Introduction

Thank you for the opportunity today to discuss Treasury’s thinking on how the public sector affects economic growth and how to lift public sector performance. These testing economic times mean that now, more than ever, public sector performance matters.

I should note up front that there are many ways of approaching the performance of the state sector other than its impact on growth. The state sector provides services to NZers that enhance living standards, that build our resilience as a nation and generally improve the lot of citizens.

And by most objective measures we do a pretty good job. The Kiwis Count quality score for public services was 68 in 2007 and 69 in 2009. These are good scores on a par with Canada. We can also look at indicators such as the World Bank Rule of Law Scores or Control of Corruption to get the sense we rate pretty well.
We should aspire to having the best performing state sector in the world. What does that mean? To provide the right services, in the right way, at the least cost.

No one here would expect Treasury to do anything other than take a reasonably hard line on government spending. Let’s be frank, that is part of our core business! The good news is there is method behind the mantra.

I am going to talk for 30 minutes or so – and look forward to following that with a good discussion. We hope this is a two way dialogue – it is from the sharing of ideas that we move our thinking forward on such challenging issues.
There has been a lot of discussion of the need for government to play its role in lifting national savings to reduce New Zealand's vulnerabilities. In a speech last November, John Whitehead, the Secretary to the Treasury, highlighted that New Zealand's net foreign debt position is one of the largest in the developed world, at nearly 90% of GDP. His call for Government to play its part in saving was reinforced by the final report of the Savings Working Group this January. The Prime Minister has also emphasised the importance his Government places on getting the government's finances in order.

To do that, we need to maximise the impact of every tax dollar we spend. The fiscal and economic impact of the Christchurch earthquake reinforces this challenge.

It will not surprise any of you to hear that Treasury thinks that the quantum of government expenditure matters for economic growth. As government takes up a bigger share of the economy, it 'crowds out' investment and export growth through higher interest and exchange rates. The growth in government size in New Zealand has been mirrored by an appreciation of our exchange rate and weaker performance in our export sectors. Managing growth in government expenditure will be a key dimension in enabling the rebalancing of growth towards investment and exports.

A Treasury Paper we have published today reminds us that there is another reason why the government needs to constrain its spending growth – the costs of raising tax to finance spending. But perhaps even more important than how much of taxpayers' money we spend is what we spend it on and how well we spend it.

Today, I’m going to talk about the key findings in this Paper, how it informs our thinking and how it fits with the initiatives that Treasury and other central agencies are pursuing to lift state sector performance.
Size does matter...

The paper highlights that taxes can discourage households from saving, working or investing in human capital. Taxes can also reduce the incentives on firms to produce, create jobs, invest and innovate.

...but don’t balance the books by taxing more

![Graph showing relationship between economic growth and productive expenditure as a percentage of GDP.](https://example.com/graph.png)

Obviously governments raise taxes in order to do useful things. But the economic cost of taxes means that the level of government spending matters for economic growth at a micro level as well as for fiscal policy. We need to balance these costs against the benefits of spending, much of which contributes to growth or advances social and distributional objectives.

This chart attempts to capture this relationship, albeit in a stylised way. Productive spending is good for growth but the benefit of that spending tends to decline as we spend more, while the marginal cost of taxation increases.

At some point the benefit of additional spending – even in growth-enhancing areas – will outweigh its costs. This implies an inverted U relationship between government spending and growth - if government becomes too big it can undermine our growth prospects – Similarly if it is too small.

New Zealand’s government doesn’t seem that big by OECD standards. Our total government spending is just below the OECD average. But we have been getting bigger.
What is clear is that since about 2004 total government spending in New Zealand has been growing faster than economic growth and faster than many of our OECD counterparts, as measured by the OECD general government series.

It is central government spending that has been driving these trends, and we can see some of the drivers if we switch to looking at the Treasury’s measure of core Crown expenditure.
Many of us will remember the hard policy choices made to reduce government spending from a peak of over 40% of GDP in the early 1990s. The lower costs of servicing government debt flowing from these spending reductions meant that spending continued to fall to 29% of GDP in 2004, despite health and education spending consuming an increasing share of the economy. But growth in social spending then overtook these positive debt dynamics and core Crown spending increased again. It is expected to peak around 35% of GDP in 2010/11. This is an increase of around six percentage points over seven years. While the economic downturn played a part, our estimates are that most of this increase is not cyclical.

I alluded earlier to the economic imperative of balancing the government’s books to reduce New Zealand’s vulnerabilities. Combined with the need to put New Zealand back on a more balanced and sustainable growth path, there seems to be a case for a smaller government relative to the size of the economy.

...but not only size matters

There is, however, no magic number as to what the size of government should be. This is because size isn’t the only thing that matters. Indeed empirical studies have failed to find a robust relationship between the overall level of spending or revenue and economic growth. Instead the impact of the size of government on growth is highly dependent on the mix of expenditure or revenue. And about how well that money is spent.

Looking at New Zealand’s mix, there seems some scope to reduce expenditures that do not measurably contribute to raising economic growth and to continue to improve the efficiency of the tax system.
Starting with tax composition, the evidence tells us that the type of taxes matter as much as their level. Taxes on property and consumption taxes, such as GST, tend to be less damaging than personal and corporate income taxes.

This rationale underpinned the tax reforms in Budget 2010, which focused on rebalancing our taxes towards GST to enable lower income and corporate taxes.

But we may not yet have this balance right. Although the company tax rate was reduced to 28% in the Budget, it is by no means low by international standards. The UK is lowering its company tax rate from 28% to 23% by 2014.

When it comes to spending, it is not just the level that matters for economic growth but also what you spend it on.
Unfortunately, there is not yet consensus around what spending enables economic growth. Some studies find that only education, research and development, and public infrastructure spending are growth enhancing. Other studies also include spending on health, public order and safety, and environmental protection.

The mix of New Zealand government spending is broadly in line with the OECD average. We appear to be slightly more growth-focused – we are a relatively big spender in education but we spend less on social protection.

Despite this, New Zealand still has a significant chunk of spending in areas that are unlikely to be growth-enhancing, like on social protection or on culture and recreation.

The growth benefits from reducing this spending need to be balanced against the other objectives of this spending. But it does highlight that all expenditure needs to meet a high burden of proof that it really does boost living standards.

We need to ensure all spending – even in growth-enhancing areas – is effective in advancing the government’s objectives and that those objectives are met as efficiently as possible.
There may be some scope to enhance the effectiveness of spending by better targeting to those who need it most. Better-targeted spending may be able to achieve the Government’s social and distributional objectives at a lower cost.

Treasury analysis suggests that lower income households have benefited from increased social spending in recent years. But middle-income households have also seen substantial gains, particularly over the past decade.

As an aside, we also need to recognise that spending is only one dimension of government size. When constrained, there may be a temptation to use regulation as an alternative to government spending, as the ongoing costs don’t directly fall on government. But when facing this temptation we should remember that compliance costs can hinder innovation and suffocate growth.

While New Zealand typically rates well on international surveys of regulation, other countries have been doing more to catch up. For example, between 1998 and 2008 we slipped from 4th to 14th in OECD rankings for product market regulation.
Both theory and evidence suggest that the public sector may be less productive than the private sector due to the inherent nature of public services and due to stronger private sector incentives to make productivity gains.

There are also challenges in measuring state sector productivity in the national accounts. No single indicator gives us a good measure of the efficiency of the state sector. While the World Bank Government effectiveness indicator places us 5th out of the 32 OECD countries for which there is data, the World Economic Forum’s Survey of the wastefulness of government spending ranks us 22nd.

We recognise there are problems in these international rankings, which are often largely perception based, but they do suggest that there is scope for improvement.

The challenge for the state sector

We know that we need to balance the government’s books and that the government has a role to play in lifting national savings.

We know that both the level and type of taxes can undermine economic growth. The Government’s fiscal strategy aims to control spending growth rather than increase taxes, in order to get back to surplus.

But we also know that what we spend on, and how well we spend it, is important.

An effective and efficient state sector not only reduces the need to tax, but is critical to maximising the effect of spending on the Government’s priorities, including economic growth.
This means we need to make hard spending choices. All state sector interventions need to demonstrate that their contribution to the government’s priorities outweigh the cost of funding them.

It also means we have to focus on efficiency. Not only do we need to do the right things, we need to do them in the right way and at the least cost. This is likely to involve being open to new models of service delivery, including using the private and NGO sector - where it makes sense to do so.

We are starting from a strong base. The New Zealand state sector has an international reputation for integrity and independence. New Zealand public servants are professional and committed to doing a good job - as seen in the immediate and on-going response to the Christchurch earthquake.

There is a risk that our state sector has become accustomed over recent years to an environment of surpluses. We’ve seen real per capita spending double since 1998. But we’re now in an environment that combines shrinking budgets with rising expectations. The Minister of Finance laid down this challenge to the public sector in his speech to IPANZ on Tuesday. He emphasised that the public sector will be under constant pressure to deliver better services for little or no extra money.

He also noted CEs are stepping up, taking a lot of initiative themselves – and generally projecting themselves as ready to lead this necessary change.

One of the keys to meeting this challenge is getting better information and then using that information to make better decisions and hold people accountable. It’s the old adage that all accountants know “you can’t manage what you can’t measure”.

Using good performance information is a common theme underpinning many of the initiatives under way to raise state sector performance.
Key focus areas

Ensure:

- State Sector Interventions are effective and efficient
- We get the most from our assets
- State Sector institutions are of a high quality and support good stewardship

This theme of performance information cuts across the three dimensions that we see as key to state sector performance. These dimensions are firstly, ensuring that what the state sector does is effective and efficient; secondly, ensuring that we get the most out of our assets; and, last but not least, ensuring that state institutions are of a high quality and support good stewardship.

Better and less costly government interventions (effectiveness and efficiency)

Improving the effectiveness and efficiency of government interventions is about both prioritising spending to its highest value use and also sharpening incentives to use existing resources well. It is all about focussing on outcomes – and driving from those high level objectives right back into our organisations. This is the critical leadership challenge.

The key to improving effectiveness lies in championing a longer-term perspective and focusing on those interventions that really make a difference to New Zealanders' lives.

As part of this longer-term perspective, state sector agencies were required to prepare four year Budget plans in the 2011 Budget process. These plans encourage agencies to take a medium-term perspective in planning how they will manage cost pressures over the next four years and deliver Government priorities.

For example, the Defence White Paper and Value for Money review underpins a focus on moving resources to the front line and into the capabilities that we will need in the future.
The recommendations recently released by the Welfare Working Group highlight some ways in which welfare spending could promote better outcomes for people at risk of long-term benefit dependency, and also promote economic growth.

Enhancing the incentives and support for moving back into work will reduce the risk of poverty, improve outcomes for children and support social and economic well-being. While some of the Welfare Working Group’s recommendations have up-front costs, they could reduce medium-term cost pressures if reforms get people back into work.

So policy matters, but even when we are doing the right things, we need to do them as efficiently as possible. The Welfare Working Group also thought about ways to improve the efficiency of welfare spending. It made recommendations about contracting for outcomes or holding delivery agencies more directly accountable for reductions in long-term welfare dependency. This may help to reduce costs, as well as improving employment outcomes.

The Better Administrative and Support Services or BASS Programme is another example of using performance information to achieve efficiency gains.

Until recently, we had very little information on the cost and quality of administrative and support services across the state sector. Under the BASS Programme, agencies are working together to benchmark the cost, efficiency, and effectiveness of their administrative and support services.
By digging into the reasons why some agencies are more efficient or effective than others, the BASS Programme is sharing good practice and establishing realistic measures that all agencies can aim to achieve. The programme will soon release a report with a lot more detailed information about back-office processes.

As with spending, regulation also needs to meet a high burden of proof.

In its Statement on Regulation in 2009, the Government committed to ensuring that new regulation is required, reasonable and robust and that existing regulation is reviewed regularly to ensure that it is fit for purpose. The Government has improved its regulatory management system by strengthening regulatory impact analysis requirements, a programme of major regulatory reviews, and an agency-by-agency scan of the stock of existing regulation.
Better use of our physical assets

The same principles that apply to spending and regulation also apply to managing state assets.

We need to prioritise resources to their highest-value use through more active management of our balance sheet, and we need to sharpen incentives to use existing assets well.

The New Zealand state sector manages over $220 billion worth of assets – around half of which are physical assets. This is forecast to grow by more than $30 billion over the next 5 years. Effective balance sheet management is increasingly critical to the delivery of better services within current resources.

We have a long way to go to get the right level of visibility over asset management – but we’re working on building a better understanding of the relationship between services and the Crown-owned assets used to deliver them. This understanding includes the mix of physical assets and capabilities that we need in order to deliver services, and what choices we have to access those capabilities.

We are reforming capital asset management to ensure that Crown assets are used more productively and efficiently. We are fortunate in being able to access good business case and project assurance practices from overseas jurisdictions like the UK and to leverage off good asset management practices in New Zealand local government.

We’ve made good progress in setting new rules and good-practice guidance for sound asset management. All capital-intensive agencies are now submitting annual capital intentions reports, which are considered at cabinet committee level.
Another significant reform is the publication of the first ever Investment Statement of the Government of New Zealand last December. By providing more information on the management of the Government’s assets and liabilities, as well as its investment priorities, the Investment Statement helps us to make better-informed choices about the use of government assets.

The first Investment Statement highlighted a number of priorities. A particular area of concern is the government’s social assets, where we need to improve utilisation of existing assets and explore alternative options for service delivery.

The problems with social assets - such as hospitals or schools - bring us back to our adage that “you can’t manage what you can’t measure”. Despite accounting for around half of the Government’s assets, we lack information about how efficiently our social assets are being used. Fixing this is a priority for us.

The Government is already trying to get better value by using alternative forms of procurement, such as Public Private Partnerships or PPPs. A corrections sector PPP is currently in the market and an education PPP is at detailed business case stage. PPPs are just one way of bringing greater commercial discipline to the use of public resources; other ways include increasing the contestability of supply in order to raise competitive pressure and external benchmarking.
Better run government (high quality state institutions)

Last but not least, the third dimension of state sector performance is about ensuring that state institutions are high quality and support good stewardship.

As highlighted by the Minister of Finance on Tuesday, the Government is focused on streamlining the government system. This chart here underscores just how comprehensively our small country has divvied up our state sector into a clutter of agencies.

There is opportunity now to achieve a better focus on what matters to New Zealanders, an enhancement of services to the public, and less complexity and duplication. This direction is likely to lead to fewer government agencies over time, to stronger governance across agencies where it is needed and for agencies to be more frequently based around common services and processes. There is an appetite to make the system work better – taking this forward will be one of the most interesting public management challenges of the next few years.

But better institutions are not just about the number or structure of agencies, it is also about their internal capability. The purpose of the Performance Improvement Framework, or PIF, is to help senior leaders improve system-wide performance through a comprehensive assessment of the capability and results of their agencies.
The agency develops and implements an action plan to address the priority issues identified by the PIF review. Treasury has just been PIFFed. I can report it is a tough but rewarding process.

Nine PIFs have been completed and four have already been published. An emerging theme is that the New Zealand state sector does a pretty good job of responding to Government priorities. But there is real scope for improvement in leadership, strategic capability and delivery.

These are not easy challenges and are grappled with by state sector agencies across the world. A key part of the way forward lies in strengthening the policy capabilities of agencies. The Review of Spending on Policy Advice will help government to ensure high professional standards and better quality policy advice.

Policy development also needs to become more open – the traditional model of a small group of public servants working behind closed doors excludes much of the expertise and experience that exists outside government.

We are more actively increasing the transparency of what goes on in government and promoting public debate. Both the PIF and BASS results will be published in all their gory detail.

The experience of the Tax Working Group is one example of the benefits that a different policy development approach can bring. A more open policy approach not only holds potential for more robust analysis, it can also help to build greater understanding of difficult policy choices, supporting more sustainable reforms. Given the economic and longer-term demographic challenges we face, New Zealand needs the public to get involved in policy development.
Conclusion

Conclusions

- State sector performance matters for economic growth:
  - right things / in the right way / at the least cost
  - size and composition matter
- More to do to:
  - bring a longer-term and outcome focus
  - enable more contestability
  - ensure interventions are delivering on priorities
  - better run government

We’ve made a start and we are heading in the right direction. But we can’t afford to rest on our laurels. There is a growing evidence base around state sector performance and there is much work to do to use this new information to lift our game. We need to be better at advising the Government on whether interventions are really delivering on their priorities. We need to go further in bringing a longer-term and greater-outcome focus to our performance information and making better use of Crown assets in delivering services. There is also more to do in enabling greater contestability both in policy advice and service delivery.

The state sector must focus on doing things that will most help New Zealanders and the economy and do them in the most efficient way. We must do this to limit the drag of taxes on the economy, as well as to play our part in lifting national savings and productivity growth.

Getting our country on a stronger growth path is critical to the future well-being of New Zealanders. And the state sector has a key role to play in reaching that aspiration.

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