Control Of Complex Structures

Notes Of A Presentation To The Master Of Public Management Programme

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The brief given me for this seminar was to draw on my experience working across a range of organisations in central government, local government, the "third sector" and the private sector based on the topic as "about the options for governments and how they organise the delivery of their outputs and the various governance and control issues involved".

I want to start with a comment on complexity. From my perspective, the complexity is not so much a function of the structures which we have developed as it is of the different demands which governments themselves face. In many respects, New Zealand's public sector reforms have sought to imitate the practices found in private markets. But the purpose of government is different from the purpose served by markets. The business of government includes managing differences which may themselves be inherently irreconcilable. This is a marked contrast with the role of markets which is inherently one of finding the level at which the market clears which, by inference, means the level at which the interests of all participants have been effectively reconciled.

Generally, also, we accept that a well functioning market will not only reconcile the interests of buyers and sellers but will also reconcile the interests of owners and management. Effectively, over time, those firms which survive will be firms which are able to produce and market their output at prices which provide an appropriate return on capital and can continue doing so as sufficient purchasers are sufficiently satisfied with what they get that the firm is able to maintain an appropriate level of sales.

Obviously, the demands which various purchasers bring to the market are themselves highly complex and variable; no one would suggest that we could centrally plan the mix and quality of goods which would satisfy, optimally, the needs of consumers given their purchasing power. The beauty of the market is that we do not need to do so. Governments have no such luxury. Their role, using imperfect information, is to strike a balance between competing demands in an environment in which it is the political decision rather than the market transaction which decides the mix of goods and services which should be available, the purposes to which they should be applied, and the persons who should be entitled to receive them[1].

My approach to the management of this complexity is that we forget its inherently political nature at our peril. In the rest of this seminar I want to provide an overview of my understanding of the key issues in management of complexity within central government and the different types of structural arrangements it has sought to employ. My starting point is to remember the background to New

Zealand's public sector reforms. The New Zealand public sector of the 1970s and early 1980s was almost completely lacking in the quality information needed for managers, ministers or the public to understand the resource implications of government decisions. Our then structures were characterised by a lack of transparency, conflict of interest and a lack of accountability. At a more subjective level I would also argue that the experience of the latter years of the Muldoon administration could be seen as the equivalent for officials with any interest in government intervention as a prolonged course of aversion therapy.

Against this background it is hardly surprising that we took an approach which concentrated on trying to create, as far as possible, a transparent system combined with a set of clear responsibilities which, taken together, would promote effective accountability

From my perspective the core of reforms was the set of measures put in place with the intention of providing for effective accountability on the part of managers of public-sector resources. The demand for quality information drove the shift to accrual accounting so that managers and Ministers could have a clear understanding of the true costs of government activity. Insights drawn from public choice theory, agent/principal theory and transactions costs theory provided the guidance for New Zealand reformers including the strong emphasis on measures to ensure as far as possible the alignment of managers' incentives with the objectives which Government had for them. This meant, amongst other things:

- giving managers clear non-conflicting objectives to avoid, for example, the risk that someone with both operational and policy responsibilities might provide policy advice which had a bias in favour of the operational interest

- Specifying the outputs which Government required but giving managers discretion over the inputs which they used to produce those outputs, a measure seen as necessary if managers were to be held accountable for their performance - if they lacked discretion over inputs, it would be all too easy for them to avoid accountability by claiming that the underlying reason for non-performance was the fact that they had been required to use inappropriate or unsatisfactory inputs

- Drawing a sharp distinction between accountability for outputs and accountability for outcomes. Here the justification was twofold; first that effective accountability required an ability both to measure and to attribute responsibility for performance and that outcomes were both difficult to measure and multi-causal; secondly that outcomes were a ministerial or government responsibility. It was the role of ministers to determine what outcomes should be pursued within their area of responsibility and what outputs should be purchased for that purpose. It was ministers who sought the necessary appropriation from Parliament to purchase the outputs and who should justify that appropriation in terms of the outcomes intended and it was ministers who should report back to Parliament on performance.

- Separating the commercial and non-commercial activities of the state on the basis that the former should be subject to market accountability but that the latter required non-market or at least proxy market accountability mechanisms. To the extent that a state activity produced goods or services which were tradable or potentially tradable then their managers should face, as near as possible, the same accountability framework as their private sector equivalents - with return on capital being seen as the appropriate benchmark.

Of necessity, this required a major restructuring of the public-sector and the adoption of new governance and control mechanisms. Taken together, the objectives of our reform programme pointed to applying market based techniques whenever possible. For example, if managers were to have discretion over the selection of the inputs which they used to produce the outputs which Government required from them, that required some discipline over price; specifically, managers should face as far as possible prices which were externally determined with at least the potential for competition in supply. This pointed to arms length contracting. It also provided the rationale for requiring even central agencies to face a cost of capital.

The requirement for transparent and non-conflicting roles for managers meant a significant fragmentation of the then public-sector. Ideally, each separate interest of the Crown should be separately identified and embedded in its own set of structural relationships so as to minimise the potential for conflict. It is possible to identify as many as seven Crown interests deserving of their own separate arrangements if the potential for conflict is to be avoided. These include purchase, provision, policy (Advisory), ownership, regulation, monitoring and evaluation.

Against that background I now want to look at the way in which issues of governance and control have played out in a number of specific situations and draw some implications for public-sector management. The specifics which I want to examine are:

- The output/outcome separation and its consequences
- The relationship between the purchase and ownership interests of the Crown
- agent/principal issues in the core public-sector
- Governance and accountability of Crown owned companies

Output / outcome separation

A theoretically neat separation. Consider, however, the necessary conditions for it to be fully effective:

- Ministers accept and are able to undertake the role of informed purchasers able to choose from a range of potential suppliers and a range of potential outputs the mix of suppliers and outputs which will best contribute to achieving their desired outcomes
- Ministers accept and respond to a regime which properly holds them to account for the quality of their purchase decisions, including their effectiveness in monitoring performance by suppliers and the outcomes which result
- Outputs and outcomes are in fact distinct or, to put it another way, officials have limited or no impact on outcomes

This model has earned New Zealand the sobriquet of the contractual state; the country which has gone furthest in applying market disciplines and practices to its core public-sector[2].

Among the issues now requiring attention are:

- How realistic is the assumption that officials do not influence outcomes? The Auditor-General of Canada in conjunction with the Treasury Board has put forward an alternative model, which would be consistent with our Public Finance Act, which sees Ministers accountable to Parliament for outcomes, officials (a) responsible to Ministers both for the quality and effectiveness of the advice they tender on which outputs might best contribute to the Minister's desired outcomes (and for that matter what outcomes the Minister might wish to pursue) and for the effect of the way in which they deliver outputs on outcomes and (b) answerable to Parliament in the sense that Parliament should be able to seek from officials explanations as to why they gave ministers the advice they did[3]

- the effect on the quality of advice; why should officials charged solely with producing outputs have any regard to the collective interest of government which is fundamentally an outcome focus?

- The effect on the public service ethos. Arguably, the sense of service which should be an integral part of the commitment of the career Public servant is itself an outcome orientation - a commitment to achieving through one's work an improvement in the quality of life for one's fellow citizens.

The relationship between the purchase and ownership interests of the Crown

The purchase interest of the Crown appears to have been treated as an interest in purchasing outputs at least cost without regard to the separate ownership interest of the Crown. To an extent, the two interests come together as it is the same chief executive who in terms of the model negotiates with the purchase Minister the provision and pricing outputs and who is responsible, under a performance agreement, to the responsible Minister for managing the Crown's ownership interest.

The potential risk is that one interest could override the other. This was discussed in a major article "An Analysis of New Zealand's New System of Public-Sector Management"[4] in which the author, an experienced Treasury officer, commented:

> "The single-minded pursuit of purchase interest is probably less risky than the single-minded pursuit of ownership interest. The Government can more easily measure the degree to which its ownership interest in a department is being satisfied: although there are problems in the valuation of capital, it can get at least a rough measure of the surplus of revenues over costs. Thus there are fewer opportunities for departments to satisfy purchase interests by sacrificing ownership interest. Nevertheless, the vigorous pursuit of purchase interest would entail some risks if it were done separately from the pursuit of ownership interests. For example, the Department might be able to lower the costs of the services it is currently providing by incurring long-term or contingent liabilities; this would be good for the government as purchaser, but bad for the government as owner. These risks would, again, be minimised by operationally combining the purchase and ownership monitoring; in that case, the single monitor of performance could, for example, seek improvements in the satisfaction of the Government's purchase interest while also checking that they weren't achieved at the cost of the Government's ownership interest."

Note the emphasis on the Government's ownership interest as a financial interest.

This seems consistent with the market model on which the current system is based. It may not be consistent with the long-term interests of government which include maintaining the capability of its organisations to deliver its required outputs year on year.

This concern is now recognised with at least lip service being given to the importance of building capability and investing in human capital with the implication this has, amongst other things, for ensuring that the pricing of outputs includes a return sufficient for any necessary reinvestment in human or other capital.

Agent / principal issues in the core public-sector

Last year I was contracted to undertake a review of agent/principal issues in the state sector as they concern the relationships between different departments. My client was the Border Control Review Team which was undertaking a comprehensive review of the management of New Zealand's border with the outside world. A principal focus of the review was the services provided by the New Zealand Customs Service, including those which affected areas of policy for which other departments had the primary responsibility. One example was responsibility of the then Ministry of Commerce for tariff policy and another that of the Ministry of Immigration. In each case, the New Zealand Customs Service was responsible at the border for enforcement. In each case the relevant Ministry was concerned that its accountability could be affected by the way in which Customs decided to handle the enforcement function and the priority which it might give to tariff matters v. immigration matters v. bio-security and the other responsibilities which it exercised.

Each of the two ministries argued that it was the principal in its relationship and that Customs was the agent with the implication that they should be able to act as the typical principal can including the power to contract, specify performance and manage payment, a particularly important issue as the funding for the outputs in which they were interested was appropriated to Customs and not to the Ministries.

This was a particularly interesting illustration of the impact which the disaggregated model has had on the public-sector. The implication that an individual Ministry could be the principal in my judgement negated the concept of the collective interest of government. If each ministry had been able to negotiate their own contract with Customs, the probability was that it would do so purely in terms of its own output obligations with a very real risk that government's overriding objective of unified border control could have been frustrated.

In a competitive market situation, these kinds of issues would almost certainly be resolved through normal market mechanisms. If there is a commercial advantage in co-ordinating any particular activity, then someone will identify the related gain and find a means for capturing it, whether through the creation of trade a association, the formation of a joint venture or Strategic Alliance or simply marketing services which will achieve the desired outcome. In the absence of equivalent mechanisms in the public-sector, there is a risk that government will lose (or may have lost) the ability to take an holistic approach notwithstanding the various initiatives taken in recent years under the label of Strategic management.

Governance and accountability of Crown owned companies

in some respects this is the most complex area of governance and control facing government. The original State Owned Enterprise model was intended to deal with government activities which, at least for the most part, involved purchasing inputs in competitive markets and producing outputs which were sold into markets which were either competitive or capable of being made competitive through regulatory change.

The main challenge facing the State Owned Enterprise model was the development of a means of monitoring performance which would replicate what happens in private capital markets. Over the years government has redefined its monitoring of SOEs with the development of the Value Based Reporting protocol using economic value added methodology. Arguably, for a government owned company which is operating in a competitive environment, this provides a market-based measure of the effectiveness with which it uses its resources.

Obviously, it still carries with it the problem that, in contrast with the conventional listed company with tradeable equity, the likelihood of change of control through the market is limited (especially if privatisation is now off the agenda). Also, the integrity of the model is clearly dependent on shareholders respecting the separate roles of owners, directors and management, something which appears to be at risk at the moment.

The more interesting concerns, from a control and governance perspective, arise in situations where the company model has been used for activities which are not market based in the sense that inputs and outputs are traded in competitive markets. These include:

- Crown Research Institutes
- Hospitals
- some other special purpose companies such as Housing New Zealand

With SOEs, it was possible to approach issues of governance and control on the basis that the Crown had no particular policy reason for owning the businesses other than, perhaps, the judgement that privatisation of at least some SOEs might not be politically acceptable. This was an approach which made it perfectly rational to treat monitoring as a matter of ensuring that the business was managed so as to earn at least an appropriate risk adjusted rate of return on the Crown's investment with other performance issues, such as the quality or relevance of the SOE's output left to the market. If the SOE was able to earn its required rate of return then presumably customers considered that the outputs it was producing to earn that return provided reasonable value. It also meant that the Crown's main objective, good stewardship of the financial resources invested in the firm, was being met.

Different issues arise with the later uses of the company structure. Neither CRIs nor hospitals undertake activities which, within the New Zealand market, are routinely undertaken in the private sector. As an example, although a number of private sector companies may invest in research, the concept of a company committed solely to research activity is not common.

In both cases, financial measures represent, at best, a means of ensuring good stewardship although with the Crown, or a Crown agency, as the principal purchaser the mere fact that a CRI or a hospital company meets its financial targets may be more of a tribute to its negotiating skills than to its financial management.

The interesting questions, from a governance and control perspective, are not so much about financial performance as they are about the purpose of Crown ownership and how that is reflected in the arrangements for governance and control.

It seems likely that the principal reason for government ownership of public hospitals is as a means of ensuring the availability of specific health services on terms that meet government objectives, coupled with the judgement that it will not be sufficient for the Government simply to enter the market place as purchaser -- the potential risks of non-supply or supply on terms which might not be consistent with government objectives mean that government needs to be involved on both sides of the purchase transaction. This of itself does not imply selection of a company structure. That selection suggests that government gave priority to a particular set of outcomes and means of achieving them. In essence, it gave priority to financial performance and the assumption that return on capital, and the particular set of duties which apply to company directors, would be the best means of achieving its desired outcomes.

This begs the question both about the Government's desired outcomes and its understanding of the preconditions for achieving those. Consider, for example:

Different institutional structures bring their own organisational culture with them. In the case of hospitals, imposing a company structure was widely seen as signalling an intention to privatise. Despite government denials it proved impossible to shake off this perception. With hindsight, it may have been much better to select a type of structure already well understood within the health sector as consistent with public provision -- the Foundation or trust -- and imposed financial performance requirements through the purchase contract rather than through specific targets for return on capital.

Similar issues arise with CRIs. The main emphasis in their statements of corporate intent is on financial performance. There has been no serious consideration of the question of why government owns CRIs -- of the objectives which ownership is intended to serve or the outputs/outcomes government believes it can achieve through ownership which would not be available otherwise.

Their enabling Act includes a requirement that research undertaken by a Crown Research Institute should be undertaken for the benefit of New Zealand. There is some doubt over the meaning of "benefit of New Zealand" . In practice, regardless of what it might mean, it appears to be a purchase requirement rather than an ownership requirement. The likeliest explanation for continuing government ownership of CRIs is a perceived national interest in maintaining a critical mass of research skills which might not otherwise be available. Nothing in the governance arrangements supports this; there is no apparent obligation on directors to report to government on the risks to the ability to maintain this critical mass nor does government monitoring address this issue (although it is now starting to emerge as a question in science funding).

Both of these uses of the company structure highlight what can be seen as the principal weakness in an otherwise necessary and effective programme of reform; an almost myopic attachment to an approach to public-sector management which relies on breaking down the complexity of government activity into a series of discrete and measurable components thus ignoring both the essentially holistic nature of government and the fact that the outcome of much of government activity is by its very nature difficult to measure.

Concluding remarks

I want to conclude my comments with a couple of personal observations on the issue of measurement. The difficulty in measuring outcomes is advanced as one reason why it would be inappropriate to hold officials accountable (an explanation which rather begs the question of why we then go on to argue that ministers should be held accountable). Typically, it is pointed out that outcomes are multi-causal so that you can never be entirely certain who or what was responsible.

We compound this, as can be inferred from a recent State Services Commission paper, by our failure to invest in evaluation[5].

The business of government is about seeking outcomes. The job of officials is a combination of advising ministers on the outcomes which it might be appropriate for them to pursue, and the outputs they might purchase for that purpose, with delivering those outputs. The suggestion that all of this should take place in a context in which the officials bear no responsibility for the outcomes is one which I find bizarre (see the earlier comment on the alternative approach proposed in Canada).

In part, the difficulties arise because we assume that the appropriate way to measure outcomes is to go direct to the desired final state and seek to measure that. An alternative is to treat the pursuit of government objectives as a journey and try to define the milestones along the way. This probably bears a much closer relationship to the way in which the policy process actually works. There are probably few situations in which officials will make a recommendation to ministers without some expectation of what might happen as a result. They might not be confident of the final outcome but they will usually have some sense of what they expect to see start happening if the policy is effective. This might be expressed in terms of something which marks progress towards the achievement of the desired outcome. It might be expressed in terms of third party response -- for example enhanced confidence on the part of key external stakeholders/observers in the capacity of the Department of Work and Income to contribute to employment generation.

What I believe we have done with our concern over measurement difficulties is to overlook the fact that the business of government is inherently about things which are difficult to measure. By concentrating, instead, on what we can measure we have created governance and control mechanisms which are at best partial and at worst risk frustrating the purpose of government.

FOOTNOTES

1. This comment needs the one qualification that outcomes can also be influenced by the way in which people respond to client driven entitlement programmes with their potential to achieve unintended (unanticipated) outcomes which may be politically difficult to roll back.

2. For a recent critique see Schick, Allen. (1999) Opportunity, strategy, and tactics in reforming public management. Paper presented at the symposium "Government of the future: getting from here to there" held in Paris, 14-15 September 1999. Public Management Service/Public Management Committee (PUMA). PUMA/SGF(99)4 [Online] URL http://www.oecd.org/puma/ especially paragraphs 41 -- 46

3. Office of the Auditor General of Canada and Treasury Board Secretariat. (1998) Modernising accountability practices in the public sector : discussion draft. Joint paper by the Office of the Auditor General of Canada and the Treasury Board Secretariat. [Online] URL http://www.tbs-sct.gc.ca/rma/account/OAGTBS_E.html ain

4. Irwin, Tim (1996). An analysis of New Zealand's new system of public sector management. In Performance Management in Government : Contemporary Illustrations.
Paris : Organisation for Economic Co-operation and Development, Public Management Committee and Public Management Service (PUMA)
http://www.oecd.org/puma/mgmtres/pac/pubs/pmg96/forward.htm

5. State Services Commission. (1999) Assessing Department's capability to contribute to strategic priorities : occasional paper no 16. State Services Commission : Wellington, New Zealand.