowly. Usually, it has been thought sufficient simply to assert that a class of outputs will contribute to an outcome without describing how it is expected to do so.

- Often, there is little empirical research or evaluation information available to support assertions of linkages between outputs and outcomes.

- Several outputs from several departments or agencies may contribute to the same outcome, and any particular output may contribute to several outcomes. In general, the output/outcome linkage is not "one-to-one", or even "one-to-many", but "many-to-many". Understanding these complex inter-relationships is crucial for the development of robust policy. If they are not well understood, policy initiatives and expenditure decisions will be uncertain, with consequences that are difficult to foresee and that may prove to be quite unfortunate.

- The Public Finance Act 1989 does not require an indication of the relative importance that the Government attaches to particular outcomes.

- There does not appear to be a strong reason why outputs are the only form of Government expenditure for which linkages to outcomes must be specified. For example, transfer payments such as social security benefits also contribute to Government outcomes and form a significant proportion of total Government expenditure.

Strategic Priorities and Overarching Goals: What Are They and Why Were They Introduced?

4.005 In theory at least, different outcomes can be in partial or complete conflict. They may also have quite different priorities. Uncertainty about the degree of coherence among different outcomes (and the relative priority that should be attached to them) has been an issue not only for Parliament but also for successive governments. In our view, the Government's expression of its strategic priorities is a very important component of its accountability dialogue with Parliament and the public.

4.006 In 1994, the then Government decided to define its strategic objectives more clearly. It adopted and promulgated a number of “strategic result areas” (SRAs) which covered the period 1994-1997. These were to be medium-term objectives for the public sector. The objectives were expected to contribute significantly to the Government's longer-term policy goals and objectives. The process of developing and defining the SRAs was co-ordinated by the Department of the Prime Minister and Cabinet. The SRAs were used to help link the various objectives of different departments – and ultimately the individual employment contracts of chief executives and employees – to the Government’s goals.

4.007 Departments were charged with developing their own key result areas (KRAs), which were to define the critical areas which a department would concentrate on in the next two to three years in contribution to the Government's SRAs. A department’s KRAs were (and still are) included in the performance agreement between chief executives and the Ministers responsible for their department. Progress towards the KRAs was (and is) assessed as part of a chief executive’s performance review, which is conducted by the State Services Commissioner.

4.008 SRAs were also promulgated for the period 1997-2000. However, in 1998, at the initiative of Ministers, work was undertaken to revise the strategic approach. This work (which is ongoing) has resulted in a reduced set of “strategic priorities and overarching goals” (SPOGs) that were promulgated by the Government on 9 December 1998.

4.009 Several aspects of the SPOG/SRA initiative are worthy of comment.

4.010 Before the first SRAs were promulgated, there was no single comprehensive statement of the Government's intended outcomes, and no indication of which outcomes the Government regarded as having a higher priority. The SRAs provided a comprehensive statement of, at least, the Government's strategic priorities. Over the last four years Ministers have often used SRAs in the Estimates as outcome statements. Similarly, they have used KRAs in purchase agreements as an adjunct to, or in substitution of, other performance measures in departmental forecast reports.

4.011 The SRA/KRA initiative is regarded by many as having merit. They argue that it has helped improve the strategic coherence of government activity. However, although it was first designed as a tool to be used largely *within* the Executive, it seems to us to have also been used as a substitute remedy for problems with the current accountability regime that should perhaps be corrected more formally.

4.012 In our view, informal arrangements can yield benefits but also pose some difficulties and create some risks. In particular:

- SPOGs/SRAs and KRAs are not defined or applied in any legislation. Their form and usage are effectively unregulated. However, they are being used in situations of fundamental constitutional importance. For example, SPOGs/SRAs have been used in the *Estimates* as outcome statements or as substitutes for outcome statements. In essence, they articulate the strategic direction of the Government and indicate the overarching objectives for the use of supply. Similarly, KRAs are often used in purchase agreements in a way that is similar to the way in which outputs are specified in the same document.
- SRAs were not, and SPOGs currently are not,[19] specified with any greater precision than other outcome statements. Work is currently being undertaken on how best to support SPOGs with meaningful and measurable indicators.

19 See *A Better Focus on Outcomes Through SRA Networks*, State Services Commission, October 1998.

- To the extent that some KRAs are also reflected in output descriptions, they risk being redundant. To the extent that some are not reflected in output descriptions (and therefore are not reflected in Parliamentary appropriations), they risk being unlawful.

4.013 SPOGs/SRAs, by definition, are intended to address matters of strategic importance. Since not every outcome can be regarded as having "strategic" importance, we do not believe they should be equated with, or purport to be, a comprehensive statement of the Government's desired outcomes. We have formed the impression that they are often used in circumstances where other, more specific outcome statements would be more appropriate.

How Should Outcomes Be Specified?

4.014 The Public Finance Act 1989 does not impose any requirements on the way in which the Government's desired outcomes must be described or specified. We believe this also poses problems and incurs some risks.

4.015 From the definition in the Act, it seems reasonable to infer that an "outcome" is a set of circumstances, or a condition of society, that the Government considers would be unlikely to occur in the absence of some intervention. By implication, there is an alternative or "counterfactual" position that the Government presumably considers would be more likely to occur if there was no intervention.

4.016 There is a complicating factor, however. Some desirable conditions of society may be only partly achievable through Government action. For example, achievement of better levels of health for all New Zealanders depends at least as much on what they as individuals do as on what the Government may do.

4.017 To the extent that the actions of other parties are unknowable, counterfactual positions sometimes cannot be estimated. In these circumstances, the desired outcome should not be "overstated". If the statement does not represent an impact on, or consequence for, the community *of the outputs or activities of the Government*, it is not an "outcome" within the meaning of the Act.

4.018 To return to the health example, it is of course desirable that all New Zealanders be healthy. However, that is not only a consequence of the actions of the Government. Accordingly, it would be more tenable to advance as the desired outcome the availability of affordable health care, since that could be a direct consequence of the actions of the Government.

4.019 We believe that Parliament will be better able to judge the merit of the Government's expenditure proposals if the estimated impact of the expenditure is made clear. This will be facilitated if, wherever possible, outcome statements are underpinned by supplementary statements expressed in terms of a measurable expectation and forecast counterfactual position.[20] It will enable Parliament to judge whether or not the estimated impact appears to justify the sums that the Government proposes to spend to achieve it. If the potential impact of the actions of non-government parties is significant, that too can be made clear.

How Should Outcomes Be Reported?

4.020 To realise the benefit of specifying outcomes in measurable terms, it is essential that those outcomes, or progress towards them, are actually measured and monitored. In its 1997 report on its *Inquiry into Departmental Reporting to Parliament* [parliamentary paper I.3c], the Finance and Expenditure Committee stated that ... *it would be worthwhile to encourage chief executives to include more reporting on the strategic issues and achievements in their annual reports.* We agree with this view.

4.021 The Committee went on to observe that *the way in which select committees interpret and respond to information from departments on strategic progress needs to acknowledge the fact that definitive judgements on cause and effect, credit and blame will seldom be either feasible or constructive. We are looking for a willingness by select committees to engage departments in conversation about what decisions are most likely to lead to the result desired by the Government and what are the most critical issues and challenges for those decisions to address.*

20 This presupposes that sufficient information is available to enable estimates and forecasts to be made. However, Parliament equally may wish to know that such information is **not** available and that the asserted benefits of an expenditure proposal are essentially speculative.

4.022 It might be argued that successive governments may have been reluctant to be more specific about their desired outcomes to avoid complications that might arise if they failed to achieve them. However, it seems to us inescapable that, if outcome statements continue to be expressed in a way that is vague and immeasurable, the information conveyed by them becomes extremely limited. Parliament and the public will find them virtually worthless.

4.023 We agree that, except in the rare cases where the achievement of a desired outcome is wholly controllable, individual departments and agencies cannot be held to account or blamed merely because that outcome does not occur. We will elaborate further on this issue in the context of risk management (Chapter 8). We believe that it is reasonable for Parliament to require that outcomes be measurable[21] and be measured.

4.024 The potential advantages of this approach can be illustrated by two examples.

4.025 First, the Fiscal Responsibility Act 1994 is quite specific as to the nature and purpose of the reports that the Minister of Finance must submit to Parliament and some of the measures that must be used. For example, the Minister must present to the House each year a budget policy statement and fiscal strategy report that use (but are not limited to) such measurable variables as the Crown's total operating expenses, total operating revenues, total debt and total net worth. It is possible, therefore, to determine afterwards the success of fiscal policies and strategies in terms of their stated objectives.

4.026 Secondly, in recent years the Ministry for the Environment has been researching environmental indicators to support the Environment 2010 Strategy. Using the indicators already developed, it is possible to monitor key characteristics of the environment. Environment-related outcomes framed in terms of such indicators will make it readily apparent whether or not environmental initiatives and regulations appear to be achieving the desired results.[22]

21 To clarify this view in the context of the points we made in paragraphs 4.016-4.019, some conditions of society may be measurable as they occur but impossible to forecast before they have occurred.

22 For a comprehensive account, see *The State of New Zealand's Environment*, Ministry for the Environment, GP Publications, 1997.

What Are "Impact Evaluations" and Should They Be Undertaken?

4.027 Impact evaluations are empirical studies that are conducted to measure and establish the real consequences of an agency's actions or programmes.

4.028 Unlike some overseas countries, the New Zealand Parliament has not previously required the impact of government spending be subject to empirical research or evaluation. The absence of empirical information means that it is difficult for Parliament to obtain assurance that the very considerable sums spent on many government activities are having the intended effect (or, indeed, any effect).[23]

4.029 Experience overseas has been salutary. There have been many examples where government programmes were established on the basis of policy models that appeared perfectly reasonable. However, subsequent empirical evaluation demonstrated that those programmes were having little or no impact in achieving their stated objectives. Some were even found to be counter-productive.

4.030 It is worth noting, however, that impact evaluations are more useful for informing policy development than as a tool of accountability. Usually, they cannot be undertaken until the programme being evaluated has been in place for sufficient time for the asserted benefits to be realised (which can be a period of years). In addition, the evaluations themselves often take some time to perform.[24]

4.031 Nonetheless, we are convinced that more research and evaluation of key areas of Government spending would be extremely beneficial. Properly directed and conducted, such studies would yield valuable information to support policy development. They would also reduce the risk of important outcomes not being achieved and substantial sums of public money being wasted.

23 For example, in the early 1970s, many evaluations were conducted in the USA of programmes to rehabilitate convicted criminals. They were so universally disappointing that some criminologists speculated that rehabilitation might be effectively impossible.

24 A very good recent example of an evaluation of a complex policy initiative, and one that will inform future policy debate, is provided by an evaluation of the 1995 changes to the legislation relating to domestic violence. See *The Domestic Violence Legislation and Child Access in New Zealand*, Ministry of Justice, May 1999.

4.032 In this respect, we see considerable advantages in ensuring that evaluation methods are determined and put in place when key programmes are being designed and implemented. It is also important to try to ensure, on a case-by-case basis, that particular evaluations are likely to be cost-beneficial, and to follow up and ensure that the evaluation is completed and reported. If the evaluation seems unlikely to be cost-beneficial, it is important to make the best use of whatever relevant data is available – whether from within the organisation or from other sources – and to understand and make clear its limitations.

Measurement Difficulties

4.033 An objection might be made that introducing a requirement for measurability is likely to cause attention to be devoted to issues that are readily measurable but less important, and diverted away from issues that are important but difficult to measure. This is objection has substance and must be confronted.

4.034 In our view, it will be an important task for governments and their officials to retain a clear focus on issues of importance, notwithstanding that those issues may be difficult to analyse and measure. The approach must be to measure what *needs* to be measured. If that proves difficult, the response must be to address the difficulties rather than refocus on things that are easier to measure.

4.035 We concede that there will be real practical and technical problems in measuring outcomes and in understanding the causal relationships that affect them. However, we also see little alternative to undertaking this work. If it is not done, everyone will be tacitly accepting that policy development and implementation will continue to be hamstrung by the absence of essential information.

Experience in the United States of America

4.036 In 1993 the United States Legislature enacted the *Government Performance and Results Act*. This Act is the primary legislative framework through which federal agencies are required to set "strategic goals" (a term that is broadly equivalent to "outcomes" in the New Zealand context), measure performance, and report on the degree to which the strategic goals were met.

4.037 Each agency must develop strategic plans that:

- cover a period of at least 5 years and include the agency's mission statement;
- identify the agency's long-term strategic goals; and
- describe how the agency intends to achieve those goals.

4.038 In doing so, agencies are required to:

- identify critical external factors that have the potential to affect the achievement of strategic goals and objectives;
- include a description of any evaluations used to establish goals; and
- set out a schedule for periodic future evaluations.

4.039 In addition, the Act requires each agency to prepare an annual performance plan. These plans must provide the direct linkage between the strategic goals outlined in the agency's strategic plan and what managers and employees do day to day. In essence, the plans must contain the annual performance goals that the agency will use to measure its progress toward achievement of its strategic goals, and the associated measures that will be used to assess annual performance and progress.

4.040 Although this legislation was enacted in 1993, it provided for significant lead times to enable agencies to undertake the necessary work. In doing so, they encountered many of the difficulties discussed above. This was especially true when determining how to specify and measure their strategic goals[25] and how to cope with the problems that arise when those goals are only partially under the agency's or the government's control.

25 *Managing for Results: Measuring Program Results That Are Under Limited Federal Control*, General Accounting Office, December 1998.

4.041 However, the results achieved so far appear to be encouraging. For example, a study undertaken by the US General Accounting Office in 1997[26] found that:

- 88% of agencies rated themselves as "moderately successful" or better in identifying suitable measurable goals; and
- 62% rated themselves as "moderately successful" or better in developing suitable performance measures to assess their achievements in relation to those goals.

Summary of Conclusions

4.042 Outcomes are the impacts on the community of the outputs or activities of the Government. At present, outcome statements are commonly rather vague. The Public Finance Act 1989 does not require that outcomes be measurable, or actually measured. It also does not require that there be any indication of their strategic priority. It requires only limited information on the relationship between outputs and outcomes, and the strategic coherence of that relationship.

4.043 This has caused difficulties. To address some of these difficulties, successive Governments have developed ancillary statements such as "strategic result areas" or "strategic priorities and overarching goals". These ancillary statements were first developed as tools to be used within the Executive, at present are not regulated, and are also generally not measurable.

4.044 Parliament may wish to consider whether or not it is satisfied with the information it currently receives in relation to outcomes and, if not, how some of the difficulties might be addressed. There is a range of possibilities, which may include imposing statutory requirements for some or all of the following:

- provision by the Government in the Estimates of a complete set of coherent outcome statements which also identify the subset of such outcomes that are regarded as having particular strategic significance;

26 C.f. *Managing for Results: Analytical Challenges in Measuring Performance*, General Accounting Office, May 1997.

- outcome statements supported by further statements or specifications that indicate how achievement of the outcome – or progress towards it – will be determined or measured;
- brief but explicit statements of the nature of the causal links being asserted between each class of outputs and its associated outcome(s);
- similar statements of the links between transfer payments and outcomes;
- measurement and annual reporting of the extent to which the Government's outcomes have been achieved or advanced; and
- evaluation of the impact of key expenditure.

5.001 In this chapter, we draw attention to a range of issues relating to current expenditure and suggest some improvements. As we defined it previously, current expenditure can be classified into three general types – expenditure on outputs, expenditure on transfer payments, and expenditure on debt servicing and repayments.

5.002 Our observations here relate only to the first two types. We see scope for Parliament to get better information through improvements in the way classes of outputs and transfer payments are described.

What Are "Outputs" and Why Were They Introduced?

5.003 The Public Finance Act 1989 defines "outputs" as the goods or services that are produced by a department, Crown entity, Office of Parliament, or other person or body. By contrast, "inputs" are the ingredients (materials, labour, plant, land, etc) that are used to produce those goods and services.

5.004 An important objective of the Public Finance Act 1989 was to shift the focus of appropriation and expenditure reporting from inputs to outputs. We supported this initiative from the first, and experience has convinced us it has been a very positive development. We believe that it gives much greater clarity to the goods and services that the Government is pur chasing with the resources Parliament has approved – rather than (as was previously the case) the general nature and cost of agency inputs.

What Are Classes of Outputs and How Are They Used?

5.005 The Public Finance Act 1989 defines a "class of outputs" as "a grouping of similar outputs". The word "similar" is not otherwise defined and therefore assumes its ordinary meaning. Generally, it has been applied to outputs with similar attributes that are intended to achieve similar purposes.

5.006 Only outputs within the same Vote can be grouped into classes. In some Votes the expenditure on a class of outputs aggregates to a very large amount, but in others it remains very small. In the 1999-2000 *Estimates*, there are 332 departmental and 131 non-departmental output classes. The amounts appropriated in them range from relatively small sums to $1,500 million.

Are There Any Problems with This Usage?

5.007 Because the Public Finance Act 1989 provides for appropriations for classes of outputs, there is scope for the Executive to transfer resources between outputs within a particular class without other prior Parliamentary authority. In addition, section 5 of that Act provides that the Governor-General (by Order in Council) may authorise the transfer of resources from one output class to another in the same Vote – so long as the amount transferred does not increase the appropriation for a class of outputs by more than 5% in any year.

5.008 Consequently, when the appropriation for a class of outputs is very small, Parliament's control is exercised at a level of fine detail. However, when it is very large, that control is necessarily much less precise and, arguably, much less effective. For example, the 1999–2000 *Estimates* provide for four non-departmental output classes for personal health services. The appropriations for each output class average around $1,000 million, but Parliament is provided with very little information about what services will be provided. Further, a sum as large as $50 million could be transferred to that output class without reference to Parliament.

5.009 Given such examples, we believe that there may be a case for imposing a statutory limit on the amount that can be transferred between classes of outputs.

How Are Classes of Outputs Described?

5.010 Section 9(2A)(e) of the Public Finance Act 1989 requires that the *Estimates* include a description of each class of outputs to be purchased by the Crown. Such descriptions determine, in part, the extent of the activities that may be lawfully funded by the appropriations.

Are There Any Problems with These Descriptions?

5.011 A critical factor in the effectiveness of Parliament's scrutiny and control is that outputs must be specified with enough precision. If specification is vague, the Government is afforded a degree of flexibility that compromises Parliament's ability to control supply.

5.012 This issue has also been of concern to the Executive itself. In 1991, the Review of State Sector Reforms[27] concluded that the processes and principles for specifying outputs needed to be clarified, given that they are the basic building blocks of the Government's decision-making and accountability mechanisms. In 1992, an interdepartmental Working Party on Output Definition made a number of recommendations on output specification and related budget processes.

5.013 We are persuaded that many output descriptions can still be improved significantly and that improved descriptions will better meet Parliament's information needs. Since the Public Finance Act 1989 came into force, we have observed a number of examples where output specification seems to have been insufficient to give substance to Parliamentary scrutiny and control. For example, in a previous year Vote Social Welfare contained output classes relating to important social work services that in our view were poorly described and poorly measured.

27 *Review of State Sector Reforms*, Logan B (Convenor), State Services Commission, 1991 – known as the "Logan Report".

5.014 One aspect of output description that we believe has caused difficulty is the issue of controllability. Most outputs are wholly, or very largely, services. The Government's direct purpose in purchasing an output is to purchase an immediate benefit or effect that is wholly or very largely within the provider organisation's control.

5.015 Such outputs are often described in terms of the activities that the service providers will undertake. If descriptions of such activities are imperfect or incomplete (which they very often are), there is a risk that service providers can legitimately claim to have delivered the outputs purchased by the Government, even though the immediate benefit or effect for which the services were purchased have not been achieved. In our view, service outputs should not generally be described simply in terms of activities, but rather in terms that reflect the desired benefit of effect.

5.016 To take an illustrative hypothetical example, the services provided by officials in processing passport applications could be measured by the total number of person hours spent on that activity. A better measure would be the number of passports actually issued, since the issued passports represent the desired benefit being purchased.

5.017 To return to the example in paragraph 5.013, the 1997-98 estimates for Vote Social Welfare provided for a class of outputs entitled "Risk Identification and Management", by which the Children, Young Persons and Their Families Service supplied services that dealt with notifications of possible child abuse or neglect. The performance measures purported to address the dimensions of quantity, quality and cost. In particular, "quality" was measured by the time between notification and first contact, and the time between submission of court reports and court hearings – both actually measures of timeliness rather than quality. Output quality could instead have been measured in relation to the way in which investigations were conducted. In other words, the desired benefit being purchased would have been the completion of a competent professional investigation.[28]

28 The Service has since developed measures of professional quality assurance, although these are not yet fully reflected in the 1999–2000 performance measures. For more information, see "The Information Needs of the Children, Young Persons and Their Families Service", *Report of the Controller and Auditor-General, Second Report for 1998*, parliamentary paper B.29 [98b].

What Are Performance Measures and Performance Standards?

5.018 Performance measures provide information on how well organisations are doing in producing their outputs. In central government, performance measures usually address the dimensions of quantity, quality, timeliness, cost and (where relevant) location. Performance standards are statements of how well the organisation *should* be doing – for example, how much quantity, what level of quality – as disclosed by the performance measures.

5.019 The Public Finance Act 1989 envisages and makes possible a useful coherence in the information used in the specification of outcomes, outputs and performance measures. The intention is that the Government will choose and specify the outcomes it wants. It will then choose and specify the outputs it believes necessary to promote those outcomes. In doing so, it is implicitly applying policy models of the causal relationships between the outputs and their associated outcomes.

5.020 The attributes of the outputs that need to be specified are those which the policy model identifies as being desirable or essential (although usually not sufficient in themselves) to cause the outcomes to occur. Performance measures can be used to specify the required attributes, and to confirm that the outputs actually produced did have those attributes.

5.021 The Public Finance Act 1989 makes no specific requirement that descriptions of classes of outputs need to include measures and standards of performance. However, ever since that Act came into force, performance measures and standards have been included in the *Estimates*. It is unclear whether or not they have been intended to form part of such descriptions or have simply been provided gratuitously.

5.022 A 1994 amendment to the Public Finance Act 1989 [section 34A(3)(d)(i)] requires each department to include a statement of objectives in its forecast financial statements. This statement must specify, for each class of outputs, the performance to be achieved as agreed with the Minister responsible for each Vote administered by the department.

Another 1994 amendment [section 34A(5)(b)] requires that the information contained in the forecast financial statements must be consistent with the information contained in the *Estimates*.

Are There Any Problems with Performance Measurement?

5.023 Since 1989, many of the performance measures actually presented in the Estimates and in departmental forecast reports have been the subject of adverse comment – particularly, in terms of their ability to reflect performance fairly and comprehensively. We expected some deficiencies in the measures initially adopted by departments and have observed a modest evolution each year since then. However, in general, we do not regard the standard achieved so far as nearly good enough.[29]

5.024 This slow evolution may have arisen in part because of the absence of clear and definitive prescriptions of the standards required for non-financial measures. Such prescriptions do exist for financial measures. Both the Public Finance Act 1989 and the Fiscal Responsibility Act 1994 require that financial information must be presented in accordance with GAAP. However, there is as yet no GAAP standard relating to non-financial information.

5.025 This is not to say that the issue has not been addressed or that there is no guidance available. For example, in 1995 the Treasury published guidelines[30] that addressed output performance measures and gave a number of examples of measures considered suitable for use in particular situations. In addition, the Audit Office has promulgated, for the guidance of our auditors, a standard[31] that sets out what we regard as appropriate criteria for performance measures.

29 Issues relating to the reporting of service performance have also been addressed in "Reporting on Service Performance for Output Classes", *Report of the Controller and Auditor-General, First Report for 1997*, parliamentary paper B.29[97a].

30 *Purchase Agreement Guidelines with Best Practices for Output Performance Measures*, the Treasury, April 1995.

31 The Audit of Service Performance Reports (OAG-18), *Manual for Audit Service Providers*, Office of the Controller and Auditor-General, February 1996.

5.026 Apart from the indispensable characteristics of validity and reliability[32] that apply to all measures, our standard requires that performance measures be relevant, complete and under standable.

5.027 In our guidelines, performance measures for a class of outputs are:

- ***relevant*** in that:
  - they meet the information requirements of stakeholders, and
  - they reflect the objectives agreed between the entity and stakeholders,
- ***complete*** in that:
  - they cover all significant activities being undertaken by the entity, and
  - the important dimensions of those activities are portrayed; and
- ***understandable*** in that:
  - the presentation, content and format are clear, and
  - targets and achievements are supported by recognised standards or are traceable to agreements.

5.028 A key consideration in determining whether or not measures are relevant is that they address attributes of the output that the policy model identifies as being causally related to the desired outcome. In other words, the logic of the policy model may require that, if the desired outcome is to occur, the outputs that are intended to cause it must have certain attributes. Relevant measures will address those attributes.

5.029 We consider that all performance measures should meet these simple tests and see value in Parliament imposing a statutory requirement that they do.

32 A measure is *valid* when it actually measures what it purports to measure. It is *reliable* when repeated measurement by the same method produces the same result.

What Are Non-departmental Output Classes?

5.030 The Government may seek to obtain services from organisations or entities other than government departments. Some of these may be Crown entities (which the Government effectively controls), but others may be independent of government. Such appropriations are referred to in the Public Finance Act 1989 and in the *Estimates* as "non-departmental output classes".

Are There Any Problems with Non-departmental Output Classes?

5.031 Because more and more outputs are being obtained from providers other than government departments, we believe that it is important that the nature of the relationship between the Government and providers is clear.

5.032 As presently worded, the Public Finance Act 1989 requires that classes of non-departmental outputs be "purchased". The term "purchased" is not directly defined in the Act, although a recent amendment inserted the clarifying definition that:

> *Purchased, in relation to a class of outputs to be purchased by the Crown, includes purchased under an agreement that is not legally enforceable.*

This clarification, although welcome, does not, in our view, resolve all the issues.

5.033 A consequence is that all transactions for the provision of non-departmental output classes are purchases and must have the form of purchases. This is achieved by entering into contract-style purchase agreements between the Minister and providers. We question whether this is appropriate in all cases.[33]

33 See also "Appropriations for Non-departmental Output Classes" in the *Report of the Controller and Auditor-General, Third Report for 1997*, parliamentary paper B.29[97c] and *Inquiry into Certain Events Concerning the New Zealand Tourism Board*, Report of the Controller and Auditor-General, April 1999, page 83.

5.034 A number of Crown entities (such as the Police Complaints Authority and the Privacy Commissioner) are required by statute to undertake certain tasks and, in doing so, to act independently. The sums appropriated by Parliament and administered by government departments are simply intended to fund those entities to undertake those tasks. In our view it is quite wrong to categorise the economic relationship as that of purchaser and provider.

5.035 We believe the word "purchase" should be defined in the Public Finance Act 1989 to have an appropriate meaning. We also consider that the flow of funds from the Crown to some Crown entities should not be characterised as the purchase of non-departmental outputs. An alternative approach would be to treat them as requited transfer payments (see paragraphs 5.041–5.045).

What Are Purchase Agreements?

5.036 Purchase agreements are documents that have the form of a contract between Ministers and the suppliers of outputs. These agreements set out in detail exactly what is being purchased and the price that is being paid.

Why Are Detailed Purchase Agreements Important?

5.037 Imprecise output specification can compromise the Executive's ability to exercise control over its own agencies. In this respect, Ministers have a remedy available that is not available to Parliament, in that they can make output descriptions in purchase agreements more specific than in the Estimates. Because purchase agreements may contain more detailed output specifications, most select committees now request copies of them in the context of their examination of the *Estimates*.

5.038 Purchase agreements do not have the legal immutability of appropriations. Ministers and chief executives may alter the contents during the term of the agreement without other parliamentary authority, provided that the alterations do not conflict with appropriations or the descriptions of outputs in the *Estimates*.

5.039 In some cases there is clear merit in using purchase agreements to provide scope for flexibility, particularly when key information is not available when the *Estimates* are being prepared. However, it is essential that a proper balance be struck. Parliament's control can be maintained only if flexibility is not conferred when it is not needed.

5.040 We believe that Parliament is entitled to expect that the specification of outputs in purchase agreements will generally be congruent with the corresponding specification in the *Estimates*. If outputs are described very loosely in the *Estimates* but precisely in purchase agreements, the Executive will be arrogating to itself information and a basis of control that Parliament is being unnecessarily denied.

What Are Transfer Payments?

5.041 Transfer payments are payments of public money to individuals and groups to provide them with resources that they would not otherwise have. Besides purchasing outputs, the Executive also seeks to advance its objectives by means of transfer payments. These account for between one-quarter and one-third of total Government expenditure.

Are There Any Problems Relating to Transfer Payments and How Can They Be Addressed?

5.042 Parliament is supplied with relatively little information beforehand about the Executive's objectives in making transfer payments or after about the effect of those payments.

5.043 It is possible to regard transfer payments as falling into one of two categories:

- ***unrequited*** transfers (for example, many social security benefits) which do not require the recipient to do anything or supply anything to qualify for the payment; and

- ***requited transfers*** (such as grants to businesses or community groups), which commit the recipient to doing something in order to receive the grant.

5.044 The difference between a requited transfer and an output is that, in the latter case, the Government owns the goods or services supplied and, in the former case, it does not.

5.045 This categorisation has implications for the information that Parliament needs in order to appropriate public money for transfer payments. In the case of requited transfers, Parliament is entitled to some general indication of how the transfer will be requited and who will be the likely beneficiary. For both requited and unrequited transfers, we believe that Parliament should receive information about the outcomes to which the transfer payments are expected to contribute.

Summary of Conclusions

5.046 The Public Finance Act 1989 shifted the appropriation process from control of inputs to control of the outputs purchased by the Crown. It also provided that Parliament should receive information in the *Estimates* on the linkage between the outputs purchased by the Crown and the Government's desired outcomes.

5.047 We believe this was a very constructive change. However, we also believe there is scope for considerable improvement in the way in which outputs are described, and the quality of the performance measures used.

5.048 The Crown also purchases outputs from sources other than government departments, such as Crown entities. We consider that some of these transactions are not well-described as "purchases" of outputs, especially when the transactions relate to Crown entities that are charged by Parliament with exercising independent functions. Some of these transactions might be better described as "requited transfer payments".

5.049 Purchases by the Crown of departmental and non-departmental outputs are commonly described in purchase agreements between the Minister and the supplying agency. Purchase agreements typically describe the outputs purchased in greater detail than is provided in the *Estimates* or in departmental forecast reports. Purchase agreements are not regulated by the Public Finance Act 1989 and can be changed during the year at the discretion of the Minister.

5.050 We believe it is important, from Parliament's perspective, to avoid a situation where outputs are specified only in very general terms in the *Estimates* and departmental forecast reports but with precision in purchase agreements. The *Estimates* and departmental forecast reports should provide sufficient information to meet the requirements of parliamentary accountability; and the descriptions of outputs in purchase agreements should be well-aligned with the descriptions in the *Estimates* and in departmental forecast reports.

6.001 The term "capability" can be used to embrace a number of organisational characteristics. However, a critical aspect of an organisation's capability is its ability to produce the required outputs. "Capability expenditure", as we have defined it in paragraph 3.042, is the expenditure that the Government must incur to establish or extend an organisation's ability to produce outputs.

6.002 At present, Parliament receives very little information about the capability of Crown-owned organisations. There is no legislation which requires that such information be provided. However, Parliament has a direct interest in knowing whether or not those organisations can do the job expected of them.

6.003 In this chapter, we discuss Parliament's interest in capability, addressing issues such as:

- the way in which output prices can affect capability and the consequent implications for Parliament's approval of supply;
- who should be accountable for capability and how;
- the extent to which capability can and should be measured and reported; and
- the relationship between capability, performance and risk.

What Is the Relationship Between Capability and Supply?

6.004 The current regime of parliamentary appropriation reflects the long-held belief that it is desirable for Parliament to exercise ultimate control over the resources available to the Executive. Crown revenues are one resource – assets owned by the Crown are another.

6.005 However, the full tally of the resources available to the Executive is not reflected simply in Crown revenues and the monetary value of its physical assets. It also includes all the key capabilities of the agencies which the Crown owns, and over which the Executive can exercise effective control.

6.006 Capabilities can be built up or run down without such changes necessarily being evident in the organisation's financial statements. For example, departments may invest in human resource development without that investment being evident on a balance sheet. To the extent that the Executive is able to convert capability resources into current consumption without a transparent appropriation for the purpose, it may be escaping Parliament's control of supply.

6.007 In Chapter 3, we discussed briefly some of the differences between the ownership interests of the Executive and those of the private sector. In particular, the Executive's ownership interest often manifests a strong element of trusteeship. To the extent that undesirable changes in capability may have occurred, but remain unmeasured and undisclosed, Parliament cannot hold to account either the Executive's trusteeship or a chief executive's stewardship.

Who Should Be Accountable for Capability?

6.008 In general, it is fruitless to purport to hold individuals to account for events or outcomes over which they have little or no control. We will return to this observation in the last chapter – which deals with risk – but we note here that it also has implications in relation to capability. Indeed, the two are closely related. Generally, when capability is eroded, then risk increases.

6.009 As we have already mentioned in paragraph 3.010, the Public Finance Act 1989 and the *Estimates* make a distinction between Vote Ministers and Responsible Ministers. At first sight this suggests that a simple distinction can be made between Ministers who should apply for and be accountable for, respectively, "current" and "capability" expenditure. Such a distinction is at least implied in the present regime and might well be made more explicit in some future arrangements.

6.010 The Public Finance Act 1989 makes explicit provision for appropriations for capital contributions to departments and Crown entities (and also capital withdrawals, although these are seldom used), and the purchase of assets by the Crown. However, although such appropriations affect capability generally, they are made in the context of a Vote. They are sought by the Responsible Minister in a Vote for which the Responsible Minister is also the Vote Minister.

6.011 We believe that Parliament may also wish to give consideration to defining more precisely the role of a Responsible Minister in relation to capability – in terms that go beyond the narrow scope of financial management. Parliament may also wish to require a "before and after" account of how that responsibility will be, or has been, discharged.

What Does Parliament Need to Know About Chief Executives' Stewardship of Capability?

6.012 An important principle underpinning the Public Finance Act 1989 is that managers should be given the freedom to manage (subject, of course, to moderating considerations of due prudence). The application of this principle was not intended to provide public sector managers with unfettered license. Rather, it was to enable them to make economically rational decisions about the best use of resources, unconstrained by rigid, centrally imposed regulation.

6.013 We are convinced that this aspect of the 1989 reforms has almost always been beneficial and we would not wish to see the present freedom of managers unnecessarily constrained. However, we also believe that Parliament has a legitimate concern in ensuring that each government department has the capability it needs to produce the outputs required of it – or that it has made credible plans to acquire that capability and will be supplied with the necessary resources to do so.

6.014 Parliament has found it useful to supplement the financial information provided about current expenditure with non-financial information about departmental performance. It may also see value in supplementing the financial information provided about the stewardship of assets with non-financial information relating to other key aspects of capability. Such information could be provided in departmental forecast reports[34] and in annual reports.[35]

Can Capability Be "Measured"?

6.015 Organisational capability has been the subject of a good deal of theoretical and empirical research. There is little doubt that it is difficult to measure and report definitively. To be meaningful, capability must be considered in the context of the particular objectives that must be achieved – for the self-evident reason that the capability to achieve one objective does not automatically imply the capability to achieve another.

6.016 Further, it is important that all key aspects of capability be measured, because many or all of an organisation's systems can be seriously affected by the breakdown of just one aspect of its capability.[36]

6.017 Finally, it is important to understand that capability cannot be measured as a simple quantity, such as height or weight. Assurance about capability, if it can be given, would be assurance that the organisation is likely to be able to achieve particular specified objectives – given particular resources and operating in particular circumstances.

34 There seems to be no overwhelming reason why an obligation to provide this information should be confined to departments. It could also be required of other selected Crown entities and public organisations, especially those subject to financial review by select committees.

35 This potential improvement has already been identified by the Finance and Expenditure Committee, in the 1997 report on its *Inquiry into Departmental Reporting to Parliament* (parliamentary paper I.3c, page 8). The Committee recommended that *departmental chief executives be required to account for the stewardship of their departments in annual reports in order that select committees can evaluate the performance of departments from an ownership perspective.*

36 For example, a critical aspect of the organisational capability of a Crown research institute is the qualify of its personnel. If key personnel are lost, the organisation's capability may collapse, notwithstanding that all other aspects remain intact.

SIX

6.018 We have been giving careful consideration to ways in which organisational capability might be comprehensively described, and how assurance about capability might be provided. Although our work is not yet complete, we have identified at least four aspects of capability that we believe can and should be measured and reported. They are:

- balance sheet assets (already required);
- human resources;
- information and control systems; and
- output production methods.

6.019 We have some observations to make about each of these aspects.

Balance Sheet Assets

6.020 The valuation and disclosure of balance sheet assets (cash on hand, physical assets, etc) is regulated by GAAP which has been developed from, and is supported by, a considerable body of professional experience. Of the four categories in paragraph 6.018, balance sheet assets constitute the only aspect of capability for which there is an agreed method of measurement.[37]

6.021 Our principal concern with assets relates not to any particular difficulty with their measurement, but to the possibility that the appropriation process may impose undesirable constraints on the ability of chief executives to manage their departments. The quantum of a department's assets is fixed by the appropriation of its opening balance sheet and thereafter is adjusted by specific appropriations for capital contributions or withdrawals. Section 11 of the Public Finance Act 1989 enables a department to use the proceeds of the sale of assets to purchase other assets, but the department may not, without further appropriation, end a financial year with a greater holding of assets than it had when it began that year.

37 There are some technical problems and controversies even with this dimension of capability.

6.022 In determining how best to achieve operational efficiencies, a private sector manager generally will be free to employ the optimum mix of capital, labour and other production factors, and to adjust that mix as necessary. However, section 11 constrains the amount of capital that departmental chief executives can employ. We question whether this constraint has proved useful in practice.

6.023 It seems to us that the economic benefits that are thought to flow from constraints on the Crown's capital investment in departments could usefully be re-examined in the light of possible inefficiencies arising from sub-optimal mixes of capital and other factors of output production. One possibility to ease the present restrictions would be to permit fiscally neutral transfers of appropriations from classes of outputs to capital contributions (by Order in Council) along the lines of the transfers between classes of outputs permitted by section 5 of the Public Finance Act 1989.

Human Resources

6.024 The importance of human skills has long been acknowledged and a number of attempts have been made to develop a method for valuing an organisation's "human capital". These have not yet met with widespread acceptance. However, there is a range of widely used methods for analysing and sizing jobs, and for determining the skills needed for competent performance.

6.025 We do not believe that it is necessary or useful to reflect human resource capability in conventional financial statements.[38] However, we are convinced that key aspects of human resource capability are measurable and can usefully be reported in accountability documents. These could include, for example, staff numbers, staff qualifications, turnover rates in critical positions, lead times for acquiring operational experience.

38 This issue is contentious, especially in relation to trading operations. See, for example, Svieby, K. E., *The New Organisational Wealth: Managing and Measuring Knowledge-Based Assets*, Berrett-Koehler, 1997. It is very important for most government organisations because important sources of their value to society lie in organisational knowledge, the quality of personnel, and other intangible assets.

Information and Control Systems

6.026 Increasing attention is being given to assessing the capability of information systems. We have been concerned at the number of examples where expensive information system projects could not be completed – or, having been completed, failed to deliver the expected benefits. The depreciated cost of an information system will ordinarily be reflected in the balance sheet. However, its operational value is usually less easy to determine.

6.027 Nonetheless, methods exist for valuing information and information systems. We are convinced that key aspects of the capability of information systems are measurable and can usefully be reported in accountability documents. These could include, for example, assessments of the extent to which the information system addresses key information needs, the system's reliability, and the timeliness with which information is available to inform key management decisions. We also believe that Parliament would welcome some means of assessing whether or not the considerable capital sums appropriated for large information technology projects have been justified by their value to the purchasing organisation.

6.028 The same general observations can be made about control systems which, in many ways, are particular applications of information systems. Again, we believe that the capability of control systems can be measured and that assurance about the quality of an organisation's control systems could usefully be included in its annual report.

6.029 For example, over recent years we have been making assessments of financial and service performance information systems and controls. We have reported these assessments to Ministers, and to select committees in the context of financial reviews. We believe that Parliament has found this information useful. We see value in making the process more formal and improving the information provided to Parliament about these important aspects of capability.

Output Production Methods

6.030 If all other aspects of capability are fixed, a department or agency can achieve greater productivity only by improving the efficiency of the methods by which it produces its outputs. Since the Public Finance Act 1989 came into force, departments have been placed under pressure to improve the efficiency of their operations. Output price reviews are ongoing, but we believe much has already been achieved.

6.031 However, at present there is no agreed means by which departments can establish realistic limits on the efficiency of their present output production methods. In the absence of this information, they are likely to have difficulty in resisting demands to achieve additional efficiencies. When realistic limits have been reached, the probable result of demands for additional efficiencies is poorer quality outputs. Given the current weaknesses in output specification and performance measurement, the loss of quality may not be readily apparent unless damaging or disastrous events begin to occur. We will explore this issue further in the final chapter.

6.032 It seems to us, however, that there are two possible approaches that could provide some remedy:

- First, where a number of departments or agencies produce similar outputs, benchmark comparisons can be made.
- Secondly, departments can model and simulate key production processes to test their capacity and identify their limitations.

6.033 Where departments and agencies are required by the Government to achieve additional production efficiencies, Parliament may wish to satisfy itself that credible plans have been made to do so. Such plans could be sketched out in the departmental forecast reports or statements of intent, and the results actually achieved could be detailed in the annual reports.

Capability and Forecasting

6.034 An issue that concerns us is the absence of any clear relationship between changes in the forecast quantity of demand-driven outputs and changes in either output appropriation or a capital contribution to adjust capability.

6.035 The amounts sought in the *Estimates* are, of course, ultimately determined by the Executive. However, as we observe in paragraph 6.031, there are limits to the extent to which departments can reasonably be expected to absorb organisational changes or achieve additional efficiencies. If they are not supplied with the necessary resources, their ability to produce outputs sought is placed at risk. In general, it seems reasonable to expect that if a department is required to make substantial changes to the nature or quantity of its outputs, there will be consequential appropriations to adjust capability.

6.036 In making this observation, however, we are also concerned at the reliability of workload forecasting by some departments. On occasion, actual workloads have shown such forecasts to have been significantly inaccurate. Unless the Executive and Parliament can have reasonable confidence in the reliability of such forecasts, they will be unable to make informed decisions about adjustments to supply.

Summary of Conclusions

6.037 In our view, Parliament needs better information than it currently receives on the capability of Crown-owned organisations. The improvements needed relate to information on the existing capability of these organisations, and the funding of changes to capability. In addition, the accountabilities relating to organisational capabilities – both of the Responsible Minister and the chief executive – need to be clarified.

6.038 Work is currently being undertaken on how capability should be measured and reported. Although the work is not yet complete, we believe it is possible now to give Parliament some useful information on at least four dimensions of capability – balance sheet assets, human resources, output production methods, and information and control systems.

6.039 We also believe it is highly desirable that Parliament receives information that relates changes in workload demand to changes in capability. This has consequences for the accuracy of workload forecasting.

6.040 Capability is related to risk and the management of capability is related to the management of risk. We explore some issues concerning risk management in the final chapter.

7.001 In this chapter, we draw attention to some apparent inconsistencies in the way Parliament currently approaches the approval of supply. As we indicated in paragraph 3.006, Parliament can exercise effective control only if approvals that are intended to be given in advance are so given, and reviews of the use of those approvals are not postponed to a point where they become practically irrelevant.

7.002 However, the way in which Parliament currently provides imprest supply creates considerable latitude for the Executive, notwithstanding that appropriations otherwise appear to be tightly prescribed. For example, new expenditure decisions that are taken by the Executive immediately after the first Appropriation Act of the year has been passed may not be validated by an Appropriation Act for many months.

When and How Does Parliament Approve Supply?

7.003 Among Parliament's most fundamental powers is its imposition of statutory control over the revenue and expenditure of the Government. In the Westminster system, the principle of parliamentary control over supply dates back many hundreds of years. It first became enshrined in New Zealand legislation as a continuance of Article 4 of the Bill of Rights 1688 of the Parliament of England. Currently, it is asserted in New Zealand's statutes in the Constitution Act 1986 and restated in the Public Finance Act 1989. It remains a key constitutional function of Parliament to examine and, as it deems appropriate, approve the expenditure proposals of the Government.

7.004 Parliament's approvals are given by means of Appropriation Acts and Imprest Supply Acts. Appropriation Acts provide the Executive with authority to spend particular sums on particular things. Imprest Supply Acts provide the Executive with authority to incur expenditure up to a specified amount.

7.005 Usually, there are three Appropriation Acts for any financial year.

- The first provides authority for the expenditure specified in the main *Estimates*.
- The second provides authority for the expenditure specified in the *Supplementary Estimates*.
- The third –
  - sanctions any transfers of appropriations that may have been authorised by Order in Council pursuant to section 5 of the Public Finance Act 1989;
  - validates any unappropriated expenditure that may have been approved by the Minister of Finance pursuant to section 12 of the Public Finance Act 1989; and
  - validates any other unapproved unappropriated expenditure that may have been incurred.

  This third Appropriation Act is passed in the year that follows the financial year to which it relates.

7.006 Section 6 of the Public Finance Act 1989 currently requires (unless otherwise agreed by a resolution of the House) that the first Appropriation Bill relating to a financial year be introduced to the House before the end of the first month after the commencement of that financial year. In practice, this means that the first Appropriation Bill must be introduced before the end of July.[39] Standing Order 327(1) requires the debate on the question of the first Appropriation Bill to be completed within three months of introduction. In practice, this means that the first Appropriation Act will be passed by the end of October.

7.007 Because there is a time lag of up to four months before the passage of the first Appropriation Act, the Executive is provided with financial authority to continue spending and incurring expenditure by means of an Imprest Supply Act, which is passed before the start of the financial year to which it relates. Other Imprest Supply Acts are passed throughout the financial year, as considered necessary, to provide the

39 Some of the problems expressed here would be resolved if the first Appropriation Act could be passed before the commencement of the year to which it relates. However, that would be difficult to achieve for practical reasons.

Executive with the authority to spend money and incur expenditure in advance of an Appropriation Act, which is introduced with the *Supplementary Estimates*. Typically, the *Supplementary Estimates* are not introduced and passed until very close to the end of the financial year to which they relate.

Are There Any Problems with This Procedure?

7.008 The first two Appropriation Acts relate respectively to the main *Estimates* and the *Supplementary Estimates*, which provide a great deal of detailed information about how the money will be spent. However, the Imprest Supply Acts that precede them need not and do not provide any such information. They are the constitutional equivalent of a blank cheque with an upper limit.

7.009 This procedure has evolved to overcome practical difficulties that have existed in the past to ensure that the Executive has the funds to continue to operate. However, the sums currently provided through imprest supply are very large[40] and give the Executive considerable latitude to operate without other parliamentary authority.

7.010 Parliament may wish to consider whether or not the current arrangements for the approval of supply could usefully be refined. The present arrangements appear to confer a degree of pseudo-precision and control on what is, in practice, a relatively unfettered use of public money by the Executive.

Can the Procedure Be Improved?

7.011 It would be possible to distinguish between expenditure on activities that have already been approved by Parliament in a previous Appropriation Act and activities that are new initiatives.[41] Imprest supply could be applied to the first category without restriction, since it would merely reflect a continuation of a status quo that Parliament had already approved.

40 For example, the Imprest Supply (First for 1998/99) Act 1998 provided authority to incur expenses of up to $6,000 million.

41 Amongst Ministers and officials, such initiatives are commonly described as requiring "new money".

7.012 However, Parliament could require that it be informed of expenditure in the second category (for example, by presenting to the House statements of Cabinet approvals in much the same manner as regulations made under other Acts are presented). This would provide Parliament with an opportunity to debate and, if it judges it appropriate, to prohibit such expenditure at an early stage.

Summary of Conclusions

7.013 Under the Constitution Act 1986 and the Public Finance Act 1989, all the expenditure incurred by the Government must eventually be appropriated by an Act of Parliament. However, when expenditure needs to be incurred before an Appropriation Act can be passed, the Executive may use the general authority of an Imprest Supply Act. Appropriation Acts are specific about what the Executive may do with the money; Imprest Supply Acts are not.

7.014 The current arrangements and timetable for enacting Appropriation Acts mean that the Government frequently uses large amounts on imprest supply for quite long periods. We believe Parliament would benefit from more, and more timely, information about how the Executive proposes to use imprest supply, particularly in cases where the Executive is incurring expenditure in a way that has not previously been debated and approved by Parliament.

8.001 It is impossible for the Executive and its agencies to function without incurring some risks. Whenever there are risks, unfortunate events can occur. After such events, it often falls to Parliament to try to determine whether or not some Minister or officials should be held accountable and, if so, who and for what.

8.002 We believe Parliament needs more information about risk than it is currently receiving. In this chapter we set out what we see as the fundamental issues. We also make some suggestions which, if adopted, may assist Parliament to form a clearer view when unfortunate events do occur.

What Information Does Parliament Need About Risk?

8.003 In recent times, both private and public sector managers have paid considerable attention to the identification and management of risk. Departmental chief executives are now expected to implement well-founded plans for risk management.[42] Such plans relate to conventional "business risks" (that is, failing to produce the required outputs or incurring avoidable injuries, inefficiencies or losses in doing so). We endorse and support this development, but believe that it is also necessary for departments to assess and seek to mitigate the risk of not achieving the Government's desired outcomes.

8.004 There are, as well, other and more direct risks. The tragic events surrounding the collapse of the Department of Conservation's viewing platform at Cave Creek threw into sharp relief many of the complexities inherent in the relationship between Parliament and Ministers and between Ministers and their chief executives. The key problem can perhaps be summed up in a simple question: "How can a fair regime of Parliamentary accountability be applied in circumstances where resources are scarce and both Ministers and public servants must necessarily incur some risks?"

42 The State Services Commission has produced a set of expectations relating to risk management based on the standard AS/NZS 4360: 1995. See *Responsibility and Accountability Standards Expected of Public Service Chief Executives*, State Services Commission, June 1997.

8.005 The size of the risk associated with some adverse event is affected by both the probability of that event occurring and the size of the loss (often estimated in monetary terms) that will result if the event occurs. Risk is managed by taking steps to reduce the probability of the event, the size of the consequential loss, or both. Risk management itself consumes scarce resources and ceases to be cost-beneficial if the cost of the resources applied to mitigate the risk (including their economic opportunity cost) exceeds the estimated reduction in the size of the risk.

8.006 We believe that it is worth making the following observations:

- In reality, estimates of the probability of an adverse event are almost always uncertain and estimates of the size of the consequential loss may also be uncertain. Hence, no method of estimating risk can produce a precisely accurate result. Any estimate, however good the data and however skilled the person who makes it, will be somewhat uncertain and therefore open to challenge (especially with the benefit of hindsight). Decisions on what resources to devote to mitigating the risk are also uncertain and open to challenge.

- The occurrence of an unfortunate event does not, by itself, imply that a risk assessment was deficient or that actions taken (or not taken) to mitigate the risk were inappropriate or negligent. Even if the probability of an adverse event is very small, it *might* still occur.

- Risk is closely inter-related with organisational capability, especially information and control systems. Organisations become more risk prone when their capability is depleted. Unless they have some reserve capacity, they may be unable to cope effectively with even modest amounts of operational stress. Good information systems reduce uncertainty, enabling better assessments to be made of possible loss. When such losses compound over time, good information systems facilitate early detection. Similarly, effective control systems help to avoid problems and mitigate their consequences.

What Is the Relationship Between Risk and Accountability?

8.007 We have stated earlier, and restate here, that it is fruitless to purport to hold individuals to account for events or outcomes over which they have little or no control. One curiosity of both the State Sector Act 1988 and the Public Finance Act 1989 is that accountability relationships are not defined (and, indeed, the term "accountability" is nowhere used).

8.008 Given that the current regime of public management is founded on accountability relationships, this omission is singular and probably unhelpful. Parliament may wish to consider whether or not it would be useful to clarify the nature and scope of key accountability relationships – for example, by amendments to the existing legislation.

8.009 It follows from our observations in paragraph 8.006 that we believe the key consideration for accountability in relation to risk management is not that some unfortunate event has occurred. Rather, it is whether or not someone who had the capacity to mitigate that risk in a prudent and cost-beneficial way was negligent in not doing so.

8.010 For chief executives, we believe the diligent management of risk requires that:

- a comprehensive and professional assessment of all the organisation's risks is undertaken;
- where resources permit, a suitable regime for the cost-beneficial management of those risks is devised, implemented, operated diligently and monitored continuously; and
- where resources do not permit, the chief executive has informed the Minister in a timely manner of the nature and extent of the risks identified, and the resources that the chief executive believes would be needed to manage those risks in a cost-beneficial way.

8.011 If a chief executive's actions conform to these three requirements, we believe that it is reasonable to conclude that he or she has discharged any reasonable duty of care and has a sufficient defence against any allegation of negligence on that account. However, where chief executives or their staff take decisions to incur risks outside the regime described above, the chief executive and/or staff member is likely to become primarily accountable for the consequences.

8.012 The accountability of Ministers is complicated by a range of considerations, including the convention of collective ministerial responsibility and the unavoidable obligation of governments to allocate scarce resources between competing priorities. For example, a government decision to apply resources to mitigate one area of risk may mean that another cannot be addressed. We believe that it must be left to Parliament to determine (on a case-by-case basis) whether, and to what extent, a Minister should be held to account.

8.013 We also believe that it is reasonable for Parliament to be informed regularly about risk assessments and risk management activity. This information could be provided in departmental forecast reports and in annual reports. In the event that a department or agency reported that a desirable risk management regime could not be put in place for lack of resources, that circumstance would be subject to parliamentary scrutiny. Under current Standing Orders, it would be open to any member of Parliament to seek to amend the *Estimates* in order to provide the resources.

Summary of Conclusions

8.014 At present, Parliament generally does not receive any information about what risks have been identified by Crown-owned organisations and how those risks are being managed. In our view the accountability dialogue between Parliament and the Executive should take account of risk and risk management.

8.015 We believe that accountability relationships and expectations need to be clarified. Chief excutives should undertake a robust and professional risk assessment and inform Ministers about the risks that have been identified, what should be done to mitigate them, and what the implications are for resources and capability. Ministers should convey that information to Parliament, so that Parliament has an opportunity to intervene if it considers that the level of risk being incurred is unacceptable.

B.29[99c]

Glossary

Accountability is the process by which an individual or organisation reports on what actions it has taken, and accepts responsibility for those actions and their foreseeable consequences.

Appropriations are statutory approvals given by Parliament to the Crown to incur expenditure up to specific amounts for specific defined purposes.

Departmental Forecast Reports are documents prepared by government departments at the start of each financial year that set out a department's forecasts of its financial statements and expected performance for that year and the succeeding two years.

The Executive consists of the Executive Council, Ministers of the Crown, Parliamentary Under-Secretaries, and government departments.

Governance refers to the processes by which an organisation is directed, controlled and held to account.

Imprest Supply is a general statutory approval given by Parliament to the Crown to incur expenditure on any lawful purpose up to a specified total in advance of an appropriation for that expenditure.

Outcomes are the impacts on, or the consequences for, the community of the outputs or activities of the Government.

Outcome statements are the Government's expression of desired impacts on, or the consequences for, the community of the Government's outputs or activities.

Outputs are the goods or services that are produced by a government department, Crown entity, Office of Parliament, or other person or body.

Statements of Intent are documents prepared by certain Crown entities at the start of each year that set out the entity's general intentions and expected financial performance for that year.

Supply is the money voted by Parliament for use by the Crown.

Vote means a grouping of one or more appropriations which are the responsibility of one Minister of the Crown and which are administered by one government department.