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:

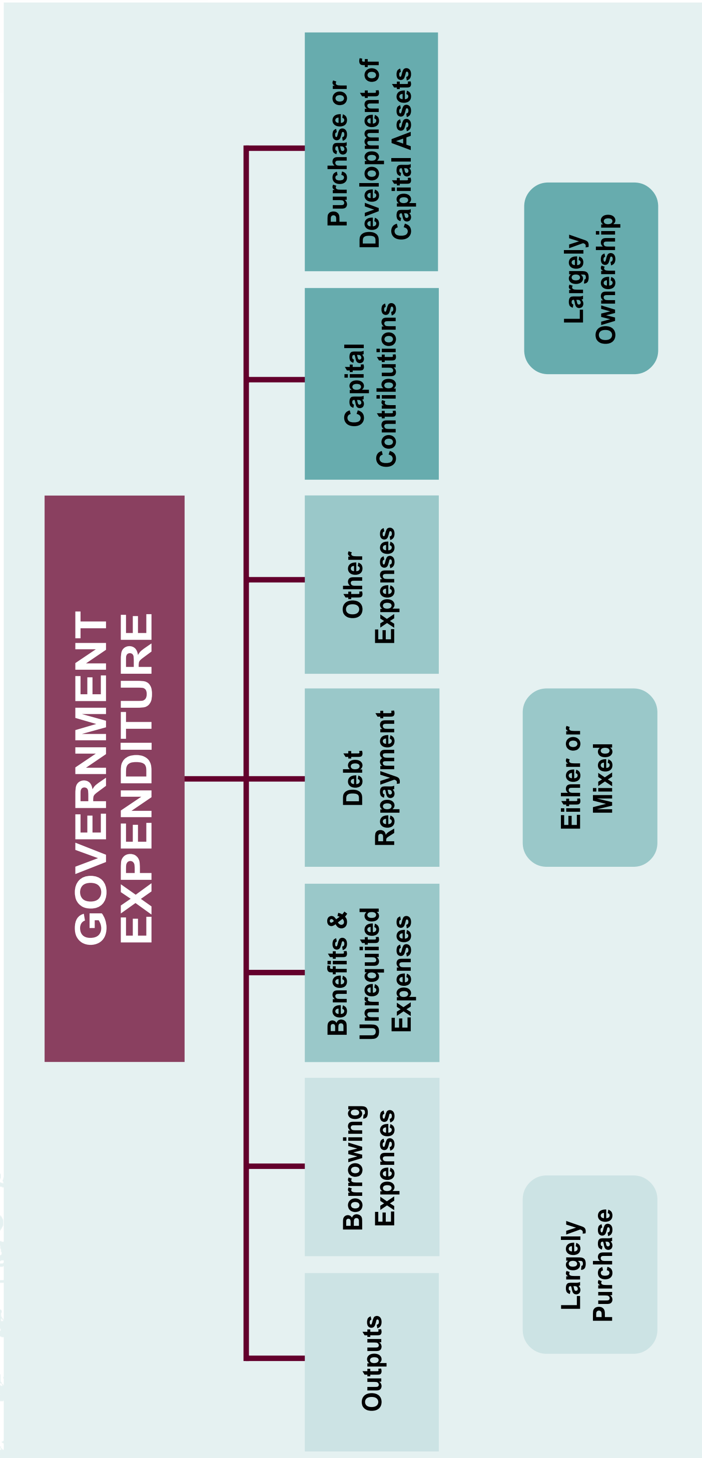
- a ***purchase*** interest, which is concerned with obtaining desired outputs at the best possible price; and
- an ***ownership*** interest, which is concerned with the efficient use of assets and with maintaining its agencies'capabilities in line with Government objectives.

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;

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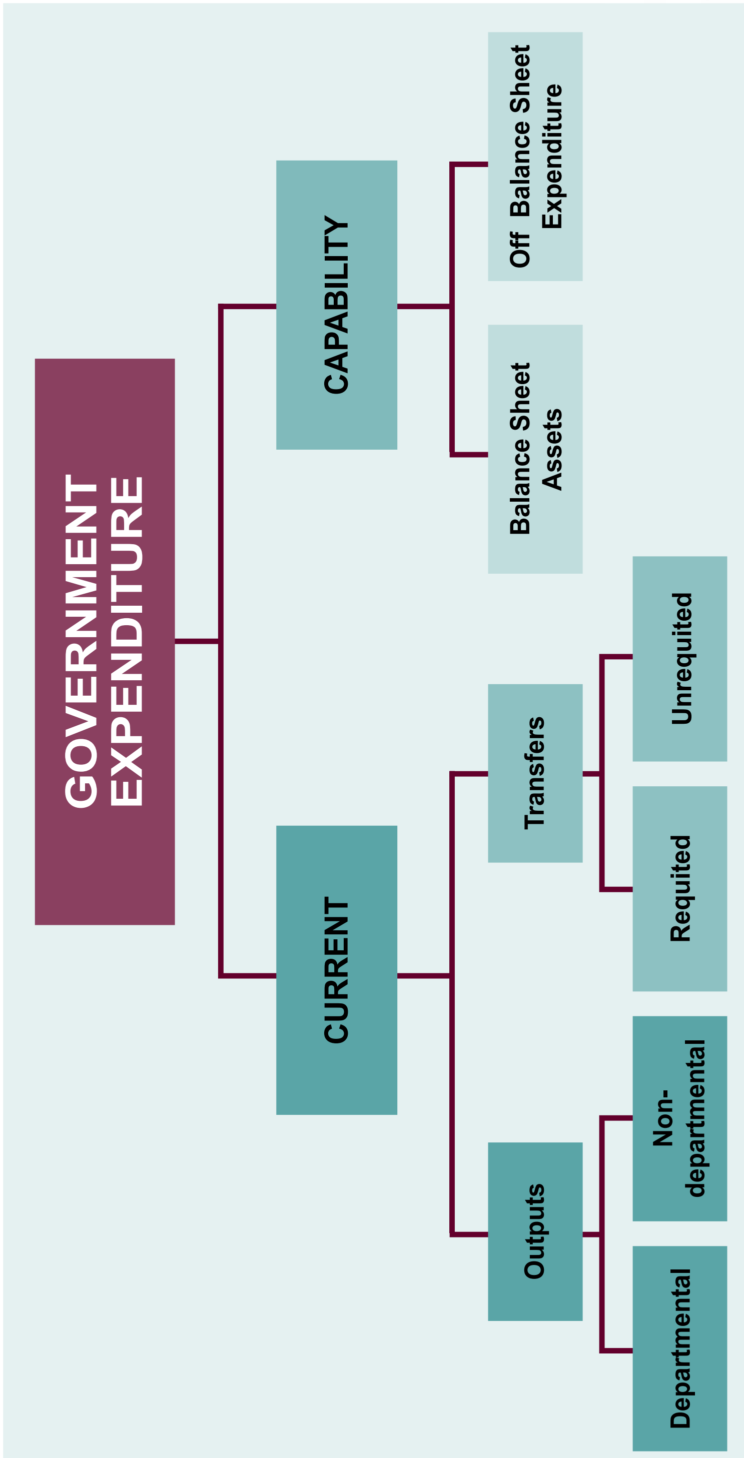
*Figure 3.2*
*Categorisation of Current and Capability Expenditure*




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.